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**GLOBAL ECONOMIC CONDITIONS AND PROSPECTS**

*Paper prepared for ASEAN by the UNCTAD Secretariat*



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## A. ECONOMIC GROWTH

### 1. Overview of growth in 1998

After widespread expectations that the world economy was eventually settling into a growth path of some 3 per cent per annum, which would eventually make it possible to reduce unemployment in industrial countries and poverty in developing countries, global growth took a sharp dive in 1998 (table 1). Particularly dramatic has been the deterioration in global economic conditions in the latter half of 1998 as a consequence of deepening recession in the East Asian economies and in Japan. A resurgence of instability in international financial markets following the August crisis in Russia, the repercussions of this crisis, especially on Latin America, and continued decline in the prices of oil and other commodities led to a deterioration of prospects that extended well beyond the East Asian region.<sup>1</sup> Thus, optimistic forecasts common only a year or so ago for the recovery of the East Asian economies and the benign impact of the Asian crisis on the global economy gave way in late 1998 to concerns about the possibility of a global recession.<sup>2</sup> The policy response to deepening crisis, including lowering of interest rates in the United States and the EU, more accommodating monetary and fiscal policies in the East Asian economies, and liquidity expansion and fiscal and aid packages introduced by Japan have helped to improve the conditions in financial markets. However, despite various ups and downs in market sentiment, the forces driving real economic performance have remained largely unchanged: prospects for 1999 have continued to deteriorate as indicated by continued downward revisions of global output forecasts (chart 1).

The adverse impact on real activity of the turbulence in global financial markets has so far been much more serious for developing than for industrial countries (table 1). For 1998, growth in GDP in the developing countries is estimated to be 1.5 per cent including China, and 0.4 per cent excluding China, as compared to 5.5 per cent and 4.9 per cent, respectively, in 1997. The

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<sup>1</sup> For a comprehensive discussion of major developments up to the first half of 1998, see UNCTAD, *Trade and Development Report, 1998*, Part One.

<sup>2</sup> Illustrative are the 1998 forecasts of the IMF for selected Asian economies and the world economy between May 1997 and September 1998. The substantial downward revision applied to all major economic regions and was particularly sharp not only for the Asian economies of Indonesia (from 7.4 per cent to -15.0 per cent), Thailand (from 7.0 per cent to -8.0 per cent), Malaysia (from 7.9 per cent to -6.4 per cent), Republic of Korea (from 6.3% to -7.0 per cent) and Hong Kong (China) (from 5.0 per cent to -5.0 per cent), but also for Venezuela (from 3.3 per cent to -2.5 per cent), Russia (from 1.0 per cent to -6.0 per cent) and Japan (from no growth to -2.5 per cent). It was also accompanied by a corresponding lowering of the 1999 forecast of world output from 3.7 per cent to 2.5. Similarly, between July 1 and August 28 of 1998, J.P. Morgan downgraded its 1998 forecast of global GDP growth from 1.8 per cent to 1.5 per cent and that of 1999 from 2.3 per cent to 1.7 per cent; J.P. Morgan, *Global Data Watch*, New York, August 28, 1998, p. 1. By early October, world GDP growth in 1998 was estimated to be 1.6 per cent but the forecast for 1999 was revised still further downwards to 0.9 per cent; J.P. Morgan, *World Financial Markets*, New York, 7 October 1998, p. 3. At 1 per cent the January forecast for global growth from the same source was little changed; see J.P. Morgan, *World Financial Markets*, 8 January 1998, p. 3.

deterioration has been pervasive, particularly among the emerging markets. At 2.3 per cent, growth in the developed world exceeded that in developing countries for the first time for many years.

The severity of the Asian crisis and its rapid spread to the economies in the region with strong fundamentals distinguish it from similar episodes of financial turmoil including the 1987 equity market crash, the EMS crisis, or the Mexican crisis, in which the impact on real activity was limited, or sharp but short. The initial international policy response exacerbated the crisis by failing to distinguish the changing nature of the interrelationship between financial and real factors, and by placing too much faith in conventional policy prescriptions.<sup>3</sup> With the exception of a few countries, the East Asian economies sank into outright recession in 1998 with loss of output as a proportion of GDP reaching double digit figures in some cases. For the five most seriously affected Asian economies (i.e. Indonesia, the Republic of Korea, Malaysia, the Philippines and Thailand) as a whole, output fell by an estimated 8 per cent in 1998. While growth in China continued to be robust thanks to expansionary fiscal packages introduced in response to the deteriorating external environment, the official estimate of 7.5 per cent is well below the average rate attained over the past 10 years and includes a large inventory accumulation of unsold output of state enterprises.<sup>4</sup>

After three consecutive years of income growth in excess of population, Africa failed to achieve an increase in per capita income in 1998. Likewise, Latin America, after attaining its highest growth rate for a quarter of a century in 1997, failed to register a tangible gain in per capita income. Performance of the transition economies in Europe and Central Asia was a serious disappointment following a turnaround in the downward trend of its output growth in 1997.

With the notable exception of Japan which entered into a severe economic recession in 1998, growth in most industrial countries was better than in developing countries, benefiting in part from significantly weakened prices of oil and non-oil commodities and flight to quality in international financial markets. In particular, the United States economy proved to be quite resilient. Despite widespread expectations of a slowdown in the second half of the year, the economy continued to surge ahead, attaining an overall annual growth rate of around 3.9 per cent in 1998 following a growth of 3.8 per cent in the preceding year. In contrast, performance weakened earlier than expected in Europe as economic growth slowed down in the last quarter of the year. Nevertheless, most EU countries, especially in the euro area, ended the year with a higher growth rate than 1997.

The seriousness of the Asian economic crisis, in terms of scope and repercussions, has been felt not only in financial markets in various parts of the world, but also in trade and related

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<sup>3</sup> For the policy response see UNCTAD, *Trade and Development Report, 1998*, Part One, chapter 3.

<sup>4</sup> Total value of inventories is estimated at \$500 billion, more than half of the economy's output; see "The Year of Living Carefully", *Business Week*, December 28, 1998, p. 30. It should also be noted that there is considerable uncertainty regarding the true growth rate in China, particularly in view of very low growth in electricity consumption and coal output, stagnant import volumes and weak export growth; for a discussion of this issue see IMF, *World Economic Outlook and International Capital Markets, Interim Assessment*, Washington, D.C., December 1998.

areas. As a result of the collapse in Asian import volumes, world trade slowed considerably in 1998, registering its weakest performance since the early 1990s. Indeed, the deteriorating economic conditions in Asia were a key factor behind the continued decline in commodity prices during 1998, lowering the growth prospects of many developing and transition economies which are mainly commodity-based (see section B below). For the OECD area, on the other hand, declines in commodity prices resulted in some 5 per cent improvement in its terms of trade with the rest of the world which greatly helped to maintain its income levels and reduce inflation.

## **2. Current economic conditions and outlook for 1999**

Global economic performance in 1998, and particularly growth in emerging markets, was strongly influenced by the continued volatility of international financial markets, and by tightened international financial conditions including reduced capital inflows and increased cost of finance (see section C below). The deep integration of markets has produced a new transmission mechanism across the global economy highlighted by the credit crunch in international capital markets following the onset of the Russian crisis. The sharp and rapid rise in risk premia has led to an abrupt slowdown not only in capital flows to emerging markets, but also in the availability of finance to relatively safe borrowers in industrial countries. The Chairman of the United States Federal Reserve Board, Alan Greenspan, has characterized “the remarkable increase in risk aversion and in increased propensity for liquidity protection in both the United States and Europe” as “virtually unprecedented in our post World War II experience”, which has arisen “without significant signs of underlying erosion in our real economies, tightened monetary policy, or higher inflation.”<sup>5</sup> This phenomenon is also remarkable because it has occurred despite rigorous adjustment policies in the crisis-ridden Asian economies, and widespread policy actions in most other emerging markets designed to retain confidence and restore private capital flows.

Although the turbulence in global financial markets experienced last October had subsided by the end of the year, external financial conditions remained tight for most emerging markets. As a result of the rise in risk perceptions on the part of international investors and the sharp decline in capital inflows, several emerging market economies which rely on foreign borrowing to finance fiscal or current account deficits (or both) have been forced to reduce their external financing needs by such means as increased taxation, public spending cuts and hikes in domestic interest rates, thereby reducing aggregate spending, output and employment. Conditions in international financial markets may well deteriorate further in the early part of 1999 with spillovers into other emerging markets from the Brazilian currency crisis in January. In industrial countries, despite the rebound in equity prices, lower bond yields, and the narrowing of spreads on private securities, financial conditions remain fragile and real economic forces underpinning growth are weak. Again, global contagion from Brazil through trade, finance and corporate earnings can be expected to reduce growth prospects not only in developing countries in the region but also in industrial countries which have closer ties with the region. Even before the Brazilian crisis, prospects for 1999 were fraught with considerable downside risks and

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<sup>5</sup> Remarks by Chairman Alan Greenspan, “The Structure of the International Financial System”, at the Annual Meeting of the Securities Industry Association, Boca Raton, Florida, 5 November 1998, [www.bog.frb.fed.us](http://www.bog.frb.fed.us).

uncertainties, as reflected in the discrepancies among the forecasts of GDP growth by various international organizations and institutions, especially for certain countries (table 2).<sup>6</sup> With the onset of the crisis in Brazil, such risks have certainly increased even though global contagion from this crisis could be contained much more easily than that from the East Asian and Russian crises.

Despite significant differences, global GDP forecasts by various institutions presented in table 2, undertaken before the Brazilian crisis, generally agree on lower growth rates for most countries in 1999 than in 1998. The expected decline is particularly marked for the industrial countries and in Latin America. In the former group, the lower growth forecast is due largely to the expected slowdown in the United States, and, to a lesser extent, in the EU. Economic conditions are expected to improve in Japan, but probably not enough to pull the economy out of recession. In Latin America the slowdown is expected to be pervasive, encompassing all the major economies in the region. This was so even before the Brazilian crisis, which will certainly deepen the deflationary forces in the region, possibly pushing it into recession. Economic growth in East Asia is generally predicted to improve thanks to the stabilization or improvement of conditions in the crisis-ridden countries. However, there is consensus concerning a slowdown in China and South Asia. African economic performance is expected to change little. Growth in transition economies is set to deteriorate considerably, in large part on account of a deep recession in Russia.

These expected changes in regional growth patterns are associated with increased trade imbalances. The United States current-account deficit will continue to widen, possibly exceeding \$300 billion in 1999 (some 4 per cent of GDP), thus absorbing a very large part of the turnaround in the trade deficits of the crisis-ridden emerging markets. In contrast, the European and Japanese trade surpluses are expected to change little. The persistence of such imbalances can create serious tensions in the global trading system to the extent that they are translated into a rapid slowdown in deficit countries.

The United States economy has so far remained extremely vigorous, despite an increasing trade deficit. However, the sustained performance in the United States has been in part due to a marked improvement in its terms of trade that is mirrored in the decline in the real incomes of its trading partners. Given its close ties to the rest of the world through trade and finance, can the United States economy remain an oasis in a sluggish global environment and continue to surge ahead at the same pace as in 1998? The consensus answer to this question is negative. There remains, nevertheless, considerable uncertainty regarding the extent of the slowdown of the United States economy to be expected in 1999, particularly since its performance in 1998 belied forecasts that growth would begin to falter during that year.

There can be little doubt, however, that continued expansion of the United States economy at rates in excess of 3 per cent as experienced in the past three years is under threat from both external and internal factors. Given that virtually every economy aside from the United States is experiencing contraction of demand, any marked recovery of growth in the rest of the

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<sup>6</sup> The rates of GDP growth given by different institutions are not always directly comparable due to the use of different weighting schemes and other factors. For a detailed explanation, see Box 1 on "International Comparison of GDP Estimates" in UNCTAD, *Trade and Development Report, 1998*.

world based on external demand must have a negative impact on United States growth prospects. In consequence, domestic demand in the United States must continue to grow at rates that are sufficient to offset this negative impact if the economy is not to lose momentum and global growth is to increase. With the United States government budget surplus continuing to grow, the recent expansion of demand has been driven by private sector spending which has outpaced private sector income, resulting in record high corporate financial deficits and record low personal savings which actually turned negative during part of 1998.<sup>7</sup> Such conditions cannot persist indefinitely. Business spending is expected to slow as earnings continue their decline throughout 1999 due to rising costs of finance resulting from increases in risk spreads, tightened lending standards, sluggish export orders, falling capacity utilization rates and profits, and rising inventories. As the budget is set to generate an increasing surplus (according to current estimates \$2.5 trillion on a cumulative basis over the next 10 years, even if the growth rate falls to around 2 per cent), maintaining the current rate of expansion in the United States, irrespective of any external impact on demand, would require growth of consumer spending to outstrip household income growth even further.

This is not likely to happen. The rate of increase in average hourly earnings has begun to decline, and households are currently committing around 17 per cent of disposable incomes to financing costs, a level not seen since the recession of the early 1990s. So far consumer expenditures have been sustained to an important extent by borrowing based on unrealized capital gains in equity portfolios.<sup>8</sup> The recent gyrations in equity prices have made borrowing against equity holdings much more risky, and a retrenchment of household finances much more likely, even in the face of rising real purchasing power over imported goods and falling interest rates. The recovery of the stock market has been driven more by the belief that the Federal Reserve will make the necessary reductions in interest rates required to stabilize financial markets, rather than by any real improvement in the prospects for corporate earnings, which continue to decline despite the continued strong expansion of the economy and modest wage growth. While the reduction in interest rates has done much to reduce the likelihood of recession, it has done little to improve the outlook for earnings. Although forecasts for growth in the United States in 1999 have been raised, particularly for the first quarter of the year, with none of the components of aggregate demand rising as rapidly as in 1998, the revised forecast growth rate is still below the long-term potential. If exports remain sluggish, particularly as a result of a sharp slowdown in Latin America, and consumer spending levels off, growth may actually fall and the economy may go through a brief recession.<sup>9</sup>

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<sup>7</sup> Part of the decline in savings is due to the national accounts definitions which do not include capital gains in household incomes, but deduct all income tax payments, which include taxes on capital gains, to determine disposable income. Thus, some of what appears to be an increase in spending is in fact an increase in taxes on realized capital gains. Given that household indebtedness has been rising less rapidly, this effect is likely to have been important and suggests that household spending may not be as vigorous as suggested by the savings figures.

<sup>8</sup> In 1995 about 60 million individuals held stocks directly, an increase of almost 10 million in three years; see New York Stock Exchange, *Shareownership 1998*, New York 1999.

<sup>9</sup> For such a forecast see J.P. Morgan, *World Financial Markets*, New York, 8 January 1999. Before the outbreak of the Brazilian crisis, the Merrill Lynch recession probability model put the risk of recession in 1999 at around 33 per cent; see *Weekly Economic and Financial Commentary*, 4 January 1999.



In Europe, the United Kingdom experienced a sharp deceleration of growth in the last quarter of 1998 and is unlikely to recover before the end of 1999. The major economies in the Euro area, notably Germany, experienced a sharp downturn in the last quarter of 1998, in large part on account of a slowdown in manufactures exports which have been one of the prime movers of growth in the region. As expected, the euro, which was launched in January 1999, started out strong relative to both the dollar and the yen, although it has experienced subsequent weakness against the dollar. Thus, much of the benefit to exporters deriving from the appreciation of the dollar in 1997 and early 1998 has now been reversed, making further export-led expansion even less likely. At the same time, the wage demands advanced by labour unions in Germany have again raised the spectre of tighter monetary policy. Given the increasing importance of trade and investment in Eastern Europe, business confidence has been undermined by economic difficulties in Russia and most firms now face excessive inventories.

Expansion in the EU will largely depend on consumption expenditure. The widespread expectations that domestic spending would lead to a vigorous growth in 1998 have been largely disappointed. While the EU has been spared the worst effects of the credit crunch, its consumers and producers appear nonetheless to have begun to revise downwards their expectations of future conditions. The consequences are likely to restrict expansion in private spending irrespective of domestic financial conditions. While changes in government in a number of countries have brought expectations of greater emphasis on growth and employment in the design of economic policy, a major fiscal stimulus is unlikely to take place to compensate for the slowdown in exports. All in all there appears to be a consensus that growth in the Euro area will be slower in 1999, even falling below 2 per cent in some forecasts (see table 2). In none of the current projections is growth expected to be rapid enough to make a dent in unemployment.

Japan has also experienced the impact of increased risk and liquidity preference, but in different ways. The weakness in the domestic financial system has produced conditions in which residents have become less willing to hold liabilities issued by domestic financial institutions which are considered to be subject to risk of closure for bankruptcy. They seek deposits in foreign banks, both in yen and the dollar, and on some occasions this has produced negative interest rates in the short-term money market. At the same time, the recent announcement of a new round of bond financing to fund the new stimulus package has been accompanied by the announcement that government agencies, including the Postal Savings Banks, have maturity structures which will prevent them from increasing their holding of government bonds. This has brought about a sharp increase in long-term interest rates and sharp losses for bond holders. Since foreign banks are unwilling to lend in yen to domestic banks or to domestic business and long-term rates are rising, Japan is also suffering from a sharp contraction in the financing of its domestic economy.<sup>10</sup> This in turn implies that Japan will not be generating any substantial financial flows to the East Asian countries in crisis even though it is running large trade surpluses with them.

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<sup>10</sup> It is also questionable whether the solution to the reluctance of banks to avail themselves of the funds available for recapitalization in the current plan for the financial sector, namely removal of restrictions and requirements for access to the funds, will actually achieve the objective of successful restructuring. There may be a case for more direct action to combine recapitalization with mergers and other rationalization.

The recently announced Miyazawa plan of \$30 billion in aid to adversely affected Asian countries offsets part of this lack of financing from Japan to East Asia.<sup>11</sup> Japan has also introduced a \$195 billion package of increased government expenditures and tax reductions, suspending the Fiscal Structural Reform Law that required the government to generate surpluses to reduce outstanding public debt, but this stimulus package does not represent a substantial increase over the government expenditures of the previous year. Private spending continues to stagnate as firms face excessive capital stock and inventories, while rationalization and adjustment in the corporate sector undermine consumer confidence. The appreciation of the yen since the summer of 1998 and the sharp increase in bond yields at the end of the year present fresh challenges to the Japanese recovery. Given its structural problems, the fiscal stimulus package is unlikely to generate another increase in private spending. It can thus at best be expected to serve only to halt further contraction rather than initiate a strong recovery. Furthermore, if mounting deficits lead to a withdrawal of the expenditure package, the economy may experience a contraction, as it did in 1997.

In East Asia, conditions in the countries directly affected by the crisis are expected to improve, even though a full-fledged recovery is still far away. Recovery is expected in the Republic of Korea and Thailand with some moderate positive growth rates in 1999, whereas for Malaysia and Indonesia further declines are likely. There has been a swift turnaround in the trade deficits of these countries, resulting in massive surpluses in some cases. However, in most countries the improvement in external balances has been due to declining imports rather than increasing export sales. In some cases sharp expansion in export volumes has not been translated into greater foreign exchange earnings because of offsetting price declines (table 6). However, import cuts appear to have bottomed out while export earnings are stabilized, in part due to the recovery of exchange rates from their post-crisis lows. This, together with more accommodating monetary and fiscal policies, is the main reason for the improvement of prospects in the region, although in some countries currency appreciation has curtailed the sharp gains in competitiveness experienced in the immediate aftermath of the crisis.

By contrast, conditions have been deteriorating in the other economies of the region compared to a year earlier. Hong Kong (China) is now in outright recession and unlikely to recover quickly in 1999; it is also one of the economies of the region most vulnerable to contagion from the Brazilian crisis. This is also true of Singapore where recession is less deep. Taiwan Province of China has started experiencing difficulties in its financial sector at a time when the worst seems to be over for most other countries in the region. In China the growth rate is expected to fall further in 1999, possibly towards the 6-7 per cent range. Despite the easing of currency pressures, China may encounter tighter conditions in international financial markets and

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<sup>11</sup> The proposal targets the five most seriously affected Asian economies noted above, and is designed to help restructure the corporate and banking sectors, to establish social safety nets, and to alleviate the credit crunch in these countries. Last year, a proposal was made to establish a \$100 billion Asian fund with contributions from Japan and other countries to help affected Asian nations. This proposal did not receive support from some other major industrial countries and multilateral financial institutions. Unlike the previous proposal, the Miyazawa Plan involves only Japanese funds for the purpose of bilateral aid to Asian countries. It has now generated a response from the United States which will contribute \$5 billion to a programme to be coordinated with Japanese funds to support bonds issued by Asian governments to restructure corporate debt and recapitalize banks.

reduced capital inflows. If its exports continue to stagnate and the limits of fiscal stimulus are reached, a devaluation of the renminbi becomes inevitable.

Since the Russian crisis, Latin America has emerged as the weakest part of the developing world, and the breakdown of the currency peg in Brazil and the subsequent meltdown have significantly worsened the region's growth prospects. Most Latin American economies have been experiencing increasing trade and fiscal deficits as a result of declines in commodity prices, and pressure on their currencies which governments have attempted to defend at interest rates far above both real and nominal growth rates. Given its relative size and trade links in the region, much will depend on how Brazil overcomes its present difficulties. It was generally agreed that even the successful implementation of the adjustment programme there, backed by the \$41.5 billion IMF package, could result in a significant drop in output. An important component of that programme, an exchange-rate regime designed to produce a gradual depreciation of the real in the order of some 7 per cent throughout the year, has had to be abandoned as difficulties in fiscal adjustment resulted in mounting pressures on the currency and rapid loss of reserves. The attempt to relieve pressure on the exchange rate by changing the method of calculation of the intervention band in mid-January failed. Capital flight accelerated, leading to the decision to float the real and a depreciation in the order of some 30 per cent within a week. It is still highly uncertain whether Brazil will be able to stabilize its currency. Depreciation raises the cost of the dollar-indexed government debt, while higher interest rates rapidly feed through to higher interest costs on outstanding debt. Given that the impact of the latter is larger than the former, recovery will depend on bringing about a stabilization of the exchange rate without a long period of high interest rates. In a similar system of floating exchange rate, Mexico has had to maintain interest rates as high as those in Brazil in order to calm its foreign exchange markets.

Even if further currency turmoil were to be avoided, Brazil is likely to suffer from a sharp contraction in economic activity, possibly in excess of 5 per cent.<sup>12</sup> The fallout from Brazil's crisis will have significant adverse repercussions for Argentina and most other economies in the region which have already been experiencing serious difficulties as a result of declines in commodity prices, dwindling capital inflows, and worsening growth prospects. This may push most major Latin American countries into recession (with the notable exception of Mexico, thanks to its links with the United States), resulting in a sharp deterioration in the outlook for economic growth for the region as a whole, including the possibility of a sizeable drop in overall output for the first time since the debt crisis of the 1980s.<sup>13</sup>

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<sup>12</sup> The projections for Brazil in table 2 pre-date the currency turmoil and generally assume orderly implementation of the IMF-backed programme. In the forecast by J.P. Morgan, the currency band was assumed to widen during the first half of 1999 to 1.20-1.50 real per dollar, and the exchange rate was assumed to float toward the weak boundary of the band, settling at 1.44 real per dollar by midyear. Under this scenario, the economy would still slide into a recession, much deeper than in the IMF programme; *op. cit.*, p. 55.

<sup>13</sup> The Brazilian turmoil has indeed resulted in considerable downward revisions in growth prospects in the region. For instance, Merrill Lynch lowered its 1999 GDP forecast for Argentina to a 2 per cent contraction, and is now predicting a recession in the region with GDP falling by 1.5 per cent; see *Weekly Economic and Financial Commentary*, 15 January 1999. A downward revision to recession is reported also by Deutsche Morgan Grenfell; see *International Herald Tribune*, 18 January 1999.

Africa was initially relatively isolated from the impact of the market turbulence originating from the financial crisis in Asia because most countries in the region have only limited access to international financial markets and have stronger trade links with the EU and the United States than with Asia. However, the outlook for African countries, in spite of the better than expected weather conditions in 1998, has deteriorated with the substantial decline in the prices of oil and non-oil commodities, notably metals. Particularly significant for some countries has been the sharp fall in the price of oil which accounts for no less than 60 per cent of the foreign exchange earnings of the region. While some African countries are net gainers from lower commodity prices to the extent that benefits from cheaper oil imports outweigh the losses from lower export prices, the region as a whole, and about one-third of the countries, are expected to be net losers. In addition, South Africa, the largest economy in the region, was also subject to financial market turbulence when its currency came under intense downward pressure at various times between May and August 1998. In contrast to the downward revision of growth forecasts for most countries in the region, and despite the setbacks to commodity prices, the performance of countries in the CFA franc zone can be expected to remain strong.

Before the outbreak of the Russian crisis, the growth performance of transition economies had shown signs of recovery. In the first half of 1998 the aggregate GDP in the region grew by more than 2 per cent, in large part due to a rapid growth in Central and Eastern Europe, including the Baltic states, where capital inflows remained high and export growth strong. In the second half of the year there was a marked slowdown in economic growth throughout the whole of Eastern Europe, due partly to the spillover effects of the Russian crisis and partly because of the weakening of west European import demand. Largely because of the collapse of growth in Russia, the average growth rate of the region as a whole fell sharply, possibly to below zero. The key macroeconomic and international financial indicators suggest that Russian GDP will continue to fall in 1999, most likely by more than in 1998; both domestic and international capital flows have dried up and are associated with the failure to produce an agreed plan to deal with the default on government and private debt. For other countries in the region, prospects will depend in large part on conditions in international capital markets and growth in the EU. On current trends, a sharp slowdown can be expected in the countries where trade balances have been deteriorating against a background of declining capital inflows. Overall, disparities in economic performance are expected to widen further, between the group of so-called leading reformers and a group, mainly in South-East Europe, where a coherent programme of reforms has proved much more difficult to design and implement. At the same time, the predominantly primary commodity exporters of the central Asian members of the CIS are expected to lag further behind the former group of countries.

### **3. Downside risks and scenarios**

Global economic performance in 1999 will depend, to a large extent, on the willingness of capital markets to place funds at risk in emerging markets as well as on the extent of risk aversion and instability in capital markets within developed economies, in particular the United States and Japan. The increased volatility and unpredictability of the behaviour of financial markets and international capital flows introduce considerable uncertainty into the assessment of the likely performance of the global economy, particularly in view of greater integration of real

and financial flows and the increased rapidity of their interaction. This interaction is capable of producing significant destabilizing feedbacks between the real economy and financial markets.

Such feedbacks with the potential to increase financial fragility can be especially serious in emerging markets. The very policies adopted to offset the declining capital flows may actually increase the perceived risk of lending to these countries, and thus cause further reductions in financial flows. For instance, high interest rates designed to offset increased risk premia and sustain foreign investment reduce economic activity. They also worsen the fiscal position through their impact on the financing costs of government debt, and weaken corporate balance sheets. All these factors raise the risk premia on lending to, and investing in, emerging markets. To the extent that such policies fail to prevent currency depreciation and that currency risks have not been hedged, there will be still further deterioration of the fiscal position and corporate balance sheets. The former will be aggravated if, as in Brazil (and in Mexico in 1994), a substantial portion of government debt is dollar-indexed. For these reasons uncertainties about exchange rates, fiscal positions and balance sheets can create the risk of a vicious spiral by reinforcing the reluctance of international lenders to increase their exposure to a country - a tendency often aggravated by pro-cyclical downgrading in its credit rating.

Such downside risks are also present in industrial countries. Monetary easing designed to address the growing prospects of economic slowdown caused by increased financial fragility, has not achieved a rapid improvement in the underlying fundamentals of economic activity, but may actually have added to financial fragility by helping market conditions diverge further from the real economy. For instance, the recovery of equity markets in the United States to levels that were considered by the Federal Reserve Chairman to reflect "irrational exuberance" raises once again the risk of a sharp technical correction which, if combined with tighter credit, could threaten current growth forecasts.

The baseline projections of various institutions given in table 2 depict a world economy with relatively weak growth in 1999, but avoiding recession. Associated with each forecast, however, are considerable downside risks which are highly interdependent in the sense that the occurrence of one would increase the likelihood of others. Accordingly, the slowdown of global economic growth may be sharper than is given by the baseline scenarios. This is indeed recognized by all the institutions referred to in table 2, which have also estimated the possible outcomes in the event of the emergence of new disturbances or the failure of some of the assumptions of the baseline projections to materialize. The outcome when specific downside risks are incorporated into the baseline projections of each institution is presented in table 3. Differences in the results are due in part to differences in the assumptions regarding the nature of downside risks as well as the way in which they are translated into quantitative terms or policy measures and of other exogenous changes incorporated into the modelling exercises. Briefly, the key assumptions in each case are:

- The risk factors taken into account in the IMF downside scenario include a failure in the recovery of capital flows to emerging economies; a correction in equity prices in the industrial countries; and a shift in the pattern of exchange rates

among the major advanced economies arising from the concern of investors about the sustainability of the large current-account deficits of the United States.<sup>14</sup>

- The downside scenario of the World Bank assumes a worsening of the recession in Japan; a drying-up of private capital flows to Latin America, compressing the region's current account deficit to near zero in 1999; and depressed growth in the United States and Europe due to steep equity market corrections of 20-30 per cent.
- Assumptions underlying the low-case scenario of OECD are associated with three interdependent sources of risk: a deepening of the crisis in East Asia and its spread to Latin America, resulting from renewed outflows of capital and further risk mark-ups on emerging market investment; continued economic decline in Japan while bank restructuring remains stalled; and a sharp correction in global equity markets. In response to such shocks, the OECD low-case scenario assumes a cautious policy stance with fixed real interest rates in the United States and Europe and fixed nominal rates in Japan.<sup>15</sup>
- The low-case scenario of UN/LINK assumes a 40 per cent decline in stock market prices in the United States and Western Europe from the peak levels of 1998; a rise in the spreads on business borrowing; a sharp decline in capital inflows to emerging markets, specifically to China and Brazil, leading to a 15 per cent devaluation of the renminbi and 20 per cent devaluation of the Brazilian real; and continued stagnation and financial difficulties in Japan.<sup>16</sup>

There are thus two potential sources of downside risks common to all low-case projections of these institutions: a correction in equity prices in industrial countries associated with a rise in risk aversion and further declines in capital flows to emerging markets. As can be seen from table 3, there are significant differences in the rate of GDP growth given by the various institutions. The most pessimistic scenario (World Bank) gives zero growth in the world economy in 1999, which would be the most serious decline since the recession of 1982.

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<sup>14</sup> Advanced economies consist of industrial countries and the Asian newly industrializing economies (Hong Kong (China), the Republic of Korea, Taiwan Province of China, and Singapore).

<sup>15</sup> To explore the impact of policy response designed to reduce the loss of output in the low-case scenario, OECD also undertakes another (less pessimistic) scenario based on a more aggressive policy response to these shocks, allowing interest rates to decline so as to limit the net equity market decline to 20 per cent (rather than the 30 per cent as in the former case) relative to their levels in early November 1998. The outcome, indicated by figures in parentheses in table 3, shows a significant gain in GDP growth, particularly for the United States.

<sup>16</sup> In the UN/LINK model, monetary policy in North America and Western Europe adjusts endogenously in response to the deteriorating economic circumstances. Departing from the baseline, UN/DESA also produces an alternative optimistic scenario, assuming a co-ordinated set of macroeconomic policy measures by the major economies, specifically an interest rate cut of 1.5 per percentage points in North America and one percentage point in Europe, and a fiscal stimulus package of public spending and tax cuts in Japan, as well as a \$17 billion aid package to Indonesia, the Republic of Korea, Malaysia, the Philippines and Thailand. Strictly speaking, since much of these policy actions are already under way, the 1999 projections from this scenario (namely, a growth rate of 2.7 for world GDP and 3.7 per cent for developing countries) should replace the baseline scenario reported in table 2.

Notwithstanding the differences in the rate of growth, it is significant that the rate of growth in the low-case scenarios is 1-2 percentage points below the respective baseline projections. The loss in GDP growth is particularly substantial for the United States.

#### **4. Policy challenges**

Since the onset of the Brazilian crisis, the prospects for global economic growth in 1999 have undoubtedly deteriorated. Another bout of global financial instability could now push the world economy into a recession. Such an outcome could be avoided only through vigilance on the part of policy makers, particularly in industrial countries where there remain considerable scope and freedom for expansionary policy actions.

In designing effective policy responses to the threat of a sharper downturn in global economic activity, it is important to diagnose correctly the underlying forces responsible for the current difficulties. It should be recalled that the present downturn in economic activity is different from the typical cyclical downturn that follows a period of sustained expansion. It has not been induced by policy actions designed to slow an overheating economy or reduce an acceleration in inflation caused by excessive government spending or increases in money wages. Inflation rates are at historical lows in industrial countries, and are below 10 per cent even in most of the crisis-stricken Asian economies that have suffered substantial devaluations and terms-of-trade losses. Budgets in most countries are in surplus, as in the United States, or have deficits at extremely low levels, the main exceptions being Brazil, Japan and Russia. Indeed, expansion has been driven by private domestic spending or by exports. Further, wage rates have generally been growing less than productivity, and other input prices have been declining so that the slowdown in earnings has been due less to cost pressures than to declining growth in sales and rising idle capacity.

The slowdown in growth has been occurring in conditions of falling prices, rising productivity and improvements in fiscal balances. Despite expansionary monetary policy the cost of private finance has been high and rising as a result of falling inflation rates and the increase in the risk premia. For instance, in the United States, despite the recent rounds of cuts, the Federal Funds rate is about 150 basis points above its 40-year average in real terms.<sup>17</sup> To the extent that risk premia continue to govern borrowing rates and that borrowers remain reluctant to increase already high levels of indebtedness, monetary policy can play only an indirect role in preventing a deepening of the downturn.

However, unlike the position during previous cyclical downturns in the 1970s and 1980s, most governments do have substantial leeway to allow public spending to play its traditional economic policy role as an automatic stabilizer for aggregate demand. The United States has considerable room to use fiscal policy, should the risk of recession increase. In Japan the recent decline in bond prices (see section C) has raised questions about the sustainability of its fiscal stance, but monetization of budget deficits through the acquisition of government bonds by the Bank of Japan could provide a way out. The EU is currently debating the possibility of amending

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<sup>17</sup> See Merrill Lynch, *Weekly Economic and Financial Commentary*, 4 January 1999.

the Stability Pact in order to exempt government investment expenditures from the calculation of the 3 per cent limit on budget deficits, and is exploring plans to manage the exchange rate of the euro within limits that would prevent excessive overvaluation. While these measures will have only an indirect effect on the decline in global demand, they represent a recognition of the need to make policy more flexible in the face of falling output.

Developing countries facing external financial difficulties have little room to use monetary policy for recovery, as noted above. Even in countries where there is scope to employ traditional fiscal policy measures, their use may be limited by the potential negative impact on financial and foreign-exchange markets. Countries that rely on commodity export earnings for fiscal revenues have introduced expenditure cuts for fear that failure to do so would jeopardize capital inflows and exchange rate stability. Others, fearing that increased government borrowing may increase interest rates and public debt and deficits, have acted to reduce government expenditures, reinforcing the downward cyclical trend in demand.

Given the limited scope in developing countries for pursuing counter-cyclical monetary and fiscal policies, and the relative ineffectiveness of monetary policy in industrial countries in arresting the slowdown, a possible policy response could be the direct injection of liquidity into developing countries through official channels to raise demand, imports and growth. This cannot be adequately done by drawing on the resources of multilateral financial institutions which have been drained by financial rescue operations. By contrast, Japan and the EU are in a position to play an important role in providing a direct liquidity injection by recycling part of their surpluses in various ways to developing countries in order to revive global demand, boost trade and accelerate growth. Given that developing countries have a higher propensity to spend and import, such schemes could prove to be superior, in terms of their effect on global growth, to domestic fiscal expansion in the surplus countries themselves.

Indeed, the greater overall impact of such surplus-recycling schemes is confirmed by simulations undertaken in UNCTAD, prior to the announcement of the Miyazawa Plan, to explore the potential role of Japan in the economic recovery of East Asia economies.<sup>18</sup> The results of the simulation exercise suggest that the regional and global growth impact of an additional Japanese aid package of \$100 billion to the crisis-ridden East Asian countries would be considerably stronger than that of a domestic fiscal stimulus of an equal magnitude. Gains in growth resulting from an aid package could be considerable for the countries in crisis. According to the simulation exercise for the Republic of Korea, the cumulative impact of aid on growth during 1998-2000 exceeds 10 per cent; and in the South-East Asian countries, the aid package adds more than 17 per cent to cumulative growth over the same period. While the impact of aid on growth in the recipient countries is, as expected, far stronger than the impact of a fiscal stimulus, for Japan the opposite is the case. However, the aid package is much more effective in promoting growth in most other regions and countries. In particular, growth in the United States and the European Union would benefit more from a Japanese aid package to the East Asian countries in crisis than a Japanese domestic fiscal stimulus of an equal amount. Moreover, while the direct, short-term impact of fiscal stimulus is greater on the level of activity in Japan itself than

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<sup>18</sup> See *The Potential Contribution of Japan to Asian Recovery: External Aid versus Domestic Fiscal Stimulus*, Paper prepared by the UNCTAD Secretariat, Geneva, October 1998.



an equivalent increase in aid to Asia, the medium-term impact is less clear after allowing for the effects of action needed subsequently to restore fiscal balance. Since the underlying cause of the decline in the trend growth rate in Japan lies in its structural problems, purely domestic stimulus packages are unlikely to restore growth permanently. Indeed, an appropriate strategy could combine action on three fronts: a temporary fiscal stimulus to promote cyclical recovery, aid to the Asian countries in crisis, and structural reforms, including a definitive solution to the domestic financial crisis. Thus, the recent policy initiatives in Japan, including the Miyazawa plan, the stimulus packages and efforts to tackle structural deficiencies in the financial sector, are to be welcomed, but for a rapid recovery in East Asia, a larger amount of long-term aid than that envisaged in the Miyazawa plan is likely to be needed.

Other means of producing a direct increase in liquidity in developing countries should also be explored. One avenue worth considering here would be to remove the debt overhang of highly indebted poor countries (HIPC) through a rapid write-off of their unpayable official and multilateral debt. In this respect, the recent proposal by the chancellor of Germany that the G-8 countries should embrace a radical plan for debt forgiveness for the world's poorest countries is a welcome development.<sup>19</sup> While such action has its merits on its own, implementing it under current conditions of a global slowdown would enhance its impact on growth and development. Similarly, a substantial SDR allocation could also provide payments support to developing and transition economies. There are already suggestions to use such an allocation on a reversible basis in order to provide liquidity to emerging markets facing a threat of contagion.<sup>20</sup> No less valid is the case for similar action to provide additional current-account financing, particularly at a time like the present when reserve needs are no longer adequately met by international capital markets even for the middle-income emerging markets which normally have access to such markets at reasonable costs.

## **B. INTERNATIONAL TRADE**

### **1. Recent developments**

Growth in the volume of world trade fell sharply to an estimated 4 per cent in 1998 after having rebounded to nearly 10 per cent in the previous year (table 4). Indeed, available alternative estimates indicate an even lower rate of growth.<sup>21</sup> Discernible in 1998 is a widespread slowdown at varying rates in the growth of import volume of individual countries and regions, in sharp

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<sup>19</sup> Gerhard Schröder, "Germany's helping hand", *Financial Times*, 21 January 1998.

<sup>20</sup> See H. Ezekiel, "The Role of Special Drawing Rights in the International Monetary System," in UNCTAD, *International Monetary and Financial Issues for the 1990s*, Vol. IX, New York and Geneva (United Nations publication, sales no. E.98-II-D.3), 1998.

<sup>21</sup> The IMF estimates growth in the volume of world trade in 1998 to be only 3.3 per cent; IMF, *World Economic Outlook and International Capital Markets*, Interim Assessment, Washington, D.C., December 1998, Table 4.1. According to estimates of J.P. Morgan, the rate of growth of export volume in 1998 was 3.5 per cent and of import volume 3.3 per cent; J.P. Morgan, *World Financial Markets*, New York, 8 January 1999.

contrast to the widespread acceleration recorded in 1997 which was particularly spectacular in Latin America and, to a lesser extent, in North America. Of major significance in 1998 was the dramatic contraction of import volumes of Japan (10 per cent) and South and East Asia, excluding China (over 6 per cent). For the five Asian economies most affected by the crisis (Indonesia, Republic of Korea, Malaysia, the Philippines and Thailand), the contraction in the volume of imports in 1998 ranged from 13 per cent in the Philippines to 27 per cent in Indonesia, again in sharp contrast to the situation in the previous year (table 5). For the global economy in general and the affected Asian economies in particular, the general slowdown in the volume of imports is the major factor underlying the corresponding deceleration in export volumes.

The widespread slowdown of imports in 1998 is equally evident in value terms. For developing countries, the slowdown in import growth resulted from a decline in domestic demand and the emergence of constraints on import capacity arising from reduced export earnings and lower capital inflows. In the first nine months of 1998, Asia's imports contracted by 16 per cent, as compared to a decline of 7 per cent for exports. For the five most affected Asian economies, imports fell by one-third while exports decreased by 3 per cent.<sup>22</sup> In China, imports fell by 9.2 per cent in October, leading to a decline of 0.7 per cent for the first 10 months of 1998. Indeed, by and large, year-on-year contractions in the quarterly value of imports were widespread and dramatic among countries in East Asia during the first three quarters of 1998 (table 6). With respect to exports, the divergence in the rates between value and volume terms bear witness to the substantial declines in the export prices of individual economies concerned.

The high degree of interdependence of trade and investment among the economies in East Asia, once a source of strength, has exacerbated the decline in exports of the countries of the region.<sup>23</sup> Thus, exports to Asia which accounted for about 60 per cent of China's overseas sales in 1997 fell 8.6 per cent (year-on-year) in the first 10 months of 1998.<sup>24</sup> As a result, China's exports for the first 10 months of 1998 were up only 1.3 per cent on a year earlier. Japanese exports to Asia also declined, being 23.7 per cent lower in the month of October than a year earlier. In the case of the Republic of Korea, merchandise exports to Japan, ASEAN and China for the first nine months of 1998 were down 19.6 per cent, 28.4 per cent and 9.2 per cent respectively.<sup>25</sup>

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<sup>22</sup> WTO Press Release, at [www.wto.org/wto/new/press117.htm](http://www.wto.org/wto/new/press117.htm).

<sup>23</sup> For intra-regional trade among developing Asian economies in 1996, the share of exports in GDP was over 12 per cent. For sub-regions and individual countries in Asia, the corresponding share was as high as some 54 per cent for the newly industrialized economies (Hong Kong (China), Republic of Korea, Singapore, and Taiwan Province of China), 34 per cent for ASEAN-4 (Indonesia, Malaysia, the Philippines, and Thailand), and 18 per cent for China; IMF, *op. cit.*, Tables 4.3 and 4.4. For a discussion of interregional trade in East Asia, see UNCTAD, *Trade and Development Report, 1998*, Part One, chapter II, and *Trade and Development Report, 1996*, Part Two, chapter I.

<sup>24</sup> Economist Intelligence Unit, "China Economy: Trade surplus plunges to \$3.08 bn", at [www.viewswire.com](http://www.viewswire.com), 18 November 1998.

<sup>25</sup> Overall, Korean exports in September 1998 were down by 3.9 per cent from a year ago, reflecting a continued decline of 10.8 per cent to developing countries but a rebound of 4.9 per cent to developed economies, as exports to the EU and the United States increased by 11.2 per cent and 2.4 per cent, respectively; *Korean Economic Daily*, 2 November 1998.

Because of the importance globally of the Asian economies and the relative dependence of both developing and developed countries on Asian markets, the economic slowdown in the region resulted in a deceleration in world import demand, with multiplier effects on the exports and incomes of countries in various regions, particularly other developing countries. Exports declined in those countries which have a high share of exports to the region. In the case of Latin America, Asia accounts for some 10 per cent of the total merchandise exports, but this share is much higher for some countries such as Peru and Ecuador, and as much as around 35 per cent in the case of Chile. In the third quarter of 1998, the exports of Latin America fell below the level of the preceding year, in sharp contrast to a substantial expansion in 1997. Similarly, import growth in 1998 slowed from 15 per cent in the first quarter to 5 per cent in the third. The deceleration in import growth was widespread among countries in the region but was particularly significant in Brazil, which experienced a reduction of nearly 5 per cent in the first nine months of 1998 as compared to an increase of 15 per cent in 1997. In Africa, the impact of the Asian crisis was felt particularly in Congo, the United Republic of Tanzania, and Zambia, since over a quarter or more of the exports of these countries go to Asia. Among the economies in transition, Kazakhstan, Romania, the Russian Federation, and Ukraine experienced a decline in the volume of their exports to Asia. Deteriorating economic conditions in East Asia were also a key factor behind the continued fall in commodity prices during 1998, with adverse impacts not only on commodity-dependent developing countries in Africa, Latin America and elsewhere, but also on major developed-country commodity exporters such as Canada and Australia.

Contrary to expectations stemming from the substantial depreciation in the currencies of the five most affected Asian economies since the onset of the crisis in July 1997 (table 7), the exports of South and East Asia as a group in 1998 were stagnant in volume terms (table 4). As already mentioned, this was partly due to weak demand in the region, falling export prices and simultaneous depreciations in importing countries. Between June 1997 and September 1998, for example, while the currencies of the five most affected Asian economies depreciated by an average of 36 per cent in real terms, those of five important commodity producing countries (Australia, Brazil, Chile, Colombia, and Russia) depreciated by an average of 21 per cent.<sup>26</sup> The eventual implications of such exchange-rate movements for international competitiveness are not clear. Indicative of the impact of the Asian currency depreciations on exports to third markets, however, are the findings of a recent study on the exports of Latin America (including Mexico) to OECD markets (excluding Mexico).<sup>27</sup> The study finds that around 58 per cent of Latin American exports to OECD countries are potentially vulnerable to Asian competition through the relative price effects of currency depreciations. Exports to North America and to Asian OECD countries have the largest shares of products exposed to Asian competition (62 per cent and 71 per cent, respectively). However, exports to the latter countries are only around 9 per cent of Latin American exports to the OECD as a whole. For manufactured products, just under 36 per cent of total Latin American exports to the OECD (with a value of \$61 billion) are exposed to Asian competition. The study finds that the smaller economies of Central America and the Caribbean are the most exposed, reflecting the large share of articles of apparel and clothing (and in some case of electrical goods) in their manufactured exports to the OECD.

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<sup>26</sup> The World Bank, *Commodity Markets and the Developing Countries*, Washington, D.C., November 1998. A more comprehensive discussion on currency depreciations is given in section C below.

<sup>27</sup> Inter-American Development Bank, *Integration and Trade in the Americas*, Periodic Note, August 1998.

The past year has also witnessed a huge swing in global current-account balances. As can be seen from table 8, Asian economies in particular have been accumulating surpluses at the relative expense of the United States and Latin America. In 1998, the current-account deficit amounted to \$294 billion in the United States, and \$52 billion in Latin American as a whole. The counterpart of the balance is found in the surpluses in OECD Europe with \$128 billion, Japan with \$122 billion, and in emerging Asia (excluding China) with \$58 billion.<sup>28</sup>

Although the turbulence experienced by Asia economies since mid-1997 has subsided, they remain vulnerable to both internal and external disturbances in a still uncertain external environment. The direct trade impact of the depreciation of the Brazilian real is likely to be limited to South America, because only countries from that region appear to depend significantly on trade with Brazil.<sup>29</sup> Argentina is likely to feel the greatest pressure, not only because of its close trade links, but also because its currency is tied to the dollar. In the Asian economies, export shares to Latin America, especially those of ASEAN members, are quite low (table 9). The Republic of Korea has the greatest exposure, but only 3 per cent of its exports go to Latin America while 20 per cent go to the United States. Nevertheless, indirect effects through financial markets and weaker worldwide growth cannot be ruled out.

For 1999, the prospects for world trade are fraught with considerable risks and uncertainties associated with the current global economic situation. Prior to the Brazilian crisis, the IMF projected an expansion of 4.4 per cent, UN (Project LINK) one at the same pace as in 1998 (4 per cent), whereas J.P. Morgan forecasts a growth in import volume of 3.1 per cent and in export volume of 1.0 per cent.<sup>30</sup> In any event, the surge in United States imports in 1998 is not expected to be sustained, and a sharp recovery in the Japanese economy is also unlikely. To the extent that the major forces at work during 1998 are likely to continue in 1999, no significant pick-up in the pace of world trade is to be expected.

## 2. Commodity markets

Oil and non-oil commodity markets were plagued by adverse conditions during 1998, as weak demand, ample supply and rising stocks all combined to exert considerable downward pressure on prices. By and large, prices of major commodity groups started to decline in mid-1997, and continued to fall in the course of 1998, among the largest movements being that of oil (table 10). Petroleum prices have not been as low as the \$11.88 per barrel recorded in November

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<sup>28</sup> J.P. Morgan, *ibid.* The past two years have also been a period of significant gains in export market share by Asian exporters, notably China, Indonesia, the Republic of Korea and the Philippines.

<sup>29</sup> In 1997, exports of Mercosur members to Brazil as a share of GDP amounted to 2.5 per cent in Argentina, 5.3 per cent in Paraguay, and 4.9 per cent in Uruguay. In the case of Chile, the corresponding share was 1.3 per cent; Morgan Stanley Dean Witter Economists, *Global Economic Forum*, January 14, 1999.

<sup>30</sup> For comparison, trade growth in 1998 is estimated at 3.3 per cent by the IMF, 4 per cent by UN/LINK, and 3.3 per cent in import volume and 3.5 per cent in export volume by J.P. Morgan; IMF, *op. cit.*, Table 4.1; and J.P. Morgan, *ibid.*

1998 at any time during recent years.<sup>31</sup> While lower oil prices benefit oil-importing developing countries, some 25 countries are dependent on petroleum for 20 per cent or more of their foreign exchange earnings.<sup>32</sup>

The overall price level of non-oil commodities in November 1998 was some 14 per cent lower than that of December 1997, and more than 18 per cent below that observed at the onset of the financial crisis in Asia in mid-1997. While the prices of vegetable oilseeds and oils actually rose (in part owing to damage to domestic production caused by floods in China and India), the declining trend in prices of other commodities reflected weakening tendencies in all the major categories (minerals, ores and metals, food and tropical beverages, and agricultural raw materials). The broad-based decline in non-oil commodity prices since the second quarter of 1997 together with the steep fall in oil prices during 1998 meant that all regions were affected in varying degrees. African economies, due to their dependence on a relatively small number of commodities and their relatively low income levels, continue to be particularly vulnerable to a fall in commodity prices.

Vagaries of weather, which were especially marked in 1998 due to the effects of El Niño, induced surges in the prices of many agricultural commodities, albeit only temporarily. El Niño-induced price increases were observed in the case of fats and oils, notably coconut and palm oil, with concomitant reductions in exports due to lower production. Grain production, notably rice, was also adversely affected by El Niño, especially in East and South Asia where poor harvests resulted in marked increases in imports. The drastic decline in tropical beverages was concentrated in arabica coffee, in contrast to the prices of robusta. High coffee prices had prevailed up to the beginning of 1998 and were responsible for a marked decline in purchases in 1997 and the early part of 1998. However, following a large South American crop, especially in Brazil, prices in November 1998 were down by more than 34 per cent from their levels of December 1997.

In addition to developments which reflected weather-related factors predominant in agriculture, commodity markets have been under additional pressures stemming from the East Asian financial crisis. Many of the fast-growing economies in Asia have become major markets for a wide range of commodities, including high-value foodstuffs, agricultural raw materials, metals and fuel. Many of them are also major suppliers of commodities to world markets (table 11). Among the most affected economies, Indonesia is a significant producer of minerals and agricultural crops, including tin, nickel, copper, rubber, wood, oil-crops, and oil; Malaysia is a

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<sup>31</sup> Average of Dubai, United Kingdom Brent and West Texas Intermediate crude prices; see UNCTAD, *Monthly Commodity Price Bulletin*, December 1998.

<sup>32</sup> For the specific list of countries, see IMF, *World Economic Outlook*, Washington, D.C., May 1998, Annex II, Table 27. The share of oil-related export revenue in merchandise exports is as high as 79 per cent for Venezuela, 48 per cent for Norway, and 25 per cent for the Russian Federation. The corresponding shares in terms of GDP are 21 per cent, 15 per cent and 5 per cent respectively; see OECD, *OECD Economic Outlook*, Paris, November 1998, Box I.5. For estimated shortfalls in 1998 export earnings due to the decline in oil prices for selected developing countries, see *Trade and Development Report 1998*, table 24.

major producer of rubber, oil-crops, wood, tin, and oil; and Thailand of rice, rubber and fish.<sup>33</sup> Moreover, exporters in other regions, especially Africa, were facing both demand declines and increasing price competition from their Asian counterparts.

But it is the decline in the actual consumption of commodities by the most affected countries, either directly (in the case of foodstuffs), or indirectly (in the case of industrial inputs and construction materials), that is the main channel through which the impact of the Asian crisis has been felt, and will continue to be felt, in commodity markets. By themselves, the five most affected Asian countries account for less than 10 per cent of global consumption of most commodities. However, when Japan is included, the share of the group rises to between 15 and more than 40 per cent (table 11). Japan, by itself a major importer of primary commodities for domestic consumption and for inputs into manufactures exports, greatly reduced its import of many commodities in the course of 1998, particularly metals and minerals, because of the slump in construction and the manufacture of automobiles. Thus, despite relatively strong demand in both Western Europe and the United States, metals prices have fallen sharply since June 1997 primarily owing to sharp declines in consumption in Japan and other East Asian countries.

Given the uncertainty in world markets, commodity prices can be expected to remain weak. The adverse effect of the Brazilian crisis will be felt mostly in the markets for oil and coffee. Of greater significance is likely to be the recession in Japan which has affected its trade with other Asian economies in both directions,<sup>34</sup> forcing the latter to divert shipments to the United States and Europe where economic activity has been robust. However, demand in these countries has not been sufficient to prevent increased supply including their own production from depressing prices. Any slowdown in the United States economy would put further downward pressure on commodity prices. Thus, given the large build-up in stocks for many commodities, prospects for a significant recovery in prices in the near future are not promising.

## C. FINANCIAL MARKETS AND PRIVATE CAPITAL FLOWS

### 1. 1998: a year of volatile financial markets

Financial markets faced increasing difficulty in assessing the regional and global impact of the Asian crisis throughout 1998. Early hopes that the crisis could be contained were dashed as the volatility of asset prices and declines in major categories of international financing for most developing regions became more severe and widespread from mid-year. Optimism was initially raised when the agreement reached in February by the Republic of Korea with its creditor banks on a plan to reschedule outstanding short-term debt led to a sharp recovery in asset prices and a strengthening of exchange rates across East Asia. Then a stronger than expected performance

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<sup>33</sup> For the relative importance of individual countries in world commodity production, see World Bank, *Commodity Markets and the Developing Countries*, Washington, D.C., August 1998, Table 4.

<sup>34</sup> Japan accounts for 16 per cent of the total exports of the five most affected Asian countries, while the latter account for 20 per cent of Japanese exports.

of the United States economy and improved prospects for a European recovery, which suggested that the developed economies might escape contamination from the crisis and provide the expanding export markets required for adjustment in East Asia, reinforced the positive impact of the debt restructuring. By the beginning of April it was widely believed that conditions in the region had stabilized and that recovery was imminent.

This favourable view of recovery in Asia received a sharp reversal in May, as political unrest in Indonesia eventually brought down the Government and refocused investor attention on the political risks of the adjustment policies being pursued in the region. Attention was not limited to Asian financial markets; other emerging markets, including those as far apart as South Africa, Russia and Brazil, faced a rapid exit of foreign capital accompanied by strong selling pressure on their currencies. In response to its loss of some \$25 billion in reserves, Brazil announced a package of spending cuts in excess of 3 per cent of GDP and increased policy interest rates to nearly 50 per cent, while in Russia official rates were raised to triple digit figures. Although the measures introduced in Brazil succeeded in halting and eventually reversing the capital outflows, Russia was obliged to raise overnight rouble rates to 200 per cent to support the exchange rate and avoid financial meltdown as stock prices collapsed and trading was suspended on the Moscow stock futures market.

International currency and equity markets were also disturbed by the nuclear tests in India and Pakistan and the subsequent announcement of international sanctions, as well as by what appeared to be a free fall of the yen in June as rumours of weakness in the banking sector were reinforced by the difficulties at the Long Term Credit Bank. The rapid decline in the Japanese currency created selling pressure in equity markets in the rest of the Asian region as investors feared the erosion of their competitiveness vis-à-vis Japan. Although the Chinese Government reconfirmed its policy of exchange rate stability, it also pointed out that it could not maintain the exchange rate if the other currencies of the region continued to depreciate in response to the weakness of the yen. Although coordinated central bank intervention led by the United States in support of the yen and a political agreement on a rescue plan for the troubled Japanese banking sector led to stabilization of the currency markets and a recovery in the Japanese stock market, this calm was relatively short-lived and both currencies and asset prices were again in rapid decline later in the summer.

As commodity prices, which had suffered weakness at the beginning of the Asian crisis, continued their precipitous decline, financial markets shifted attention towards the impact of the crisis on fiscal and trade balances in commodity exporters, in particular certain Latin American countries and Russia. As a result, in August and September there was a marked resurgence of financial instability as international investors fled emerging markets irrespective of local conditions and deserted riskier assets in developed markets in a flight to quality. Increased instability was accompanied by falls in major categories of external financing for developing and transition economies.

Conditions in Russia were of particular importance in the rapid re-emergence of volatility and the rush to liquidity in the late summer. As noted above, Russian financial markets had already been under pressure in June; extremely high interest rates had to be employed to defend the rouble and there were problems in attracting investors to debt auctions and to participation in the privatization of a large state enterprise. But by August the difficulties spread to other

rouble-denominated assets, leading to the *de facto* default of some \$30 billion in rouble-denominated government debt, accompanied by a 90-day moratorium on private foreign debt servicing, and preclusion of holdings of short-term money-market instruments by foreigners. The resulting difficulties that this created for foreign lenders and investors led to the bankruptcy of a large United States hedge fund that had specialized in investing in Russian government securities and a rapid rush to liquidity. Underlying this turmoil was the attempt by some large Western banks that had lent directly or indirectly against the collateral of Russian government debt to unwind positions and realize profits to cover losses. These difficulties in what were considered to be well-managed and supervised institutions led to a radical reassessment of risk and a flight to the most liquid, least risky instruments such as certain government bonds and related exchange-traded (as opposed to customized, OTC) interest-rate derivatives.

In the United States, the sharp rise in credit spreads between non-investment grade paper and Treasury securities produced massive losses in the arbitrage positions of another (even larger) United States hedge fund whose positions in such securities were large enough to lead the Federal Reserve to coordinate a rescue in order to avoid the possible breakdown of market liquidity in response to the sale of the fund's portfolio to pay creditors. Equity prices reacted with steep declines in 25 emerging financial markets in August (in 13 cases - Argentina, Brazil, Chile, Hungary, Indonesia, Malaysia, Mexico, Peru, the Philippines, Poland, South Africa, Turkey and Venezuela - the declines amounted to 25 per cent or more). Latin American markets generally experienced larger declines than those of East Asia after the crisis in that region. Between mid-August and mid-October international bond issues by entities from developing and transition economies were extremely rare: the only such issues by entities other than those of Hong Kong (China) and Taiwan Province of China were two by Lebanon.

Yield spreads<sup>35</sup> on internationally issued bonds of developing and transition economies had already tended to rise during the first half of 1998, but they were subject to further sharp increases after the Russian crisis (chart 2). Among countries which experienced large outflows of capital during this period, Brazil lost approximately one-third of its international reserves in little more than two months, and both Argentina and Chile experienced severe pressure on their currencies. Mexico, with a flexible exchange-rate policy designed to raise the risks of speculation against the currency, was forced to increase interest rates sharply in order to prevent large capital outflows.

There was also a reversal of the trend toward a stronger dollar, and sharp downward revisions in forecasts for private capital inflows to developing and transition economies. However, not all developing economies were equally affected: in East Asia, for example, while Hong Kong (China) experienced a sustained attack on its currency, elsewhere, in countries such as Indonesia, Republic of Korea, Malaysia and Thailand exchange rates remained relatively stable and the trend towards lower interest rates continued. Nonetheless, the events of the summer and autumn of 1998 provide another stark reminder of the potency of contagion in today's international financial markets as investors often unwind positions characterized by high degrees of leverage in response to shocks frequently originating in markets in which the share of their global exposure is relatively small.

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<sup>35</sup> For the definition of yield spread see the notes to chart 2.



## 2. Anatomy of the financial crisis in Russia

As the crises in East Asia, the Russian crisis combines banking and currency crises, linked through excessive currency exposure and domestic lending funded by foreign borrowing and capital inflows. However, the underlying causes of this crisis are quite different from those in East Asia on account of the much greater role played by domestic macroeconomic imbalances and structural and institutional weaknesses.

As part of its efforts to achieve stabilization through control of the money supply, the Russian Government financed its fiscal deficit by increased issue of treasury securities (known by the acronyms GKO and OFZ). This led to a rapid increase in debt service that reached about one-third of federal spending in the first quarter of 1998. Russian banks were the major buyers of this paper, borrowing dollars from foreign banks through repo contracts<sup>36</sup> and generating arbitrage profits from the substantial differential between Russian and foreign interest rates. Russian banks thus assumed the risk of a devaluation of the rouble, but in view of the IMF's support for a stable exchange rate this risk was considered to be low.

About a quarter of the subsequently defaulted government debt was purchased directly by foreign investors, some of whom financed their purchases with roubles received on repo agreements with Russian banks. These investors had hedged their currency risks associated with their positions in Russian government debt with forward contracts worth about \$40 billion purchased from Russian as well as Western banks. They were faced with losses of up to 100 per cent of their positions when the suspension of payment on the bonds became a *de facto* default, and payments due on the forward contracts were prohibited. The situation was aggravated by the suspension of payment on forwards by Western banks as well.

While domestic factors were responsible for Russia's increased vulnerability, the Asian crisis played a crucial role in triggering the Russian crisis through its impact, firstly, on perceived international lending risk and, secondly, on commodity prices, particularly those of oil and other primary products which constitute the majority of Russia's exports. The fall in commodity prices reversed the Russian payments balance from a surplus of \$3.9 billion in the first half of 1997 to a deficit of around \$6 billion in the first half of 1998. In the absence of other sources of foreign exchange, rouble stability required intervention that resulted in a decline in reserves and higher interest rates to attract capital inflows. However, when interest rates on government securities rocketed to above 100 per cent, the decline in the value of government securities led to margin calls on Russian banks for additional collateral on their repo loans from foreign creditors. Russian banks thus had to find funds to purchase additional government securities to restore the collateral for their loans just at the time when the central bank was draining liquidity from the market to defend the exchange rate and foreign lenders were unwilling to increase their exposure to Russian banks. The banks' efforts to borrow more to meet margin calls were transferred to the interbank money market, but lacking central-bank support for its liquidity, this market proved unable to meet these additional demands for funding and ceased to function.

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<sup>36</sup> A "repo" or repurchase agreement is a contract between a seller and a buyer of securities (usually those issued by a government) under which the former repurchases them from the latter at a higher price some time in the future. These contracts are used in many financial markets as a vehicle for short-term financing of inventories of securities, where the securities being financed serve as collateral for the loans.

Thus, the only remaining alternative for the banks was to close their repo positions by repaying the borrowed dollars. This created additional demand for dollars and increased the downward pressure on the exchange rate and international reserves, provoking further monetary tightening by the central bank and further falls in the prices of government securities. These in turn generated additional margin calls and a further demand for dollars in what became an unsustainable spiral that reduced reserves at the rate of approximately \$4 billion a month. A wider band for the rouble/dollar exchange rate was introduced in the third week in August around a new central rate corresponding to a rouble depreciation of more than 25 per cent and was accompanied by various emergency measures including a 90-day moratorium on obligations on selected private foreign debts with a maturity of more than 180 days and on those due to margin calls and foreign exchange contracts as well as other capital controls. The Government also announced a moratorium on its own debt in anticipation of a forced conversion of GKO's and other bonds maturing in 1999 into longer-term debt instruments. As noted, this moratorium produced losses for foreign and Russian banks and investors. For Russian banks the losses associated with the crisis are estimated at 40 per cent of their assets, and all are considered to be technically insolvent.<sup>37</sup> On the other hand, the losses for Western banks due to their Russian exposure were relatively small,<sup>38</sup> although they were an important factor in initiating the global liquidity crisis that pushed financial markets to the point of breakdown.

### **3. Capital flows, currency markets and policy responses**

As noted above, exchange-rate changes brought about substantial shifts in the relative competitiveness of different countries and regions as markets reacted to the Asian crisis. In addition to the sharp fluctuations in the exchange rates of the Asian countries affected, 1998 also witnessed increased volatility in the foreign-exchange markets of several other developing countries as well as in the major internationally traded currencies, the dollar, the yen and the European currencies, notably the mark.

#### ***a. Industrial countries***

Given Japan's linkages to the rest of Asia and its internal economic difficulties, the yen was especially hard hit by the East Asian crisis, and by the late spring market participants were selling the currency aggressively in what appeared to be a total collapse of confidence. As already noted, the resulting depreciation was halted only by combined intervention in support of the yen in the early summer. However, the yen has been strengthening since that time, taking a particularly large jump in the first week of October when it appreciated by over 10 per cent in two days. This abrupt reversal of the fortunes of the yen to a range of 110-115 to the dollar against expectations of a yen in excess of 150 has been due more to technical factors than to any real

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<sup>37</sup> For further detail see, "The Russian Crisis", a paper prepared jointly by the secretariats of the United Nations Conference on Trade and Development and the United Nations Economic Commission for Europe, Geneva, October, 1998.

<sup>38</sup> In the case of German banks, for example, whose lending to Russia amounts to more than 50 per cent of the total by international banks, their assets in Russia are less than 5 per cent of their total foreign assets.

improvement in the outlook for the Japanese economy or to any change in Japanese monetary policy.

One factor supporting the currency was the decision of the Trust Fund Bureau to stop purchasing Japanese government bonds. The TFB receives funds from the Postal Savings System and other government agencies such as pension funds and typically invests them in government bonds to finance fiscal stimulus programmes.<sup>39</sup> The expiry in the near term of a large amount of fixed-term high-interest postal savings deposits has created the possibility of a net outflow from the Postal Savings System and thus a reduction of the funds available to the TFB which has announced that it would purchase no new bonds in the 1999 fiscal year. The result was a rapid market perception that the supply of bonds would increase as a result of the 5.9 percent increase in second budget spending at a time while demand would be falling. This produced a sharp increase in the slope of the yield curve as long-term interest rates shot up above 2 per cent from less than 1 percent in October 1998.

The second factor in the appreciation of the yen was the reversal of the yen carry trade, as expectations of rising Japanese interest rates and a strengthening yen led investors to unwind positions in which they had borrowed yen to invest in foreign currencies, especially the dollar. Third, the recent decision to reduce risk-adjusted capital requirements for domestic banks without international operations to 4 per cent has encouraged a large number of Japanese banks to close their foreign offices and repatriate funds. Finally, the impact of rising interest rates and the steepening of the yield curve has produced substantial losses on bank bond portfolios, again leading to repatriation of dollar assets to cover them. All of these factors have led to a sale of dollars by Japanese financial institutions, which, along with the strengthening current account surplus, have produced sustained upward pressure on the yen. Moreover, the continued deterioration in the United States trade balance and the possible adverse effects of global financial instability on the country's economy created expectations that the Federal Reserve would move quickly to cut interest rates, thereby reinforcing the downward movement of the dollar.

The Japanese economy is therefore facing increased difficulties affecting both the real and the financial sectors: despite large injections of liquidity by the Bank of Japan, the currency is strengthening while interest rates are rising. This not only hurts the competitiveness of the Japanese economy, but has generated substantial losses for the bond portfolios of banks already under pressure. Thus, at the beginning of what appears to be a difficult recovery, neither capital markets nor foreign exchange markets are well placed to provide support to the Japanese economy.

Instability in financial markets has also produced large swings in the value of the dollar vis-à-vis the European currencies. Since the Russian crisis was initially considered as a threat to the stability of the German banking system, the major lender to the area, initial reactions included a strengthening of the dollar against the mark. This tendency was soon reversed as large

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<sup>39</sup> Such fiscal stimulus packages are financed by the so-called "second budget", covering the Fiscal Investment and Loan Program; see UNCTAD, *Trade and Development Report 1995*, pp. 189-190.

United States hedge funds<sup>40</sup> were asked for increased collateral on their Russian positions and had to reduce the size of their balance sheets, and by the beginning of October the mark had strengthened.

While the dollar has been weaker against the yen, its weakness relative to European currencies has been reversed in 1999. The euro fell from 1.18 at launch on January 1 to 1.13 at the end of January. This has been due to the continued exceptionally strong performance of the United States economy against the widespread realization that Europe will not experience a strong growth in 1999. Thus, after the publication of the initial estimates of GDP growth of nearly 6 per cent for the fourth quarter of 1998, expectations for further interest rate cuts in the United States in the near term, given the continued fall in inflation and benign wage growth, turned neutral. Against this background, the possibility of further interest rate cuts in Europe provides support for the dollar. The continued strong performance of the United States equity market has also attracted foreign investors. Depreciating against both the major currencies in the global system, Europe should however avoid the loss of competitiveness that had been feared from an excessively tight monetary policy operated by a European Central Bank seeking to establish its reputation as the guardian of the internal purchasing power of the euro.

#### ***b. Emerging markets***

The behaviour of exchange rates in developing countries has been influenced by the movements in the major currencies as well as policy responses to conditions in international financial markets (table 7). Some governments have felt constrained to take measures aimed at restoring capital inflows, whilst others have been concerned mainly to shield their domestic economies from the impact of volatile capital flows or have been able to maintain the overall thrust of their macroeconomic policies largely unchanged. The Hong Kong dollar, the Chinese renminbi and the Argentinian peso have remained stable at their fixed rates to the dollar. While most Asian currencies strengthened in the course of the year, the change was in the opposite direction for most Latin American currencies.

Hong Kong (China) and Malaysia have moved in different ways to prevent capital flows from threatening exchange-rate and domestic macroeconomic stability. In a series of measures starting in mid-August, the authorities in Hong Kong (China), the location of one of the world's freest financial markets, acted to squeeze or restrict short selling of equities and thus limit speculative strains on its currency and on share prices. A major target of this intervention was the so-called "double play", in which speculators combined short sales of stock or stock futures

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<sup>40</sup> Hedge funds are private investment pools which originally acquired their name because they used a form of spread trading in which long positions in investments expected to increase in value were balanced by short positions in the same type of assets that were expected to decline in value. These funds now typically follow more aggressive strategies based on high levels of leverage and remuneration of managers consisting primarily of percentages of investment profits. The most widely discussed case of recent difficulties among such funds is that of Long-Term Capital Management (LTCM), for which (as discussed above) the United States Federal Reserve organized a consortium of creditors and investors for the purpose of an injection of emergency financing to prevent the fund from becoming insolvent owing to losses on highly leveraged positions in such instruments as United States government bonds and the shares of companies involved in takeover activity, as well as Russian securities. But difficulties were also experienced by a number of other hedge funds, in many cases owing to the movements in asset prices following the Russian financial crisis.

with the purchase of United States dollars against Hong Kong dollars. Under Hong Kong's Currency Board system, the purchase of dollars automatically reduces domestic liquidity and puts upward pressure on interest rates, increasing the costs of financing long stock positions and thus producing pressure to sell shares and causing prices to fall. This creates the possibility to profit by closing the prior short sales of stock at the lower prices. To diminish the profitability of such trades the Hong Kong Monetary Authority purchased stock (estimated at about US \$15 billion) to prevent the fall in stock prices and create losses for short sellers forced to close positions at higher prices. Other steps taken to curb speculation were margin surcharges on large positions in the stock futures market and a temporary moratorium on short selling of three of the most important shares traded in Hong Kong (China).

The Malaysian ringgit fell steadily throughout the year to more than 4.20 to the dollar until the introduction of exchange controls in September when the rate was fixed at 3.80 to the dollar. At the beginning of September, with the objectives of keeping interest rates low to counter deteriorating prospects for growth and to lessen the pressure of non-performing loans on its banking sector, Malaysia introduced stringent new exchange controls affecting current as well as capital transactions. These controls are designed to restrict trading outside Malaysia of financial assets denominated in ringgit. Official approval will now be required for most cross-border capital flows and some current transactions, and ringgit deposits held offshore were to be repatriated within a month of the announcement of the measures.

Other East Asian currencies have continued to fluctuate widely but on a generally improving trend. These movements have been influenced both by factors specific to individual countries, and by the movement of the yen relative to the dollar. A number of currencies have achieved a measure of stability after mid-summer turbulence. The Indonesia rupiah went from 8000 at the beginning of the year to above 15000 at the height of the political crisis, but has now returned to a range around 8000. The Taiwanese dollar, backed by substantial reserves and a relatively strong economic performance, nonetheless fell from 28 to around 35 to the dollar in mid-year before strengthening more recently. Two currencies have improved steadily over the year: the Thai baht has appreciated by around 20 per cent against the dollar, but with a setback during the summer; the Korean won has also appreciated, stabilizing in a range around 1300 to the dollar compared with 1800 at the beginning of the year. The apparent return of stability in exchange rates in countries such as Indonesia, Thailand and the Republic of Korea has also been associated with erosion of some of their increased competitiveness achieved since 1997 and thus may presage future currency adjustments in the region.

Other developing countries that have been dependent on commodity earnings to preserve current-account balance have been especially hard hit by recent developments. Russia and several Latin American economies are outstanding examples, as are some OECD countries such as Canada, Australia and New Zealand which have also experienced depreciations of approximately 10 per cent.

In Latin America, as already noted, in the aftermath of the Russian financial crisis Brazil experienced sustained currency attacks. The Government had earlier relaxed existing controls on capital flows in order to facilitate inflows, but this policy has subsequently been reversed as the crisis persisted. The real followed a path of gradual depreciation according to an adjustable peg formula, despite heavy speculative pressure, at the cost of a substantial loss of reserves.

Toward the end of the year the Government signed an agreement with the IMF on new measures of fiscal austerity supported by a \$41.5 billion external financial package. In January dissension in the government majority, indicating lack of full support for the fiscal adjustment package, led to a resumption of outflows to levels last seen in August and September. The difficulties were compounded by the announcement by a number of Federal States that they were unable or unwilling to meet interest payments on their debt to the Federal Government. With reserves in mid-January nearing the level considered critical for defence of the currency, a new method was introduced to calculate the intervention band to allow for a slightly more rapid depreciation. This caused a sharp acceleration in selling pressure. The intervention band was abandoned and the Central Bank announced on 15 January that it would no longer intervene, leaving the exchange rate to float. In the absence of any indication from the Government of a desired exchange rate or any consistent intervention policy, and only moderate increases in interest rates, the real continued to depreciate, reaching the rate of 2 real per dollar, down from 1.22 before the announcement of the new exchange-rate intervention band. The only formal policy move has been to announce the unification of the official and the floating foreign-exchange markets in an attempt to increase the supply of dollars reaching the market and to allow stock market margin accounts to be invested in government securities, reducing the effective cost. Throughout the last half of January market traders continued to test the response of the Government by continuing sales, and domestic residents continued to seek to convert domestic currency to dollars. Concerns that the Government could introduce measures similar to those used after the introduction of the Collor plan, freezing bank accounts and introducing capital controls, led to some flight of deposits from the banks and increased the fragility of the domestic banking system. However, by the end of January, outflows had fallen back from their peak levels and the exchange rate had recovered from its lows, suggesting that the market was stabilizing in a range of 1.70-1.90.

In Chile external pressures at the end of 1998 have led to changes in the fluctuation band for the peso/dollar rate and to a new rule for the central rate to accommodate a more rapid depreciation. Reserve requirements on capital inflows have also been relaxed to alleviate the pressure on the currency. In Colombia the fluctuation band for the peso/dollar rate was shifted by an amount corresponding to a 9 per cent depreciation of the central rate for the peso. In Venezuela, where the effects of weak oil prices have been accompanied by uncertainty over the policies of the new Government, the bolivar has so far managed to withstand downward pressures and the currency regime of a fluctuation band around a central rate subject to small monthly adjustments has survived the crisis in Brazil. In Mexico, which has a floating exchange rate, the peso experienced a substantial depreciation during 1998 which at one point exceeded 25 per cent. In none of these countries has the Brazilian crisis had a major negative impact on the foreign-exchange markets, although the Mexican peso did fall against the dollar at one point, recovering subsequently. Argentina, because of its close trade links with Brazil through Mercosur, has had to use tight monetary policy, and has suggested that it might move to a formal adoption of the United States dollar to avoid the increases in interest rates that have frequently been required when there is market turbulence despite the strength of its Currency Board system. Such a step would have little impact on the economy, except for the loss of seigniorage earnings from interest on dollar reserves which would now be put in circulation.

#### 4. Prospects for private capital flows to emerging markets

More unfavourable conditions in international financial markets since mid-1997 initially had uneven effects on different regions. In East Asia major categories of external financing declined sharply in 1997, and this trend accelerated in the first half of 1998. The exposure of BIS-reporting banks to the region, for example, actually decreased by more than \$50 billion (after adjustment for the effect of changes in exchange rates), a large part of the contraction being concentrated in Indonesia (\$8.9 billion), Republic of Korea (\$20.6 billion), Malaysia (\$4.3 billion), and Thailand (\$13.8 billion).<sup>41</sup> Net bond issues by countries of East Asia in the first half of 1998 amounted to only \$3.3 billion, with issues by the Republic of Korea accounting for a large share.

For the Asia/Pacific region as a whole, total private capital inflows fell by more than 60 per cent between 1996 and 1997, on account of a more than \$100 billion swing in the flows received by the five East Asian economies most affected by the crisis (table 12). The decline continued throughout 1998; a large part was due to the outflow of some \$30 billion from the crisis-ridden countries, but unfavourable market conditions also affected the other countries in the region which experienced a drop of about \$25 billion in total capital flows.

Elsewhere the main initial manifestations of the more unfavourable environment were periods of turbulence in currency and stock markets but external financial flows were less affected. Indeed, there was widespread optimism regarding capital flows to Latin America and Eastern Europe, where they were expected to remain in 1998 at their 1997 levels.<sup>42</sup> However, in the event, there has also been a deceleration of capital flows to most emerging financial markets outside East Asia. For example, the (exchange-rate-adjusted) exposure of BIS-reporting banks to Latin America actually contracted in the second quarter of 1998 (after increasing by \$15.6 billion in the first quarter), as did their exposure to Africa. The increase in their exposure to the transition economies of Eastern Europe and of the former Soviet Union fell from \$6.5 billion in the first quarter of 1998 to \$4.2 billion in the second, and only for West Asia of the major developing regions did the level of bank lending actually increase in the second quarter (sustained to a significant extent by syndicated loan facilities for Saudi Arabian oil companies). Net flows to developing and transition economies from new external bond issues remained relatively buoyant in the first two quarters of 1998 for Latin America (at \$20.6 billion) and for the transition economies of Eastern Europe and the countries of the former Soviet Union (at \$7.6 billion). However, flows in this form contracted sharply in the third quarter, in part as a reflection of the virtual halt in new external bond issues by developing and transition economies after the Russian crisis discussed above: net flows to Eastern Europe and countries of the former Soviet Union, the only region not experiencing a fall, were due almost entirely to the Russian Federation's exchange of domestic Treasury bills for eurodollar bonds.

Following the outbreak of the Russian crisis, the estimates of the Institute of International Finance (IIF) and J.P. Morgan of the out-turn for total net capital flows to emerging markets for

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<sup>41</sup> See "International Banking and Financial Market Developments", *BIS Quarterly Review*, November 1998, table 6A. The BIS's alternative semi-annual reporting system for the consolidated international claims of reporting banks shows similar figures for exchange-rate-adjusted changes in exposure.

<sup>42</sup> For a discussion of these projections see UNCTAD, *Trade and Development Report 1998*, p. 69.

the year as a whole have been revised downwards by substantial amounts. The largest downward revisions for 1998 involve bank lending and portfolio investment, and all major regions are affected. The category of financing that has been least affected by these revisions is FDI, whose relative buoyancy may reflect the influence of increased acquisition of businesses in East Asia in response to lower prices in foreign exchange resulting from currency depreciation as well as to the liberalization of some controls on inward investment. Overall, however, total capital inflows to developing countries and transition economies as a whole are estimated to have fallen by between \$110 and 130 billion.

Current prospects for 1999 are for further declines in private capital inflows to emerging markets with total net inflows being projected in the \$120-140 billion range. An important part of these flows is accounted for by FDI which is expected to remain broadly unchanged around some \$100 billion. While net portfolio inflows are projected to show a moderate improvement, net debt inflows (borrowing from private creditors including bond issuance) are expected to continue to decline. Commercial banks are likely to reduce their exposure to both Latin America and East Asia.

Among various regions, the largest decline in capital inflows in 1999 is expected in Latin America where projections are for a total inflow of some \$50 billion, representing a decline of 30-40 per cent compared with 1997, in large part on account of a sharp decline in net lending. Capital flows into the European emerging markets are expected to stabilize. As for the Asian emerging markets, a moderate slowdown in net private flows to China is expected to be balanced by recovery in overall capital flows to the region as a whole, in large part on account of a deceleration in the pace of outflows from the crisis-ridden countries.

In view of the severity and the duration of the current global financial instability, these projections may understate the eventual decline in capital flows for the current year. Given that the new-issue market for United States corporations has recovered only very slowly from a virtual halt in activity in the autumn of 1998, it is unlikely that emerging markets will fare much better. If firms have difficulty raising funds for domestic investment, this is likely to extend to their cross-border direct investment as well. Commercial banks in the United States have stepped in to replace some of the financing slack in that country, but only for better-grade borrowers. Also indicative of the current reluctance of banks to commit additional funds to emerging-market borrowers is the failure of any private lenders to participate in the Brazilian rescue package. There is considerable uncertainty regarding the contagion from the Brazilian crisis. So far its adverse impact on financial markets in other emerging markets appears to have been much more limited than that of the Russian crisis. However, if stability is not restored rapidly and recession deepens, the impact on other economies in the region through trade flows can depress income levels significantly, reducing profitability. Capital inflows can then be expected to worsen as a result of both the increase in perceived financial risks and the reduced expected return on investments. Any failure to fully implement the adjustment programme and to reach agreement with creditors could undermine confidence further and depress private flows to other emerging markets.



*Table 1*

<b>WORLD OUTPUT, 1996-1998</b>			
<i>(Percentage changes over previous year)</i>			
<i>Region/country</i>	<i>1996</i>	<i>1997</i>	<i>1998 <sup>a</sup></i>
World	3.0	3.2	2.0
Developed market-economy countries	2.5	2.7	2.3
United States	2.8	3.8	3.9
Japan	3.9	0.9	-2.5
European Union	1.7	2.5	2.8
Euro area	1.6	2.4	2.9
Germany	1.4	2.2	2.7
France	1.5	2.4	3.0
Italy	0.7	1.5	1.7
United Kingdom	2.2	3.3	2.3
Transition economies	-1.6	1.4	-1.0
Developing countries	5.9	5.5	1.5
Latin America	3.6	5.3	2.3
Africa	4.6	3.3	2.7
Asia	7.1	5.9	0.9
China	9.6	8.8	7.5
Other countries	6.4	5.0	-1.0
Newly industrializing economies	6.4	6.0	-2.3
Hong Kong, China	5.0	5.2	-4.0
Republic of Korea	7.1	5.5	-6.2
Singapore	6.9	7.8	0.0
Taiwan Province of China	5.7	6.8	4.5
ASEAN-4	7.0	3.5	-9.6
Indonesia	8.0	4.6	-15.3
Malaysia	8.6	7.5	-7.5
Philippines	5.7	5.1	1.0
Thailand	5.5	-0.4	-8.0
ASEAN-4 plus Republic of Korea	7.0	4.5	-8.0
Developing countries, excluding China	5.3	4.9	0.4

*Source:* UNCTAD secretariat calculations, based on data in 1990 dollars.

*a* Preliminary estimates.

Table 2

**BASELINE FORECASTS OF GDP GROWTH IN 1999 FOR SELECTED ECONOMIC REGIONS AND COUNTRIES BY VARIOUS INSTITUTIONS**

*(Percentages <sup>a</sup>)*

<i>Region/country</i>	<i>IMF</i>	<i>World Bank</i>	<i>OECD</i>	<i>UN/LINK</i>	<i>J.P. Morgan</i>
<b>World</b>	2.2	1.9	2.1	2	1.0
<b>OECD</b>		1.6	1.7		0.9
Industrial countries	1.7			1½	
Major industrialized countries (G-7)	1.5	1.4	1.4	1½	0.8
United States	1.8	1.6	1.5	2¼	1.0
Japan	-0.5	-0.2	0.2	-1	0.0
European Union	2.2		2.2	2¼	
Euro area	2.4		2.5	2½	1.7
Germany	2.0		2.2	2¼	1.4
France	2.6		2.4	2½	1.6
Italy	1.9		2.1	2	1.8
United Kingdom	0.9		0.8	1½	-0.4
<b>Economies in transition</b>	-1.9	0.1		¾	-0.4 <sup>b</sup>
Central & Eastern Europe	2.2	4.0		3¼	
Russian Federation	-8.3		-6.0	-5	-5.9
<b>Developing countries</b>	3.5	2.7		3	
Africa	3.8	3.2 <sup>c</sup>		3½	3.8
Asia	4.3				3.0 <sup>d</sup>
Eastern & Southern Asia				4¼	
Excl. China				2¼	
Developing East Asia		4.8			
Excl. China		-0.4		1½	
Hong Kong, China	-1.0		1.5	0	-0.8
Republic of Korea	-1.0	1.0	0.5	1½	4.0
Singapore	-0.8		0.5	½	-1.0
Taiwan Province of China	3.9		4.0	5	3.2
ASEAN-4 <sup>e</sup>	-1.4	-0.5			-0.3 <sup>f</sup>
Indonesia	-3.4	-2.8	-3.0	-2	-3.5
Malaysia	-2.0	0.5	-0.5	1	-1.0
Philippines	2.5	2.5	2.0	2½	2.6
Thailand	1.0	0.3	2.0	-½	3.0
China	6.6		7.7	8	6.5
Latin America	1.5	0.6		1¼	-0.8
Argentina	3.0		1.5	2	0.0
Brazil	-1.0		-1.5	-1½	-4.3
Mexico	3.0		3.6	3	1.9

**Source:** IMF, *World Economic Outlook and International Capital Markets*, Interim Assessment, Washington, D.C., December 1998; World Bank, *Global Economic Prospects 1998/1999*, Washington, D.C., December 1998; OECD, *OECD Economic Outlook*, December 1998; UN/LINK; and J.P. Morgan, *World Financial Markets*, New York, 8 January 1999.

<sup>a</sup> Based on weights in terms of purchasing power parity in the case of IMF, World Bank and OECD, and in terms of exchange rates in the case of UN/LINK and J.P. Morgan.

<sup>b</sup> Bulgaria, Czech Republic, Greece, Hungary, Poland, Russia and Turkey.

<sup>c</sup> Sub-Saharan Africa

<sup>d</sup> China, Hong Kong (China), India, Indonesia, Republic of Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, and Thailand.

<sup>e</sup> Indonesia, Malaysia, the Philippines and Thailand.

<sup>f</sup> ASEAN-4 plus Singapore.

Table 3

<b>1999 GDP GROWTH OF SELECTED ECONOMIC REGIONS AND COUNTRIES UNDER THE LOW-CASE SCENARIO OF VARIOUS INSTITUTIONS</b>		
<i>(Percentages)</i>		
<i>Institution/region</i>	<i>Baseline</i>	<i>Low-case scenario <sup>a</sup></i>
<b>IMF</b>		
World	2.2	0.9
Industrial countries	1.7	0.4 <sup>b</sup>
Developing countries	3.5	2.0 <sup>c</sup>
<b>WORLD BANK</b>		
World	1.9	0.0
Major industrial countries (G-7)	1.4	-0.3
United States	1.6	-0.2
Japan	-0.2	-4.0
Major European Union economies <sup>d</sup>	2.1	1.9
<b>OECD</b>		
OECD countries	1.7	0.1 (0.6)
United States	1.5	-0.4 (0.4)
Japan	0.2	-2.4 (-2.2)
European Union	2.2	0.7 (1.0)
<b>UN/LINK</b>		
World	2.0	0.9
Developing countries	3.0	1.6

**Source:** IMF, *World Economic Outlook and International Capital Markets*, Interim Assessment, Washington, D.C., December 1998; World Bank, *Global Economic Prospects 1998/1999*, Washington, D.C., December 1998; OECD, *OECD Economic Outlook*, Paris, December 1998; UN/LINK.

**a** Figures in parentheses refer to an alternative and more optimistic scenario.

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

**c** Comprises all countries except the industrial countries.

**d** Germany, France, the United Kingdom and Italy.

**Table 4****EXPORTS AND IMPORTS BY MAJOR REGIONS AND ECONOMIC GROUPINGS,  
1996-1998***(Percentage changes in volume over previous year)*

	1996	1997	1998 <sup>a</sup>
World <sup>b</sup>	5.4	9.5	4.1
<b>Exports</b>			
Developed market-economy countries	4.2	9.2	4.6
<i>of which:</i>			
North America	6.2	10.9	4.4
Western Europe	3.9	8.4	6.4
Japan	0.6	9.6	-3.7
Developing countries	6.6	11.1	1.9
<i>of which:</i>			
Africa	8.0	3.9	0.3
Latin America	9.3	13.3	8.8
South and East Asia	6.0	10.3	1.0
China	2.4	26.4	4.6
<b>Imports</b>			
Developed market-economy countries	4.7	9.0	6.6
<i>of which:</i>			
North America	5.6	13.3	13.1
Western Europe	4.3	7.6	5.7
Japan	3.5	2.7	-10.0
Developing countries	8.5	11.1	-0.5
<i>of which:</i>			
Africa	3.4	8.2	2.4
Latin America	8.4	26.6	11.6
South and East Asia	8.1	8.4	-6.2
China	11.4	10.3	4.2

**Source:** UN/DESA, based on data of the United Nations regional commissions and the IMF.**a** Preliminary estimates.**b** Average of the growth of the volume of world exports and imports.

**Table 5****EXPORT AND IMPORT VOLUME OF SELECTED ASIAN ECONOMIES, 1996-1998***(Percentage change over previous year)*

<i>Country</i>	<i>Export volume</i>			<i>Import volume</i>		
	<i>1996</i>	<i>1997</i>	<i>1998<sup>a</sup></i>	<i>1996</i>	<i>1997</i>	<i>1998<sup>a</sup></i>
Indonesia	5.5	10.2	-9.4	7.8	17.2	-26.6
Republic of Korea	13.0	23.6	12.2	14.8	3.8	-20.8
Malaysia	7.2	8.8	-4.2	4.2	8.3	-19.8
Philippines	20.3	17.6	16.9	21.1	14.4	-12.6
Thailand	-1.8	6.6	4.6	-0.9	-10.0	-25.0

**Source:** IMF, "Economic and Financial Situation in Asia: Latest Developments", background paper prepared for presentation by Michel Camdessus, Managing Director of the International Monetary Fund, Asia-Europe Finance Ministers Meeting, Frankfurt, Germany, 16 January 1999.

**a** Estimates.

**Table 6**


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**EXPORTS AND IMPORTS OF SELECTED ASIAN ECONOMIES:  
FIRST THREE QUARTERS OF 1998 <sup>a</sup>**

*(Percentage change from the same quarter 1997)*

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	<i>Hong Kong, China</i>	<i>Indonesia</i>	<i>Japan</i>	<i>Republic of Korea</i>	<i>Malaysia</i>	<i>Philippines</i>	<i>Singapore</i>	<i>Taiwan Province of China</i>	<i>Thailand</i>
<b>Import value</b>									
<b>Q1</b>	-5.1	-31.3	-13.3	-35.5	-18.7	-5.9	-16.3	-5.4	-39.8
<b>Q2</b>	-6.1	-26.7	-19.4	-36.7	-33.1	-17.4	-24.4	-6.9	-38.2
<b>Q3</b>	-15.4	-46.4	-20.3	-39.6	-29.3	-10.6	-23.4	-15.4	-34.2
<b>Export value</b>									
<b>Q1</b>	-0.9	-1.0	-2.8	8.5	-11.3	23.8	-6.8	-0.3	-2.9
<b>Q2</b>	-3.2	-8.8	-12.2	-1.8	-9.6	14.4	-14.0	-7.8	-5.3
<b>Q3</b>	-10.3	-3.4	-13.1	-9.6	-10.0	15.2	-9.3	-9.6	-8.7
<b>Export volume</b>									
<b>Q1</b>	1.4	32.8	2.2	32.4	-	-	7.6	3.8	14.1
<b>Q2</b>	-0.5	19.1	-3.5	20.7	-	-	-2.1	0.8	12.8
<b>Q3</b>	-7.3	27.6	-1.6	11.4	-	-	-1.8	-	5.7

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**Source:** IMF, *World Economic Outlook and International Capital Markets*, Interim Assessment, Washington, D.C., December 1998, Table 4.5.

**a** In US dollar terms on a national accounts basis except for the Philippines, Singapore and Thailand where figures are on a balance-of-payments basis.

Table 7

<b>MOVEMENTS IN EXCHANGE RATES<sup>a</sup>, JUNE 1997 - SEPTEMBER 1998</b>			
<i>(Percentage changes of monthly averages)</i>			
<i>Country</i>	<i>Bilateral exchange rate with</i>		<i>Real effective exchange rate<sup>b</sup></i>
	<i>US dollar</i>	<i>Japanese yen</i>	
United States	-	17.6	10.5
Japan	-15.0	-	-9.6
Germany	0.9	18.7	2.1
France	1.6	19.5	2.0
United Kingdom	1.9	19.8	7.3
Italy	0.3	17.9	1.8
Canada	-9.2	6.8	-6.2
Australia	-21.9	-8.1	-16.9
New Zealand	-26.3	-13.3	-20.2
China	-	17.4	0.4
India	-15.9	-1.1	-6.3
Hong Kong, China	-	17.5	12.6
Republic of Korea	-33.8	-22.2	-23.7
Singapore	-17.6	-3.1	-8.2
Taiwan Province of China	-19.4	-5.2	-14.9
Indonesia	-77.7	-73.8	-58.0
Malaysia	-39.8	-29.2	-28.8
Philippines	-38.3	-27.5	-27.2
Thailand	-36.7	-25.6	-22.3
Argentina	-	17.7	3.4
Brazil	-5.8	10.8	0.2
Chile	-11.3	4.3	-2.4
Venezuela	-17.2	-2.6	28.0
Mexico	-22.2	-8.5	-4.4
Poland	-10.6	5.1	2.4
Hungary	-13.8	1.3	2.1
Turkey	-47.5	-38.3	19.8
South Africa	-27.0	-14.1	-21.1

**Source:** IMF, *World Economic Outlook*, Washington, D.C., September 1998.

**a** A negative sign signifies a depreciation of the currency of the country.

**b** Nominal trade-weighted exchange rates, deflated by consumer price indices. Partner country weights capture both bilateral and third-country effects based on data for 1988-1990.

**Table 8**

<b>CURRENT ACCOUNT POSITIONS OF SELECTED DEVELOPED AND DEVELOPING COUNTRIES, 1996-1998</b>			
<i>(Percentage of GDP)</i>			
<i>Region / country</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>
<b>Developed countries</b>			
United States	-1.8	-1.9	-2.7
Japan	1.4	2.2	3.4
European Union	1.0	1.5	1.2
Germany	-0.6	-0.2	0.1
France	1.3	2.8	2.1
Italy	3.3	2.9	2.5
United Kingdom	-0.2	0.6	-0.5
<b>Newly industrializing economies</b>			
Hong Kong, China	-1.1	-3.1	-
Republic of Korea	-4.7	-1.8	13.2
Singapore	15.9	15.4	19.2
Taiwan Province of China	4.0	2.7	2.0
<b>ASEAN</b>			
Indonesia	-3.3	-1.8	3.0
Malaysia	-4.9	-4.2	11.0
Philippines	-4.7	-5.2	1.2
Thailand	-7.9	-2.0	11.4
China	0.9	3.3	2.4
<b>Latin America</b>			
Argentina	-1.9	-3.5	-4.5
Brazil	-3.0	-4.1	-4.2
Chile	-5.4	-5.3	-6.8
Mexico	-0.7	-1.9	-3.5

**Source:** IMF, *World Economic Outlook and International Capital Markets*, Interim Assessment, Washington, D.C., December 1998, Table 4.10.



**Table 9**

**EXPORTS OF SELECTED ASIAN ECONOMIES TO NORTH AMERICA AND LATIN AMERICA, 1992-1996**

*(Period average percentage share of country's total exports)*

<i>From:</i>										
<i>To:</i>	<i>Japan</i>	<i>China</i>	<i>Hong Kong, China</i>	<i>Indonesia</i>	<i>Republic of Korea</i>	<i>Malaysia</i>	<i>Philippines</i>	<i>Singapore</i>	<i>Taiwan Province of China</i>	<i>Thailand</i>
North America	32.5	25.4	18.7	16.8	24.7	21.7	38.5	20.5	29.4	21.6
United States	28.6	22.4	16.5	15.0	20.1	19.8	36.6	19.1	25.8	19.7
Canada	1.6	1.6	1.1	0.9	1.4	0.8	1.3	0.5	1.9	1.2
Latin America	2.4	1.5	1.2	0.9	3.1	1.1	0.5	0.9	1.7	0.6
Argentina	0.2	0.3	0.2	0.1	0.4	0.1	0.0	0.2	0.2	0.1
Brazil	0.5	0.4	0.4	0.2	0.9	0.4	0.1	0.3	0.4	0.2
Chile	0.2	0.3	0.2	0.1	0.5	0.1	0.1	0.1	0.2	0.1
Colombia	0.2	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.1	0.0
Ecuador	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Mexico	1.0	0.3	0.2	0.4	1.0	0.4	0.2	0.2	0.7	0.2
Peru	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Venezuela	0.1	0.1	0.0	0.0	0.2	0.0	0.0	0.0	0.1	0.0

**Source:** J.P. Morgan, *Global Data Watch*, New York, 22 January 1999.

Table 10

<b>WORLD PRIMARY COMMODITY PRICES, 1995-1998</b>					
<i>(Percentage change over previous year)</i>					
<i>Commodity group</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>Nov. 1998<sup>a</sup></i>	<i>Nov. 1998<sup>b</sup></i>
<b>All commodities<sup>c</sup></b>	<b>9.9</b>	<b>-4.2</b>	<b>0.0</b>	<b>-13.5</b>	<b>-18.4</b>
<b>Food and tropical beverages</b>	<b>4.5</b>	<b>2.1</b>	<b>2.1</b>	<b>-18.5</b>	<b>-20.1</b>
<i>Tropical beverages</i>	1.1	-15.2	33.3	-26.9	-33.3
Coffee	0.7	-19.1	54.7	-34.4	-47.6
Cocoa	2.7	1.2	11.2	-8.2	-5.5
Tea <sup>d</sup>	-	9.9	41.5	-13.9	9.2
<i>Food</i>	5.9	6.8	-4.0	-16.9	-15.9
Sugar	10.8	-9.9	-4.9	-34.6	-29.5
Beef	-31.2	-6.4	4.0	-10.3	-5.6
Maize	15.5	25.0	-25.3	-14.8	-14.7
Wheat	18.5	16.2	-22.6	-8.2	-9.5
Rice	-10.1	5.0	-10.7	2.3	-14.8
Bananas	0.1	7.5	4.3	38.0	9.4
<b>Vegetable oilseeds and oils</b>	<b>10.3</b>	<b>-4.2</b>	<b>-0.9</b>	<b>8.0</b>	<b>13.0</b>
<b>Agricultural raw materials</b>	<b>15.0</b>	<b>-9.9</b>	<b>-10.3</b>	<b>-4.1</b>	<b>-14.1</b>
Hides and skins	4.3	-23.7	-19.8	-44.6	-42.9
Cotton	27.1	-14.1	-9.0	-7.5	-13.0
Tobacco	-11.2	15.6	15.5	-11.6	-11.0
Rubber	38.6	-11.9	-28.3	-4.8	-36.7
Tropical logs	5.4	-20.1	-5.5	5.6	3.3
<b>Minerals, ores and metals</b>	<b>20.2</b>	<b>-12.1</b>	<b>0.0</b>	<b>-9.4</b>	<b>-23.7</b>
Aluminium	22.3	-16.6	6.2	-15.4	-17.4
Phosphate rock	6.1	8.6	7.9	4.9	4.9
Iron ore	5.8	6.0	1.1	2.8	2.8
Tin	13.7	-0.8	-8.4	-0.6	-1.6
Copper	27.2	-21.8	-0.8	-10.7	-39.7
Nickel	29.8	-8.8	-7.6	-30.5	-41.5
Tungsten ore	49.6	-17.9	-9.3	-6.5	-14.0
Lead	15.2	22.7	-19.4	-6.1	-19.6
Zinc	3.4	-0.6	28.4	-12.3	-28.6
<b>Crude petroleum</b>	<b>9.3</b>	<b>20.8</b>	<b>-6.0</b>	<b>-30.9</b>	<b>-33.7</b>

*Source:* UNCTAD, *Monthly Commodity Price Bulletin*, various issues.

*a* Change from December 1997.

*b* Change from June 1997.

*c* Excluding crude petroleum.

*d* New series with data starting in 1995.

*Table 11*

**EAST ASIAN PRODUCTION AND CONSUMPTION OF MAJOR COMMODITIES**

<i>Region/country</i>	<i>Aluminium</i>	<i>Copper</i>	<i>Lead</i>	<i>Nickel</i>	<i>Tin</i>	<i>Zinc</i>	<i>Oil</i>	<i>Coal</i>	<i>Rubber</i>	<i>Cereals</i>	<i>Sugar</i>	<i>Oil-crops</i>	<i>Wood</i>
<b>Output</b> ( <i>percentage share of world total</i> )													
ASEAN-4 and Rep. of Korea	1.0	5.4	0.3	9.1	29.2	0.4	3.1	1.5	75.5	4.3	7.9	25.2	17.3
Japan	0.1	0.0	0.2	0.0	0.0	1.0	0.0	0.1	0.0	0.5	0.3	0.1	4.1
China	9.4	3.7	17.5	4.7	26.5	12.1	4.6	30.1	6.1	17.9	5.9	10.1	10.7
East Asia <sup>a</sup>	10.5	9.1	18.0	13.8	55.7	13.5	7.7	31.8	81.6	22.7	14.1	35.3	32.4
<b>Consumption</b> ( <i>percentage share of world total</i> )													
ASEAN-4 and Rep. of Korea	5.6	8.7	8.7	6.9	11.2	7.7	6.7	2.3	19.2	5.3	8.0	25.1	9.8
Japan	11.2	11.4	5.6	18.3	12.3	9.7	7.8	3.9	11.4	2.0	0.3	1.8	7.7
China	9.6	8.1	7.3	3.8	13.9	10.4	5.5	29.7	15.5	22.2	5.9	10.8	12.7
East Asia <sup>a</sup>	29.4	33.7	24.3	36.7 <sup>b</sup>	42.2	31.1	22.3	37.1	46.2	29.5	14.2	37.7	31.3

**Source:** The World Bank, *Commodity Markets and the Developing Countries*, Washington, D.C., August 1998, Tables 3 and 4.

<sup>a</sup> China, Hong Kong (China), Indonesia, Japan, Republic of Korea, the Philippines, Singapore, Taiwan Province of China, Thailand.

<sup>b</sup> Excluding Republic of Korea.

Table 12

ESTIMATES AND FORECASTS OF NET CAPITAL FLOWS TO DEVELOPING AND TRANSITION ECONOMIES								
<i>(Billions of US dollars)</i>								
Source/type/region	Total				Change over previous year			
	1996	1997	1998 <sup>a</sup>	1999 <sup>b</sup>	1997	1998 <sup>a</sup>	1999 <sup>b</sup>	
<b>J.P. Morgan</b>								
<b>Total net capital inflows</b>	317	283	150	119	-34	-133	-31	
<i>Net debt inflows</i>	183	141	41	1	-42	-100	-40	
Medium and Long-term	132	184	107	22	52	-77	-85	
Short-term	51	-43	-66	-20	-94	-23	46	
<i>Net equity inflows</i>	133	141	109	117	8	-32	8	
Net portfolio investment	19	0	-10	18	-19	-10	28	
Net direct investment	114	141	119	99	27	-22	-20	
Asia	171	109	48	27	-62	-61	-21	
Latin America	82	90	78	54	8	-12	-24	
Europe and Africa	64	83	23	38	19	-60	15	
<b>Institute of International Finance</b>								
<b>Private flows, net</b>	326.8	259.6	151.9	140.0	-67.2	-107.7	-11.9	
<i>Equity investment</i>	130.5	140.5	113.3	122.6	10.0	-27.2	9.3	
Direct Equity	94.8	116.5	111.0	103.9	21.7	-5.5	-7.1	
Portfolio Equity	35.7	24.0	2.4	18.7	-11.7	-21.6	16.3	
<i>Private creditors</i>	196.3	119.1	38.6	17.4	-77.2	-80.5	-21.2	
Commercial banks	121.0	24.8	-9.7	-8.2	-96.2	-34.5	1.5	
Non-bank private creditors	75.2	94.3	48.3	25.6	19.1	-46.0	-22.7	
Latin America	104.2	106.4	87.6	54.0	2.2	-18.8	-33.6	
Europe <sup>c</sup>	44.5	67.5	44.1	44.2	23.0	-23.4	0.1	
Africa / Middle East <sup>c</sup>	6.2	16.9	8.7	12.8	10.7	-8.2	4.1	
Asia / Pacific	169.7	68.4	15.8	32.5	-101.3	-52.6	16.7	
Five Asian economies <sup>d</sup>	103.2	-1.1	-28.3	-4.8	-104.3	-27.2	23.5	

**Source:** J.P. Morgan, *World Financial Markets*, New York, January 1999; Institute of International Finance, *Capital Flows to Emerging Market Economies*, Washington, D.C., 29 September 1998 and 27 January 1999.

**a** Estimate.

**b** Forecast.

**c** Refers to figures from the IIF September 1998 publication.

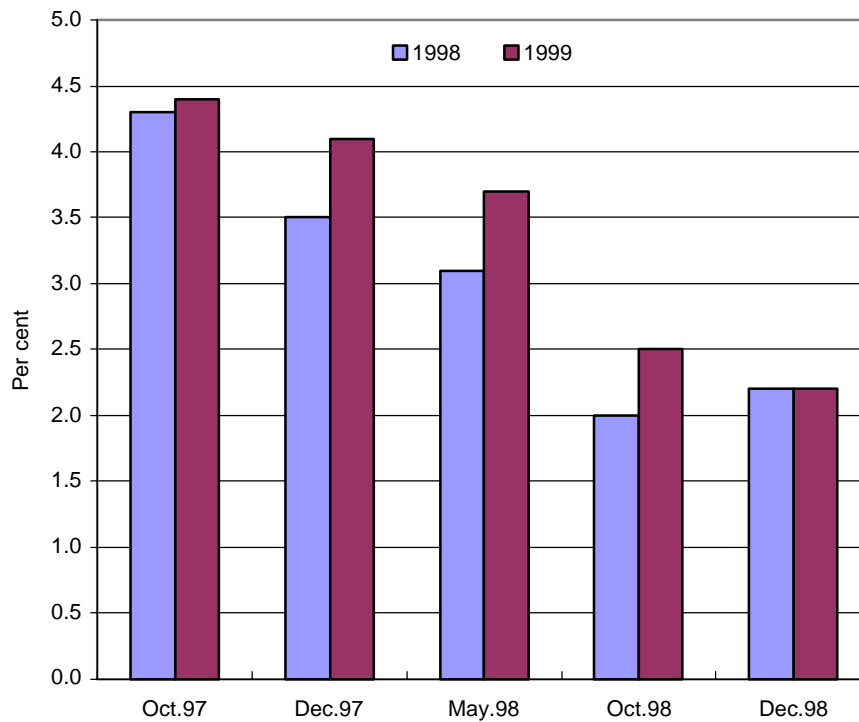
**d** Indonesia, Republic of Korea, Malaysia, the Philippines, Thailand.

*Chart 1*

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**IMF REVISIONS TO WORLD GROWTH PROJECTIONS <sup>a</sup>***(Percentage change in world real GDP)*

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**Source:** IMF, *World Economic Outlook and International Capital Markets*, Interim Assessment, Washington, D.C., December 1998.

**a** Date refers to when IMF's *World Economic Outlook* was issued.

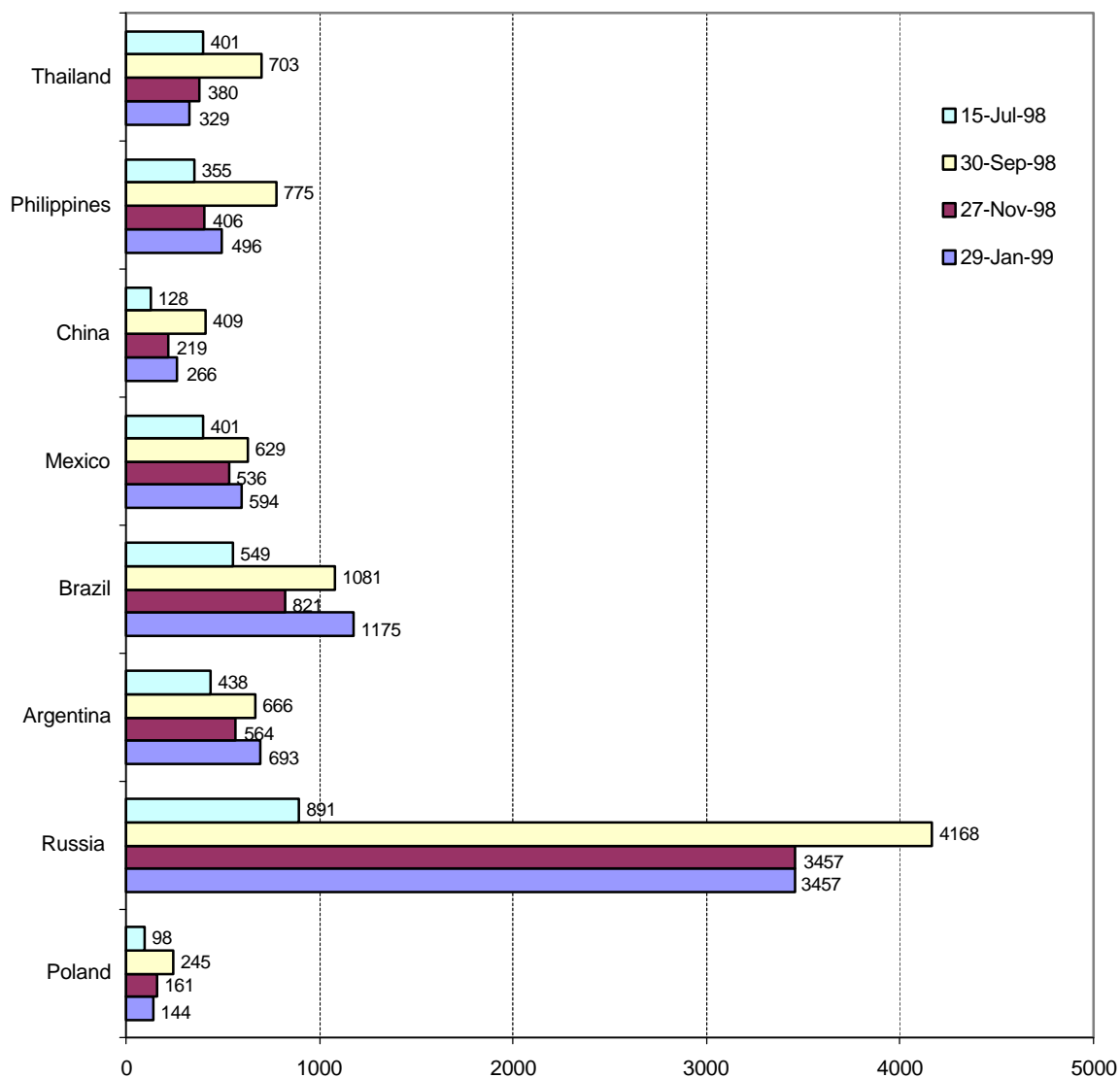
Chart 2

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**SELECTED INTERNATIONALLY ISSUED EMERGING MARKETS BONDS:  
YIELD SPREAD <sup>a</sup> OVER UNITED STATES TREASURY BONDS**

(Basis points <sup>b</sup>)

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**Source:** *Financial Times*, various issues.

**a** Differential between the yield on bonds issued by the borrowing country and those of the same maturity issued by the government of the country in whose currency the borrower's bonds are denominated.

**b** 1/100th of one per cent.