Chapter I

THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS

A. Global trends

1. World output

The East Asian crisis has come at a time when certain weaknesses and imbalances in the global economy were also prevalent. Before the crisis, global growth depended on expansion in the United States and East Asia. With the notable exceptions of China and its Taiwan Province, the fast-growing economies of East Asia, together with the United States, were the major contributors to global demand, running large external deficits financed by private capital inflows. In virtually all industrial countries except the United States and the United Kingdom exports were the engine of faster growth, especially so in Japan and continental Europe, where domestic demand was sluggish owing to restrictive fiscal policies. These disparities were reflected in increased exchange rate instability and trade imbalances, with Western Europe and Japan running large surpluses.

In East Asia the attempt to adjust exchange rates and reduce external deficits to sustain rapid growth has had the opposite effect: it has eliminated or reduced the deficits but only by disrupting growth. The East Asian crisis has thus increased the magnitude of the global demand gap and produced even greater trade imbalances and currency volatility. The policy response, in turn, has done nothing to alleviate the risks to global trade and growth posed by these imbalances; rather, it has tended to accentuate them.

The direct impact of the Asian crisis on global economic developments was not significant in 1997, although growth in the East Asian countries dropped sharply in the last quarter of the year. Slower growth in Asia and Africa was more than offset by accelerated growth in other countries and regions. Growth in world output increased slightly in 1997, to reach 3.2 per cent (table 1), while inflation remained low in most countries at levels not experienced since the 1950s – in large part owing to a continued decline in commodity prices, notably the price of oil.

Growth in developed market economies registered only a slight improvement in 1997, reaching 2.7 per cent, and was largely due to an acceleration of growth in the United States. Improvements in economic conditions in the European Union, where the larger members had been struggling to initiate a sustained recovery, was also a contributory factor. Exports remained the major source of demand growth in the European Union, although investment demand had started to recover in a number of countries. By contrast, growth continued to be erratic in Japan, falling from 3.9 per cent in 1996 to less than 1 per cent in 1997.

For the transition economies of Central and Eastern Europe, 1997 marked the very first year of positive growth for the region as a whole since 1989, though performance continued to diverge widely among countries. In the Russian Federa-

Table 1

WORLD OUTPUT, 1990-1998

(Percentage changes over previous year)

Region/country	*1990-1995*	*1996*	*1997*[a]	*1998*[b]
World	1.9	3.0	3.2	2.0
Developed market-economy countries	1.7	2.5	2.7	1.8
of which:				
United States	2.3	2.8	3.8	2.3
Japan	1.4	3.9	0.9	-1.3
European Union	1.3	1.7	2.5	2.6
of which:				
Germany	1.7	1.4	2.2	2.3
France	1.1	1.5	2.4	2.5
Italy	1.1	0.7	1.5	2.2
United Kingdom	1.2	2.2	3.3	2.1
Transition economies	-8.2	-1.6	1.4	2.2
Developing countries	4.9	5.9	5.4	2.3
of which:				
Latin America	3.3	3.6	5.2	3.1
Africa	1.1	4.6	3.3	3.7
Asia	6.4	7.1	5.9	1.8
of which:				
China	12.4	9.6	8.8	6.0
Other countries	5.1	6.4	5.0	0.5
Memo item:				
Developing countries, excluding China	4.0	5.3	4.9	1.7

Source: UNCTAD secretariat calculations, based on data in 1990 dollars.
a Estimate.
b Forecast.

tion the contraction of the economy appeared to be coming to an end, although contagion from the Asian crisis will probably prevent any significant expansion. In 1997 growth averaged only a little over 1 per cent, nevertheless constituting a significant improvement on the nearly 2 per cent decline in 1996.

In contrast to both the developed and the transition economies, growth in developing countries as a whole declined in 1997, in part as a consequence of the financial turmoil in East Asia. Nevertheless, at 5.4 per cent, it was still far above the rates attained in those economies. Growth slowed down in China, but the decline was even more pronounced in the Asian countries hit by the financial crisis. Growth in Africa also fell sharply, to a level barely adequate to keep pace with population, because of declining commodity prices and adverse weather conditions, as well as continued civil strife in some countries. Unlike in the other developing regions, economic performance in Latin America in 1997 was the best for a quarter of a century. Continued expansion of exports and a strong recovery in investment resulted in an acceleration of growth, which reached 5.2 per cent in 1997, while price stability was consolidated with a decline in the rate of inflation.

2. World trade

The volume of world exports rebounded to an impressive increase of 9.5 per cent in 1997, after slowing down from 9.0 per cent in 1995 to 5.0 per cent in 1996 (table 2); in value terms the expansion was only one third as high. As a consequence, the divergence which has been evident between the growth trend of world trade and that of world output in recent years widened further. The stronger than expected volume growth of world exports in 1997 is the second highest in more than two decades and comes close to the record rate of 10 per cent in 1994. With the exception of African exports and Chinese imports, there was a widespread acceleration, at varying rates, in the volume growth of individual countries' and regions' exports and imports. Latin American imports in particular grew by over 21 per cent because of strong GDP growth, compared with 12.5 per cent for exports. For the same reason, the growth rates of both export and import volume in the United States reached double digits (12 per cent). Also notable is the performance of the European Union, where exports grew faster than imports, and that of the transition economies, where imports grew faster than exports.

Of particular significance in 1997 is the recovery of growth in export volume in Japan and other Asian countries, and more so in China, where exports rose by over 20 per cent, compared with a reduction of 1 per cent the previous year. Japan, China, and South and East Asia all had rates of growth of exports exceeding that of imports. And despite the slump in GDP growth in Japan and the countries affected by the financial crisis, there was a slight increase in the rate of import growth in all these developing countries of Asia, except China.

For 1998, expectations are for a reduced expansion of world trade. The outcome, however, is clouded by uncertainties, especially those relating to an export-led recovery in Asia. For the most affected Asian economies, the sharp fall in their real effective exchange rates and the existence of spare production capacity, together with sound economic fundamentals and past performance records, argue in favour of a reasonably strong export-led recovery. On the other hand, there are offsetting factors such as higher import costs and a severe liquidity crisis and credit crunch. Currently discernible in these countries are a greater contraction of imports and a lack of any significant

Table 2

EXPORTS AND IMPORTS BY MAJOR REGIONS AND ECONOMIC GROUPINGS, 1995-1997

(Percentage changes in volume over previous year)

	1995	*1996*	*1997*
Exports			
World	9.0	5.0	9.5
Developed market-economy countries	7.6	4.2	8.8
of which:			
Japan	4.0	-0.5	9.5
United States	8.7	6.3	11.9
European Union	8.5	4.0	8.0
Transition economies	17.5	7.5	11.0
Developing countries	11.5	6.0	11.5
of which:			
Africa	5.0	7.0	5.5
Latin America	12.0	11.0	12.5
South and East Asia	13.0	6.5	10.5
China	17.5	-1.0	20.5
Memo item:			
Six major East Asian economies[a]	14.5	6.5	10.0
Imports			
World	9.0	5.0	9.0
Developed market-economy countries	8.2	3.8	7.9
of which:			
Japan	12.5	2.0	2.5
United States	7.0	5.7	12.0
European Union	7.5	2.5	6.5
Transition economies	17.0	14.5	16.0
Developing countries	11.0	6.5	10.0
of which:			
Africa	6.5	0.5	11.5
Latin America	3.0	11.5	21.5
South and East Asia	15.5	5.5	6.5
China	9.0	7.0	5.0
Memo item:			
Six major East Asian economies[a]	15.5	4.5	5.5

Source: WTO Press Release, 19 March 1998, table 2; UNCTAD secretariat estimates.

a Hong Kong, China; Republic of Korea; Malaysia; Singapore; Taiwan Province of China; Thailand.

expansion of exports. The behaviour of imports is perhaps to be expected in view of the experience of previous episodes of large devaluations, when imports first contracted before expanding. The behaviour of exports, however, appears to be a departure from the previous experiences of rapid recovery, which tended to continue for about three years after devaluation.

The effects of the crisis differ considerably among the most severely affected countries, and there is the potential for spillover in various ways into other countries and the world economy in general. As a group, the five most affected countries (Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand – hereafter referred to as Asia-5) account for only a relatively modest share of global economic activity. In 1996, for instance, they accounted for 3.6 per cent of output, around 7 per cent of both exports and imports, 6 per cent of FDI inflows, 4 per cent of FDI stocks and less than 4 per cent of gross international bank lending. In terms of trade flows, these five countries accounted for less than 10 per cent of the exports or imports of countries outside Asia. Their share in both imports and exports was 2.5 per cent in the EU, but around 8.5 per cent in the United States. Hence a substantial change in the economic performance of these countries is unlikely to have a major impact on the trade and growth of countries outside Asia.

However, the Asia-5 countries constitute a key part of the trade-investment network in the Asian region. Their shares in the exports of Japan, China and Singapore, for instance, are considerably higher than those of the United States, and they also trade intensively with one other. The crisis is affecting seriously all the countries in the region which, taken together, have provided an important impetus to the expansion of global output and trade in recent years. Therefore, as discussed in greater detail in chapter II, the implications of the crisis for global trade can go well beyond what might be expected on the basis of the relative importance in the world economy of the countries suffering from the financial crisis.

3. Commodity markets

In 1997, while non-oil primary commodity prices remained at the same level as in the previous year, prices of both oil and manufactured products fell by some 6 per cent (table 3). Underlying the apparently stable price for non-oil commodities was a sharp increase in the prices of tropical beverages, in contrast to falling prices for agricultural raw materials. While there was an increase in the prices of commodities that had suffered significant damage from unfavourable climatic conditions caused by El Niño, commodity prices in general were on a declining trend. During 1985-1997, the rise in non-oil primary commodities as a group was a mere 2.2 per cent per annum in current dollar terms, giving a yearly decline of 0.5 per cent in real terms. The decline in real terms was particularly pronounced for all the major tropical beverages (coffee, cocoa and tea) and some metals (particularly tin and tungsten). Despite recovery in both nominal and real terms during the 1990s, prices of non-oil commodities remained relatively depressed.

Worth noting is the apparent lack of correspondence between commodity prices and industrial demand during the current cycle. Prices of agricultural raw materials, for instance, declined by around 10 per cent in 1997 even though GDP in developed market-economy countries grew by 2.7 per cent. In contrast, when GDP in those economies grew by 3 per cent in 1994, there was an increase of 14.6 per cent in the prices of agricultural raw materials. While it is evident that some commodities were in ample supply (sugar, for instance), the relatively low rate of inflation in developed economies was a disincentive to speculative buying of commodities, as was the sharp appreciation of the dollar in both 1996 and 1997 after relative stability during the first half of the 1990s.

Oil prices in 1997 started to decline later than prices of most other primary commodities. There were various contributory factors in addition to a slowing of demand growth in a number of countries affected by the Asian crisis. An unseasonably warm winter in the Northern Hemisphere reduced the demand for heating oil, while there was a marked expansion in supplies, particularly in OPEC member countries where a 10 per cent increase in quotas was approved in November 1997, and a considerable build-up of inventories – from the previous year – of crude and oil products at all stages of the marketing chain.

While the prices of agricultural commodities appeared to have more or less stabilized, albeit at lower levels than those prevailing in mid-1997,

Table 3

WORLD PRIMARY COMMODITY PRICES, 1995-1998

(Percentage changes over previous year)

Commodity group	*1995*	*1996*	*1997*	*April 1998*[a]
All commodities[b]	**9.9**	**-4.2**	**0.0**	**-4.5**
Food and tropical beverages	**4.5**	**2.1**	**2.1**	**-6.9**
Tropical beverages	1.1	-15.2	33.3	-11.5
Coffee	0.7	-19.1	54.7	-15.3
Cocoa	2.7	1.2	11.2	-0.6
Tea	-10.3	8.8	25.8	15.5
Food	5.9	6.8	-4.0	-6.1
Sugar	10.8	-9.9	-4.9	-25.1
Beef	-31.2	-6.4	4.0	-3.1
Maize	15.5	25.0	-25.3	-9.5
Wheat	18.5	16.2	-22.6	-8.9
Rice	-10.1	5.0	-10.7	17.8
Bananas	0.1	7.5	4.3	49.3
Vegetable oilseeds and oils	**10.3**	**-4.2**	**-0.9**	**9.7**
Agricultural raw materials	**15.0**	**-9.9**	**-10.3**	**-2.5**
Hides and skins	4.3	-23.7	-19.8	-10.5
Cotton	22.3	-17.4	-1.5	-13.3
Tobacco	-11.2	15.6	15.5	-1.3
Rubber	38.6	-11.9	-28.3	1.0
Tropical logs	5.4	-20.1	-5.5	-2.0
Minerals, ores and metals	**20.2**	**-12.1**	**0.0**	**-1.7**
Aluminium	22.3	-16.6	6.2	-7.3
Phosphate rock	6.1	8.6	7.9	0.0
Iron ore	5.8	6.0	1.1	2.8
Tin	13.7	-0.8	-8.4	3.6
Copper	27.2	-21.8	-0.8	2.2
Nickel	29.8	-8.8	-7.6	-9.3
Tungsten ore	49.6	-17.9	-9.3	0.0
Crude petroleum	**9.3**	**20.8**	**-6.0**	**-21.4**
Memo item:				
Manufactures[c]	**11.1**	**-3.6**	**-5.7**	**..**

Source: UNCTAD, *Monthly Commodity Price Bulletin*, various issues; United Nations, *Monthly Bulletin of Statistics*, various issues.

a Change from December 1997.

b Excluding crude petroleum.

c Unit value index of exports of manufactures from developed market-economy countries.

most metal prices and the price of petroleum continued to decline until April 1998. The problems faced by commodity markets have been compounded by the adverse effects of the Asian crisis. From June 1997 to April 1998, non-oil commodity prices declined on average by 10.6 per cent, with larger falls in agricultural raw materials (12.0 per cent) and metals (17.3 per cent) than in food and beverages (10.1 per cent). The corresponding decline in the price of oil was 24.6 per cent. To a large extent, these price falls were associated with the Asian crisis, notably in the case of copper, nickel and natural rubber. 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, which are supplied by other developing countries. Many of them are also major commodity suppliers. The ASIA-5 are in fact themselves major exporters of a wide range of food items and agricultural raw materials, such as vegetable oilseeds and oils, coffee, bananas, tea, cocoa beans, natural rubber, tin and copper.

While lower oil prices will benefit oil-importing developing countries, some 25 developing countries are dependent on petroleum for 20 per cent or more of their foreign exchange earnings. Again, the decline in commodity prices in general will help to keep inflation down in developed countries, but as discussed in greater detail in chapter II, it will adversely affect a large number of developing countries highly dependent on commodity export earnings.

B. Regional economic performance and short-term prospects

The impact of the Asian crisis is the major factor responsible for the expected slowdown in the growth of the world economy in 1998. As the effects of the Asian turmoil continued to unfold, the forecasts for 1998 made by international and national organizations as well as other institutions were subject to continuous downward revision (see also box 1). For example, the IMF reduced its forecast of global output growth for 1998 from 4.3 per cent in its *World Economic Outlook* of October 1997 to 3.5 per cent in its *Interim Assessment* in December of the same year. A further revision in its *World Economic Outlook* of May 1998 brought the rate down to 3.1 per cent. Continual downward revisions of such magnitude within a period of only a few months bear witness to the significance of the Asian developments for global growth and to uncertainties about the depth of the crisis and the impact of the policies adopted in response. The downward revisions in GDP growth forecasts have been more substantial for developing than for developed countries. Indeed, developing countries are expected to be affected more than the developed countries by adverse movements in trade volumes and prices. Moreover, a number of developing countries have been responding to the crisis by pre-emptive monetary and fiscal tightening designed to maintain market confidence and reduce their vulnerability to an interruption of capital inflows.

1. Developed market-economy countries

(a) United States

Now in its eighth year of growth, the United States economy must normally be considered to be in the late stages of a long cyclical expansion when the growth of output should be declining. Yet growth rose by a full percentage point to 3.8 per cent in 1997, driven by strong private sector demand. Domestic demand grew even faster, but because of the deterioration of the current account, the growth of output remained below that of domestic demand. The external balance was greatly influenced by a continuation of the tendency of the dollar to appreciate; in real effective terms the exchange rate of the dollar reached its highest level since 1986. Growth was also dampened by the continued increase in the fiscal surplus.

Despite growth well above official estimates of trend potential, and a gradual increase in real wages, inflation continued to lessen in 1997, thanks

to the strength of the dollar and the fall in the prices of oil and other commodities, as well as an improvement in productivity. With stable nominal interest rates since spring 1997, the decline in inflation has produced a moderate increase in real interest rates which has also served to slow expansion. Strong growth and low inflation have continued to support the continued rapid rise in equity prices, despite admonitions from the Chairman of the Federal Reserve that markets should guard against irrational exuberance. The strong performance of stock prices has helped to improve fiscal balances by increasing capital gains tax receipts. In addition, it has had a positive impact on growth by lowering the cost of capital and stimulating consumer expenditures. However, equity prices have now reached the level where they are susceptible to substantial short-term correction or contagion from the worsening of economic conditions in East Asia. While this could produce a contraction of domestic demand by reducing household wealth and increasing financing costs, such effects would be partly offset by reduced tax payments worsening the fiscal balance.

In 1998 the adjustment process in East Asia is expected to increase the United States payments deficit substantially. A large build-up in inventories at the beginning of the year, together with a continued increase in the fiscal surplus, expected to reach $40 billion in the current fiscal year, will all cause growth to slow. However, United States GDP growth is expected to fall back only to 2.3 per cent, since part of the negative impact from East Asia has been offset by declining petroleum and commodity prices which have brought about an improvement in the terms of trade. Following an expansion in the first quarter of 5.4 per cent at an annual rate, growth is expected to slow dramatically in the second half of the year. Signs of impending slowdown in the economy are evident from the fall in corporate profits in the last quarter of 1997, down by 2.3 per cent at a quarterly rate from the previous quarter. This decline continued at about the same pace in the first quarter of 1998, and is beginning to be reflected in increased volatility of equity prices. Thus, although the forces sustaining growth are relatively strong, there are substantial risks represented by the negative impact on domestic demand growth of a possibly sharp correction in equity values and the drag produced by the fiscal surplus and external deficit. Should such forces prevail and come on top of a deepening of deflation in East Asia, the economy may have a rougher landing than currently foreseen.

(b) Japan

The attempt to reduce the fiscal deficit, and the effects of the East Asian crisis, were too much for the fragile recovery in the Japanese economy during late 1996 and early 1997. Growth had been strong in the first quarter of 1997 as a result of an increase in consumer spending in anticipation of the restoration of value-added taxes on consumption expenditures. There was consequently a sharp decline in subsequent quarters that was aggravated by the continued weakness of the financial system, resulting in the closure of several well-known large banks and brokerage houses. The fall in consumption was also due to the slower growth of nominal labour compensation from 3.6 per cent on an annual basis in the third quarter of 1997 to only 1.2 per cent in the first quarter of 1998. It is likely that this reflects a decline in profits-linked bonus payments, indicating weakness in the manufacturing sector. Both business and public investment had fallen by the end of the year. The latter reflects the absence of special government budget measures, which caused a sharp fall-off in construction activity and added further to deflationary pressures. Unlike in 1996, the economy did not recover in the last quarter, as the impact of the East Asian crisis started to be felt. By the spring of 1998 unemployment had risen to 4.1 per cent, and imports contracted more rapidly than exports as the economy slipped into outright recession.

In late December 1997, the authorities announced a series of measures designed to restore confidence, including a temporary tax cut of 2 trillion yen and the provision of public funds amounting to 6 per cent of GDP to protect depositors of failed institutions and to recapitalize weak but solvent banks. Because of concern that the increased stringency of capital requirements due to be announced in April was causing banks to reduce lending, a proposal was made to channel 2.4 per cent of GDP from the Fiscal Investment and Loan Programme through state-owned financial institutions to small and medium-sized enterprises facing difficulty in borrowing from commercial banks.

Increasing international pressure on Japan to use fiscal policy to stimulate domestic demand as the economy entered recession, together with chronic yen weakness, led to the announcement in June 1998 of a new fiscal stimulus package, including another 2 trillion yen in temporary tax reductions and an increase in total public works

Box 1

INTERNATIONAL COMPARISON OF GDP ESTIMATES

The conceptual difficulties and limitations of using national accounts statistics to measure economic growth are well known: they reflect only economic, and not social, costs or values and have little to say about output composition, income distribution or the quality of life. In measuring the *change* in the level of economic activity over time, further complications arise from (a) changes in definitions used; (b) changes in prices of products and services; and (c) changes in the quality of available products and services. Depending on the period in question, changes in technology, resources, tastes and institutional structure may also be relevant. In addition, there are alternative index-number formulas as well as growth-rate formulas that can be used for computing the average growth rates over a given period.

Real GDP has traditionally been measured by using the prices of a particular base year to calculate value-added in each sector and aggregating to obtain total GDP. This fixed base-year method is simple to use and yields a measure of real GDP that equals the sum of its components, so that it is easy to gauge the relative importance of a given sector in the economy. Such a measure of aggregate real output is obviously dependent not only on the distribution of production by sector, but also on the distribution of prices by sector in the base year. It follows that, especially in periods of substantial structural change, the entire history of real GDP growth changes every time the base year changes.[1]

For the purpose of aggregation across countries to derive regional or group totals, it is necessary to convert the value of each country's output into a common currency. Traditionally, market exchange rates have been used for this purpose. The set of exchange rates used affects not only the relative weights of individual countries, but also the dollar value of the aggregate and thus the rate of growth. The choice of a given base year should avoid periods of abnormally high dollar exchange rates or large external imbalances and that is why in some cases period averages are used.

Available studies have shown that market exchange rates may, for a variety of reasons, fail to reflect properly the relative purchasing power over domestic goods among economies, even those with uniform and stable exchange rates. Factors responsible for this failure include speculative bubbles, exchange market interventions, asymmetrical speed of adjustment in goods and asset markets, macroeconomic shocks, and significant discrepancies in the relative prices of traded and non-traded output, which are a feature of most developing countries.

Studies show a tendency for official exchange rates to understate the purchasing power of national currencies to a relatively greater extent in countries with a low per capita GDP than in those with a high one. Thus, the conversion of GDP into dollars using market exchange rates when aggregating national data would tend to understate the dollar value of output in low-income countries relative to that in high-income countries. China provides a striking example. Although its average real growth during 1970-1990 was more than double that of the world economy, its share of world output in 1990, calculated on the basis of the market exchange rate, was less than in 1970 because of the substantial depreciation of the yuan over this period.[2]

In response to the need for more satisfactory international comparisons of output, the International Comparisons Project (ICP)[3] developed a methodology for computing benchmark indices which can be used to convert time series of GDP in constant dollars into "international dollars", so that the output of each country in each year is expressed in a common set of international prices representing purchasing power parity in the base year. To obtain a more accurate measure of the relative sizes of economies, the IMF decided to use weights based on purchasing power parity (PPP) for the purpose of aggregating the GDP of individual countries, beginning with its *World Economic Outlook* of May 1993. The PPP-based weights were derived from PPP estimates of GDP made by the ICP, supplemented by the World Bank and IMF staff estimates for countries not covered by that project.

Such PPP-based weights, derived from *estimates* of PPP rather than from data for exchange rates, are open to criticism on a number of technical grounds. Nevertheless, the IMF considered the bias associated with the weights based on PPP to be less than that stemming from weights based on market exchange rates. The differences in GDP weights for 1990 between using exchange rates derived from a three-year moving average for 1987-1989 and PPP are striking. The shares of industrial countries and

Box 1 (concluded)

developing countries were respectively 73.2 per cent and 17.7 per cent on the basis of market exchange rates but 54.5 per cent and 34.4 per cent in PPP terms.[4] Among the industrial countries, particularly sharp was the reduction in the relative importance of the Japanese economy (from 14.6 per cent to 7.6 per cent) and to a lesser extent that of the United States economy (from 26.7 per cent to 22.5 per cent). Among developing regions, the gain in relative importance was particularly striking for Asia (from 7.3 per cent to 17.7 per cent), owing in part to the greater weight of China in PPP terms.

With respect to the difference in terms of the implication for GDP growth between the two methods, the use of PPP-based weights logically led to a somewhat stronger growth of the world economy during 1983-1992 according to IMF computations, and especially for the developing countries as a group. In contrast, the outcome for industrial countries as a whole was marginally negative. Extension of the procedure to 1993-1995 resulted in significantly higher average annual rates of GDP growth not only for the global economy, but also for both developing and developed countries as a whole.[5] In a more recent comparison of individual country GDP weights based on PPP relative to those derived by converting 1992-1996 averages of nominal GDP into dollars using annual average market exchange rates,[6] the relative importance of Japan declined from 18.1 per cent to 9.4 per cent, in contrast to a corresponding increase from 2.4 per cent to 11.9 per cent for China. However, the PPP-based weights of the individual country are not the same as those given by the IMF, mentioned earlier. It is not clear whether the discrepancy is the outcome of using a different methodology in estimating PPP or of applying more up-to-date PPP estimates, or whether it is simply due to a difference in country coverage.

There are clearly advantages and disadvantages associated with alternative approaches to measuring real GDP. It is perhaps best not to regard one method as superior to another, so much as to consider each as a means of providing a different perception of the performance of an economy or of a group of countries. No single method of aggregating data across countries can be expected to be appropriate for all purposes. Indeed, PPP-based weights would not be appropriate, for instance, for aggregating international trade or capital movements which are transacted at market exchange rates. Accordingly, caution should be exercised in comparing growth in world trade with growth in output based on PPP weights.

What is also clear is that estimates of real GDP growth for a given region and period provided by different agencies may be somewhat different for a variety of reasons, including differences in weighting schemes, base year and country coverage, even if the database is the same. In comparing data on GDP growth at the regional or global level available from alternative sources, it is essential to keep such differences in mind.

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1 For the United States economy, because of the spectacular fall in computer prices, changing the base period to more recent years results in a significant drop in both the share of the computer industry in real GDP and its contribution to GDP growth. To avoid overstating growth in recent years, the Bureau of Economic Analysis of the Department of Commerce switched to a chain-weighted procedure to measure real GDP growth – i.e. computing an index which is the geometric mean of values based on current prices and those of the preceding year. By continually moving the base period forward rather than using some distant year as a base, the chain-weighted procedure eliminates the problems associated with the fixed base-year method. In particular, switches in production between similarly priced products will not distort the measure of growth, and the historical growth record will be unaffected by an arbitrary shift of the base year. The chain-weighted procedure, however, is not without its limitations and disadvantages. Current prices are not so readily available and are subject to revisions. In addition, an error in any of the elements in the chain will remain uncorrected, and there is a tendency for such errors to cumulate over time. A more serious difficulty is that the components of GDP no longer add up to the total.

2 See *The Economist*, 28 November 1992.

3 The ICP was coordinated by the United Nations and supported by the World Bank, the OECD and other international agencies.

4 IMF, *World Economic Outlook*, May 1993, annex IV, table 33.

5 With regard to industrial countries, output growth in 1995 came out the same for both methods; see Asian Development Bank, *Asian Development Outlook 1994* (Hong Kong, China: Oxford University Press, 1994), pp. 229-230.

6 Morgan Guaranty Trust Company, “Measuring the world economy”, *World Financial Markets*, New York, 2 January 1998, p. 114.

expenditures to 7.7 trillion yen. It is officially estimated that the entire package will produce a 2 per cent increase in GDP. While the tax reductions are to be immediate, the higher public expenditure will take more time to work through to an increase in income. The impact on growth in the current year is thus likely to be substantially lower. The ultimate success of the package will depend on how far it reverses the decline in private spending. At the same time, plans were announced to force banks to fully write off or sell existing bad loans.

The crisis in East Asia poses a particular problem for Japan since the majority of foreign lending by banks, as well as over 40 per cent of merchandise exports and 37 per cent of service exports, go to the region. Asia-5 accounts for almost 20 per cent of merchandise exports and 16 per cent of imports (see also chapter II). The risk of a deepening of the recession is especially critical, for it comes on top of continued weakness in the financial sector. A deepening of the recession will make it more difficult to clear the existing assets that have to be liquidated, and will exacerbate the problem of non-performing loans and the asset overhang, thus further weakening the banks. A severe contraction that placed banks in difficulty would certainly lead to repatriation of dollar assets held by Japanese financial institutions, putting pressure on United States interest rates and equity prices, making debt servicing in East Asia more difficult, and creating turbulence in global exchange rates and asset markets. Furthermore, given the role that Japan has played as a source of direct investment and as a market for exports from the rest of Asia, recession in that country would preclude recovery in the region. It is unclear whether the new government expenditure package will be capable of permanently restoring growth in Japan, since the recent temporary tax reductions appear to have had only a marginal impact on consumer spending.

In the current state of the global economy, Japan cannot rely on external demand to compensate for the deficiency in internal demand. Increasing net exports by shrinking both imports and exports is largely self-defeating. The only alternative is to attempt to increase exports by allowing the yen to weaken further against the dollar, but that could also be self-defeating as Japan would be competing with the rest of Asia for United States markets – something that would certainly lead to further competitive devaluations in the region, possibly including China. Furthermore, there is the risk that this strategy would be interpreted as a purely temporary policy move, generating expectations of an early reversal and anticipation of yen appreciation, and hence causing a reversal of capital flows back to Japan, which would again put pressure on global equity markets.

As a mature developed economy Japan can no longer depend on the rest of the world for its demand growth. It clearly needs to find an internal source of demand. In *TDR 1996* the UNCTAD secretariat recommended boosting demand by decreasing domestic costs through liberalization of the retail and service sectors. This is a necessary first step towards the exploitation of the new technologies in the transportation and telecommunications industries along the lines of what was done in the United States, where the deregulation of air and road transport, and antitrust actions in the computer and telecommunications industry, created additional employment and technological innovation. Furthermore, it could bring about substantial changes in the way the wholesale and retail sectors operate. In this sense, Japan resembles the other East Asian economies which have experienced a decline in their terms of trade relative to the information-based products that have come to dominate the growth process in the United States.

There is also a need to take steps to clear the asset overhang resulting from bad loans and bankruptcies in order to restore normal market conditions. The rationale for avoiding a rapid disposition of assets has been to allow time for economic conditions to improve and for balance sheets to be strengthened; there has been no such improvement or strengthening, however. Furthermore, all of East Asia will be entering a period of asset disposal. Japan finds itself in a position similar to that of the Eastern European countries attempting to privatize; namely, there are insufficient domestic buyers, and thus sellers will have to look to foreign buyers. The recent policy of speeding the removal of bad loans from bank balance sheets is certainly a step in the right direction. However, in all probability only a small proportion of asset values will be recovered and most bad loans will end up as losses to be covered by the public sector. This outcome should not be used to justify expenditure reductions in other areas, as has been done in Thailand and the Republic of Korea.

(c) European Union

The United Kingdom was the first EU member to emerge from recession in the 1990s, and continues to enjoy economic expansion. During 1997 a number of the smaller economies, such as Denmark, Finland, Ireland, the Netherlands, Norway and Portugal, also grew at or well above their potential growth rates. The larger continental economies have been unable to match the United Kingdom's continuous performance or the recent rapid growth of the smaller economies, Spain being the exception. These core European economies appeared to be entering a period of more sustained growth as conditions improved in the fourth quarter.

During 1997 inflation, as measured by the rise in consumer prices, was uniformly low at 2.2 per cent or below in all countries except the United Kingdom, where the rise was 3.1 per cent, and Greece, where it was at 5.5 per cent. Despite the nascent recovery in economic activity, unemployment has remained at over 11 per cent in France, Germany and Italy. Policies designed to cut fiscal deficits to 3 per cent or below in order to qualify for the third stage of monetary union continued to restrain growth in domestic demand, while high unemployment and weak real wage growth kept consumption down.

Because of close trade links and increasing integration among the countries in the European Union, the recovery in domestic demand has had a strong multiplier effect that has produced sustained export growth. However, the major support for demand came from outside the region, including North America, the transition economies and developing countries outside East Asia. The increase in net exports was concentrated in those countries whose currencies have recently declined relative to the dollar, including France and Germany. Export performance in 1997 remained moderate in countries whose currencies had depreciated earlier, such as Greece, Italy, Sweden and the United Kingdom.

The Asian crisis is expected to reduce both GDP and export growth in the European Union by over 0.5 percentage points. The impact is likely to be spread unevenly across the region, as well as among sectors. However, steady and more balanced growth in 1998 will require strengthening domestic demand to replace the reliance on exports. The introduction of the single currency, the euro, in January 1999 is expected to provide some stimulus to domestic demand. By that date, the 11 countries entering the third stage of monetary union will have a uniform rate of interest. The convergence of long-term rates has now been more or less completed, but short-term rates in high-yield countries such as Italy and Spain will have to be reduced significantly towards the uniform rate, which is likely to be below 4 per cent.

There are other aspects of the introduction of the single currency that may be less positive. The current European Monetary System will cease to exist as from January 1999 and be replaced by the new European Central Bank, which will be in charge of monetary policy in the eurozone. Its primary objective will be the stability of the euro. Given the significant differences in financial structure and economic performance of the 11 countries involved, it is clear that a centralized monetary policy will not always be precisely that which would otherwise have been pursued by central banks acting on the basis of national conditions and priorities. Of course, this was one of the reasons for requiring substantial economic convergence before initiating monetary union. Nevertheless, differences remain and there is uncertainty whether the monetary policy which suits the area as a whole will err on the side of restriction or expansion. Since the new European Central Bank will be working in uncharted areas, it is likely to err more on the restrictive side. Although fiscal policy will remain largely within the competence of national governments, the scope for independent national fiscal action to counter a centralized monetary policy that is deemed inappropriate from the point of view of an individual country will be, for all practical purposes, constrained by the provisions of the Stability and Growth Pact of June 1997. Until there is sufficient experience and convergence, it is thus likely that overall policy will remain restrictive and offset many of the benefits of the lower short-term interest rates that may result from the single monetary policy. Fears of a weak euro may thus be exaggerated.

With a single currency, trade among participating EU members will no longer be influenced by movements in national exchange rates, nor will capital movements be influenced by interest rate differentials, but there will still be differences in wages, productivity and real incomes. Economic adjustment will consequently have to be made in terms of greater variations in levels of output and employment, since exchange rate adjustment is no

longer an available instrument and the scope for national policy measures is diminished. Performance will thus be determined by relative competitiveness and purchasing power as determined by the growth of relative wages and productivity.

For example, if, as is currently the case, nominal wage rates in Germany grow by less than labour productivity, German goods will become increasingly competitive, and the profitability of domestic firms and sales of German goods in the rest of the EU will be enhanced. Demand will thus be transferred to German producers, lowering output and employment in the rest of the Union. Since reducing interest rates relative to Germany is no longer possible, and since any increase in demand through fiscal expenditure would be limited by the Stability and Growth Pact and would in large part be drained off to Germany, the only available alternative policy would be to counter with reduced unit labour costs. Such a result can be achieved either through changes in nominal wages or through increased productivity. Since wages can be adjusted more rapidly than productivity can be increased, it is likely that policies to defend domestic producers will hold back wages and prices, with the risk of deflation greater than that of inflation. On the other hand, if a reduction in real wages is impossible because of social resistance, unemployment will rise. Either response will not only make it more difficult to expand domestic demand, but also tend to strengthen the euro, thereby reducing the contribution of external demand to growth. The major challenge facing the new European Central Bank is thus unlikely to be the prevention of inflation, but rather to sustain domestic profitability and demand at levels compatible with acceptable rates of unemployment.

2. *Developing countries*

(a) Latin America

Since the debt crisis of the 1980s the major challenge in Latin America has been to reconcile growth fast enough to keep unemployment at acceptable levels and reduce poverty with a sustainable external payments position. The recovery that has taken place since the Mexican crisis suggests that this dilemma is still present, as the payments position has continued to worsen, although the deficits now involve a higher proportion of capital goods in total imports than in the past. These difficulties have been compounded by the impact of the East Asian crisis on commodity and petroleum prices. The heavy reliance on private capital inflows to finance the growing payments deficits has meant that Latin American countries are still subject to the risk of contagion.

There was a particularly strong recovery in 1997 in countries such as Argentina, Chile, Mexico, Peru and Uruguay, which all had GDP growth of 6.5 per cent or more (table 4). The Chilean economy, in particular, experienced its fourteenth year of consecutive growth in spite of restrictive policies imposed to check the overheating of the economy that became evident in 1996. The consumption-led boom in Brazil in 1996 was similarly moderated in 1997 by a tightening of monetary policy and the introduction of budget reductions in response to the East Asian crisis. Although GDP growth at 3.5 per cent was below the regional average, it was nevertheless an improvement over the preceding year, and was the fifth year of uninterrupted growth, with declining inflation but a rising external deficit.

Responsible for the surge of growth in Latin America was a strong recovery in investment, together with continued expansion in exports. Owing in large part to the impact of the East Asian crisis, export prices were virtually at the same level as the previous year for the region as a whole, and higher export earnings were due entirely to the increase in export volumes, which was 2.5 times that of GDP. The trend in export prices will be downward in 1998 as the impact of the East Asian crisis works its way through the global economy.

Intraregional trade continued to play an important role in the growth dynamics of the region, reinforcing economic interdependence among countries, particularly those associated with the Southern Cone. The nearly complete implementation of the Southern Cone Common Market arrangement led to an expansion of intraregional trade in general, and of trade in grains in particular. Argentina has continued to capitalize on export opportunities, chiefly in the Brazilian market, whereas Mexico's exports, concentrated on manufactures to North America, continued to benefit from its post-crisis currency depreciation.

On the other hand, because of a sharp increase in imports of capital goods associated with in-

Table 4

LATIN AMERICA: OUTPUT AND TRADE, 1995-1997

(Percentage changes over previous year)

	Output[a]			Export volume			Import volume		
Country	1995	1996	1997[b]	1995	1996	1997[b]	1995	1996	1997[b]
All countries	0.6	3.6	5.2	12.0	11.0	12.5	3.0	11.5	21.5
of which:									
Argentina	-5.0	3.5	8.0	20.3	5.6	7.3	-14.4	19.7	27.6
Bolivia	3.8	3.9	4.0	5.2	9.4	5.5	13.2	-0.3	23.3
Brazil	3.9	3.1	3.5	-2.3	3.7	7.3	31.4	6.1	21.2
Chile	8.2	7.2	6.5	11.5	14.5	9.6	23.1	12.4	14.9
Colombia	5.9	2.2	3.0	2.2	5.0	12.3	6.8	0.4	11.1
Costa Rica	2.2	-0.6	2.5	8.7	10.8	7.2	-2.9	6.0	18.7
Ecuador	2.7	2.0	3.5	7.1	3.3	3.5	14.5	-8.0	20.4
El Salvador	6.3	2.5	4.0	15.3	5.8	21.2	21.6	-8.8	14.4
Guatemala	5.0	3.1	4.0	19.4	12.4	13.2	10.7	-1.5	17.9
Mexico	-6.6	5.2	7.0	24.4	16.0	19.2	-13.8	18.8	24.6
Paraguay	4.5	1.0	2.5	19.7	-10.7	-1.6	20.2	-10.6	4.8
Peru	7.8	2.5	7.0	8.2	6.1	12.7	27.5	1.7	14.2
Uruguay	-2.3	4.8	6.5	-0.7	16.8	13.9	-5.3	15.7	17.1
Venezuela	3.5	-1.4	5.0	6.0	3.2	8.1	24.9	-22.0	34.4

Source: WTO Press Release, 19 March 1998; ECLAC, *Preliminary Overview of the Economy of Latin America and the Caribbean 1996,* Santiago, Chile, 1996 (United Nations publication, Sales No. E.96.II.G.13), tables A.9 and A.10 (for trade in 1995); and *ibid.*, tables A.1, A.8 and A.9.

a Based on values in 1990 prices.

b Preliminary.

creased investment, imports in 1997 expanded in volume terms at rates much higher than those of exports for practically all countries in the region, with the major exceptions of Colombia and El Salvador. The growth in import volume in Argentina, for instance, was an unprecedented 28 per cent. In Brazil and Mexico, currency appreciation and a surge in capital inflows led to a corresponding rate of 21 per cent and 25 per cent respectively, although rising domestic demand was also important in Mexico. The faster growth of imports than of exports led to a substantial widening of the current account deficit for the region, which amounted to $60 billion, up from $35 billion in 1996, and is attributable to large deficits in Argentina, Brazil and Mexico together with a smaller than usual surplus in Venezuela.

While average export prices for 1997 in the region as a whole remained stable, coffee prices, which are important for Colombia and the Central American countries, were strong. On the other hand, oil exporters such as Bolivia, Ecuador, Mexico and Venezuela and exporters of industrial raw materials such as Chile suffered terms of trade losses to varying degrees. Chile’s terms of trade were also affected by falling prices for fishmeal and fresh fruits.

Accompanying the acceleration in output growth was a continuation of the sharp downward trend in inflation, which fell to its lowest level in half a century. The rate of inflation in 1997 was lower than in 1996 in 10 countries and remained stable in 11 others. Argentina had one of the low-

est rates of inflation in the world. In contrast, the rate soared to a record high in Venezuela following price liberalization and a major devaluation.

Capital inflows in 1997, following the sharp reversal of the declines recorded in 1995 because of the Mexican peso crisis, surged to a record $73 billion, or some 4 per cent of regional GDP, and were more than sufficient to cover the substantial increase in the current account deficit. The composition of capital inflows has shifted since the early 1990s, with FDI now constituting nearly two thirds of the total, compared with less than one fifth in 1994. Currently, short-term capital inflows from banks represent only a moderate portion of total inflows in most countries (and are primarily the result of foreign trade financing). The magnitude of capital inflows led to currency appreciation, especially during the first half of 1997, when the dollar strengthened in international markets. Overall, the region's currencies appreciated at an average rate of 4 per cent against the dollar in 1997, but by as much as 20 per cent in Venezuela. Three countries experienced depreciations – El Salvador, Nicaragua, and Trinidad and Tobago.

Growth for the region in 1998 is expected to slow to around 3 per cent primarily as a result of developments in East Asia. As the East Asian financial crisis intensified towards the end of 1997, some of the emerging financial markets in Latin America came under pressure, most markedly in Brazil, but also in Argentina, Chile and Mexico. In most countries, pressure was relieved primarily through the immediate adoption of restrictive monetary and fiscal policies, the effects of which continue to be felt throughout the region.

The Central Bank of Brazil, faced with a sharp decline in share prices and growing pressures on foreign exchange reserves in October 1997, increased interest rates to over 40 per cent, and the Ministry of Finance announced a package of expenditure cuts and tax increases worth $18 billion, aimed at reducing the public sector deficit by the equivalent of almost 2.5 percentage points of GDP. Although monetary policy was relaxed in subsequent months and the public sector deficit continued to increase, to some 6-7 per cent of GDP, growth in the economy has fallen back and can be expected to be less than 2 per cent in 1998. However, interest rate differentials remain high and the offer of dollar-linked returns has caused a sharp increase in capital inflows, which exceeded $10 billion in March 1998.

In Argentina, stock market prices also retreated in response to the October 1997 crash and interest rates rose. The main source of concern was the potential impact of a spread of the East Asian crisis to Brazil, since Argentina has become increasingly dependent on exports to its principal MERCOSUR partner. In Chile, in spite of raising interest rates in real terms from 6.5 per cent to 8.5 per cent between October 1997 and January 1998, the Central Bank had to allow the peso value of the dollar to float upwards, and can be expected to maintain tight monetary conditions in order to prevent further depreciation.

Latin American exports are expected to slow down in 1998 as East Asian demand continues to weaken. In addition, countries in the region are likely to lose competitiveness to varying degrees because of the depreciation of several Asian currencies. To maintain its competitiveness, for instance, Brazil in early 1998 widened the bands within which its currency is permitted to fluctuate against the dollar. The expected lower international prices of oil and non-oil commodities will also tend to reduce export revenues of many countries in the region; and the collapse of copper prices has already produced a serious decline in earnings in Chile.

Although the focus of concern stemming from the East Asian crisis has shifted from capital flows to trade, the region is likely to remain vulnerable to the volatility of capital inflows, notwithstanding the progress that has been made in the composition of capital inflows and strengthening of the banking sector in recent years. For the region as a whole, short-term foreign debt is currently equivalent to 35 per cent of export earnings (ranging from 11 per cent in Venezuela to 78 per cent in Peru among the large countries) and to 70 per cent of total reserves (ranging from 33 per cent in Venezuela to 154 per cent in Mexico). Prospects for 1998 as a whole will be crucially affected by developments in both the United States and Japan.

(b) Asia

The spread of the financial crisis across the Asian economies during the second half of 1997 had a varying impact on countries in the region (table 5) and was greatest in South-East Asia, where growth rates fell by almost half from 1996 levels. Growth in South Asia also declined, but

Table 5

DEVELOPING ASIA: OUTPUT AND TRADE IN SELECTED SUBREGIONS AND COUNTRIES, 1995-1997

(Percentage changes over previous year)

	Output[a]			*Value of exports*			*Value of imports*		
Region/country	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*
Newly industrializing economies	7.4	6.4	6.0	20.9	4.5	3.4	22.9	5.2	3.0
of which:									
Hong Kong, China	3.9	5.0	5.2	14.8	4.0	4.0	19.1	3.0	5.1
Republic of Korea	8.9	7.1	5.5	31.5	4.1	7.2	32.1	12.2	-2.3
Singapore	8.7	6.9	7.8	21.0	6.4	-3.1	21.6	5.4	0.1
Taiwan Province of China	6.0	5.7	6.8	20.0	3.8	5.2	21.2	-0.1	10.1
South-East Asia	8.2	7.1	3.9	24.3	6.0	8.7	29.7	6.3	2.4
of which:									
Indonesia	8.2	8.0	4.6	18.0	5.8	11.2	26.6	8.1	4.8
Malaysia	9.5	8.6	7.5	26.6	7.3	6.0	30.4	1.7	7.0
Philippines	4.8	5.7	5.1	29.4	17.7	22.8	23.7	20.8	14.0
Thailand	8.8	5.5	-0.4	24.8	-1.9	3.2	31.9	0.6	-9.3
South Asia	6.6	6.8	4.8	20.5	5.5	5.1	25.7	7.7	5.6
of which:									
Bangladesh	4.4	5.4	5.7	37.2	12.2	13.7	39.4	17.8	3.0
India	7.2	7.5	5.0	20.8	4.1	5.0	28.0	5.1	8.2
Nepal	2.8	6.1	4.3	-9.6	1.7	10.3	21.9	9.0	10.3
Pakistan	5.2	4.6	3.1	16.1	7.1	-2.7	18.5	16.7	-5.0
Sri Lanka	5.5	3.8	6.3	18.7	7.9	13.0	11.6	2.5	7.0
China	10.5	9.6	8.8	24.9	17.9	20.0	15.5	19.5	2.5

Source: *Asian Development Outlook 1998* (Hong Kong, China: Oxford University Press for the Asian Development Bank, 1998), tables A1, A11 and A13.

a Based on data in constant prices.

for the first time in this decade exceeded that in South-East Asia. Export and import growth rates were comparable to those of the preceding year, but much lower than in 1995.

In October 1997 the financial crisis reached Hong Kong, China, where the stock market suffered the biggest loss ever recorded, and subsequently the other first-tier NIEs (the Republic of Korea, Singapore and Taiwan Province of China). To the extent that GDP growth in these economies was affected in 1997 (6.0 per cent, down from 6.4 per cent in 1996) this was due to a sharp fall in world demand and prices for such products as electronics, semiconductors, steel and petrochemicals.

The Chinese economy sustained its strong growth momentum in 1997, although it failed to attain the official target of 10 per cent. Weak domestic demand was partly offset by a surge in exports. The prices of a wide range of consumer goods were reduced through a combination of

administrative measures and macroeconomic policies. Township and village enterprises accounted for nearly half of the country's industrial output and one third of its exports in 1997, and they were also responsible for GDP expansion at about double the rate for the economy as a whole. The Asian crisis has brought into sharper focus the need for government to give greater attention to problems in the financial sector and to adopt measures to enhance the effectiveness of monetary policy and restructure the assets of state banks.

In South-East Asia, GDP growth at less than 4 per cent in 1997 was the lowest for two decades. The financial difficulties in the countries of the region were compounded by the abnormal weather created by El Niño, which has so far brought the severest drought in 50 years to Indonesia, Malaysia, the Philippines, Singapore and Thailand. For the first three countries, which were the hardest hit, the economic effects will continue to be felt in 1998.

Growth in South Asia in 1997 fell to less than 5 per cent (from 6.8 per cent in 1996). There were wide disparities in performance among countries, reflecting differences in performance in the agricultural and manufacturing sectors. The significant decline in output growth in both India and Pakistan is attributable in part to the impact of adverse weather on agriculture. In Pakistan, cotton viruses also played a part. Growth in Bangladesh was the most rapid it had been in the 1990s, primarily because of an impressive expansion in agricultural production, notably for rice. Faster growth in Sri Lanka, on the other hand, was the outcome of a recovery in agriculture together with sustained growth in manufacturing, which continued to be the most dynamic sector.

The impact of the Asian financial crisis on South Asia has been less dramatic because of restrictions on capital account convertibility and more limited exposure to short-term foreign debt. The currencies of India and Pakistan depreciated by around 10 per cent in the latter half of 1997. Unlike in South-East Asia, the economies of the subregion remain less closely integrated with the global economy because of a gradual approach to trade liberalization, financial deregulation and privatization. The creation of new regional arrangements such as the South Asian Preferential Trade Agreement is a step towards closer integration within the region and also with the world economy.

Economic performance in West Asia continued to be dominated by developments in the oil sector and by political conditions in the subregion. GDP grew by 7.6 per cent in 1997, compared with 10.4 per cent the previous year, mainly because of higher oil production which more than compensated for the decline in price. Governments in the region gave increasing importance to the private sector and foreign investment, and continued to implement policies designed to correct internal and external imbalances as well as to enhance efficiency and productivity. The pace of progress, however, varied widely from country to country and, with the exception of Jordan, Lebanon, the Syrian Arab Republic and Yemen, there is continued heavy dependence on oil. In view of the less than bright prospects for oil prices, growth for the region in 1998 is expected to decline further, to less than 6 per cent.

All first-tier NIEs are expected to grow more slowly than in 1997, most markedly the Republic of Korea, where output is projected to contract by 6 per cent. The slowdown is expected to be least in Taiwan Province of China, falling to around 4-5 per cent. The declines are likely to be more substantial for Singapore and Hong Kong, China, as a result of the fall in South-East Asia's demand for their exports, reduced tourist earnings and the impact of tighter monetary policy. Growth in Singapore is unlikely to exceed 1 per cent, while Hong Kong, China, is likely to go into recession with a contraction of the economy of 2-3 per cent. Growth in China is also likely to slow in 1998, to around 6 per cent. Unemployment is expected to become more serious with further lay-offs from public enterprises during the three years of scheduled reform that started in 1997, and there is also the likelihood of reduced export growth due to loss of competitiveness.

For South-East Asia, the outlook for 1998 is extremely uncertain and will depend, *inter alia,* on how and to what extent governments fulfil the conditions associated with borrowing from the IMF. Of particular concern is the case of Indonesia, where massive lay-offs and soaring prices of essential foodstuffs have increased unemployment and poverty levels dramatically and given rise to social unrest. Other countries severely affected in social terms by the crisis include Thailand and the Republic of Korea. (The social impact of the crisis on the most affected countries is discussed in chapter III.)

In South-East Asia exports have yet to respond to the dramatic currency depreciations that have taken place. The improvement in the trade balance in the most affected economies so far has been due primarily to a sharp decline in imports. Because of the huge burden of private sector debt, Thailand is expected to have a negative growth rate in 1998 of 8 per cent, while contraction in Indonesia may exceed 12 per cent. Malaysia is also likely to experience recession, while growth in the Philippines may remain positive but substantially reduced.

Growth in 1998 for South Asia is expected to revert back to the 1996 level with the recovery of Pakistan and India, but in most countries it will continue to be constrained by inadequate infrastructure as well as political instability. Without further adjustments in exchange rates, major export sectors, such as garments, textiles, plastics and synthetic fibres, which compete with exports from other Asian economies will be adversely affected. Pakistan in particular, with its exports largely in textiles and clothing, will face keener competition. Following their nuclear tests, India and Pakistan have been subject to economic sanctions by some of their major trading partners. Should such sanctions be intensified, both economies may face payments difficulties and a slowdown in growth even though they may avoid a serious financial crisis and currency turbulence associated with capital flight.

(c) Africa

Growth continued in 1997, albeit at a much slower pace than in 1996. At 3.3 per cent it was barely above the rate of population growth and well below the 4.6 per cent achieved in 1996. There was considerable variation in performance among subregions and individual countries, where much depended on weather conditions, the behaviour of commodity prices, as well as the existence or absence of armed conflicts and social unrest (table 6).

In spite of the progress made in export diversification, regional exports continued to be dominated by minerals in South Africa; oil and gas in Algeria; oil in Nigeria; crude and refined oil in Egypt; phosphates and phosphoric acid and citrus in Morocco; cocoa and coffee in Côte d'Ivoire; oil and diamonds in Angola; diamonds in Botswana; copper in Zambia; oil, timber and

Table 6

OUTPUT GROWTH OF AFRICAN COUNTRIES, 1990-1997

(Percentage changes over previous year)

Country	*1990 -1995*[a]	*1995*	*1996*	*1997*
Algeria	0.4	4.5	4.0	4.5
Angola	-2.4	6.2	7.2	8.0
Benin	4.3	4.8	5.6	5.9
Botswana	4.7	4.5	6.2	4.9
Burkina Faso	3.3	4.5	5.5	6.6
Burundi	-1.7	-3.4	-12.9	4.3
Cameroon	-1.4	4.4	5.0	5.1
Cape Verde	4.3	4.7	4.2	4.5
Central African Republic	1.1	4.1	-3.9	-3.3
Chad	2.7	5.5	2.8	6.3
Comoros	0.2	-2.4	-0.4	0.0
Congo	-0.4	0.8	5.9	-17.6
Côte d'Ivoire	1.1	6.9	6.8	6.1
Dem. Rep. of the Congo	-7.6	1.6	1.3	-5.0
Djibouti	-2.0	-3.1	-5.0	0.8
Egypt	1.4	2.3	4.3	5.0
Equatorial Guinea	8.2	14.9	38.9	96.7
Eritrea	2.0	5.5	6.9	4.4
Ethiopia	2.0	5.4	11.9	5.3
Gabon	2.4	3.7	3.2	4.5
Gambia	0.6	-6.5	2.8	2.2
Ghana	4.3	4.0	5.2	3.0
Guinea	3.6	4.4	4.5	4.8
Guinea-Bissau	3.3	1.6	5.8	5.2
Kenya	1.6	4.4	4.3	2.0
Lesotho	6.0	9.3	12.6	7.2
Libyan Arab Jamahiriya	-1.0	-1.1	2.0	2.0
Madagascar	-0.3	1.8	2.0	3.5
Malawi	1.2	9.0	16.1	5.6
Mali	2.7	6.3	4.0	6.6
Mauritania	3.9	4.6	4.5	4.3
Mauritius	4.9	4.4	6.1	5.6
Morocco	1.0	-7.2	11.8	-1.1
Mozambique	5.8	1.5	6.4	6.6
Namibia	4.1	2.5	5.0	4.0
Niger	0.8	3.2	3.3	4.5
Nigeria	2.7	2.6	2.4	3.2
Rwanda	-10.0	23.2	11.4	12.7
Sao Tome and Principe	1.7	1.9	1.9	1.8
Senegal	2.3	9.8	5.1	4.7
Seychelles	2.8	-1.8	1.7	2.1
South Africa	0.8	3.4	3.1	2.2
Sudan	5.9	4.5	4.3	5.0
Swaziland	2.0	3.5	2.5	2.5
Togo	-0.6	8.4	6.2	5.8
Tunisia	3.9	2.9	6.9	5.1
Uganda	7.5	9.6	9.4	4.2
United Rep. of Tanzania	4.1	3.8	4.2	4.1
Zambia	-0.5	-3.1	6.4	4.6
Zimbabwe	0.8	0.1	7.4	4.5

Source: UNCTAD secretariat calculations, based on data in 1990 dollars.
a Annual average.

manganese in Gabon; metals, tobacco and cotton in Zimbabwe; and tea and coffee in Kenya. Primary-commodity-exporting countries were adversely affected by a reversal of favourable commodity prices, particularly oil prices.

In addition, drought and flood conditions caused by the El Niño weather pattern undermined agricultural production in countries as diverse as Morocco in North Africa, Ethiopia, Kenya, Somalia and the United Republic of Tanzania in East Africa, Zambia and Zimbabwe in Southern Africa, as well as several countries in the Sahel region. Rain-fed agricultural production in various countries (Eritrea, Ethiopia, Kenya, Somalia, Uganda and the United Republic of Tanzania) was devastated by the vagaries caused by El Niño, which brought excessive rain in parts of East Africa, but drought in parts of Southern and North Africa. As a result of extensive damage to crops as well as losses of large numbers of livestock, there was a collapse in food production. Food shortages were especially severe in the countries of Southern and East Africa. At the same time, damage to infrastructure (roads, bridges and railway lines) seriously disrupted the movement of goods both within and between countries.

Although a large number of countries in the region registered growth rates of above 4 per cent in 1997, some large economies, including the Democratic Republic of the Congo, Morocco, Nigeria and South Africa, experienced low or negative growth. In many countries, sustained policy efforts and macroeconomic stability have created an environment conducive to investment and increased production. Although traditional commodities continued to dominate total exports, diversification into non-traditional exports has been progressing in several countries in North and Southern Africa, such as Egypt, Tunisia and Botswana. Also notable were a spread and strengthening of economic growth among countries in the region, in contrast to the early 1990s when one third of the countries had declining output. Countries of the franc zone (CFA), such as Côte d'Ivoire, Mali and Senegal, continued with further recovery following their exchange rate adjustments in 1994. However, growth in Uganda was more than halved compared with the previous two years, while economic performance remained disappointing in Nigeria and South Africa.

On a subregional basis, only Central Africa had less than 3 per cent growth in output in 1997. For the other subregions, it was 3.4 per cent in Southern Africa and a little below 4 per cent in East, West and North Africa. However, with the exception of West Africa, which managed to sustain the previous year's rate, all subregions had significantly slower growth than in 1996. In East Africa, growth declined not only in Ethiopia and Uganda, but also in Kenya, by far the largest country in the subregion, owing to the effect of drought on agricultural output, although policy uncertainty also played a part. In West Africa, lower oil prices together with an uncertain business environment weakened recovery in non-oil sectors in Nigeria. In Ghana, mining activity was depressed by the sharp fall in the price of gold to its lowest level in 18 years, although the country benefited from higher cocoa production and prices. The phenomenal increase in output in Equatorial Guinea was due to a new discovery of oil. The growth momentum in the CFA economies in the subregion, such as Benin, Burkina Faso, Côte d'Ivoire, Mali, Senegal and Togo, was sustained by increased exports. In North Africa, the decline in output in Morocco was in sharp contrast to the acceleration of growth in Egypt, or the relatively good performance of Tunisia. In Central Africa, output declined by 5 per cent in the Democratic Republic of the Congo, which is the largest economy in the subregion, whereas Cameroon, Gabon and other CFA countries continued to maintain their growth momentum. In Southern Africa, agricultural production was seriously affected by El Niño. The slowdown in agriculture, together with that in mining as well as in investment and exports, led to a sharp fall in Zimbabwe's GDP growth. On the other hand, strong oil exports and the return of stability to some parts of the country led to an acceleration of growth in Angola. Output growth in South Africa, the largest economy on the continent, suffered from the downturn in the gold mining sector as a result of the sharp fall in the price of gold.

Financing the current account deficit remains the major challenge facing African countries. The overall current account deficit increased slightly, from $7 billion in 1996 to $7.2 in 1997. As a share of GDP, however, it fell from 2.6 per cent to 2.0 per cent, in contrast to high and persistent current account imbalances in the past. Indeed, only a few countries, such as Equatorial Guinea, Lesotho, Mozambique and Sudan, had current account deficits above 20 per cent of GDP. In some 10 countries, including Burundi, Cameroon, Morocco, South Africa, Tunisia, Uganda and Zimbabwe, the

deficit was less than 3 per cent, and in others, such as Algeria, Botswana, Gabon, Namibia and Nigeria, there was a surplus. Current account deficits are increasingly financed by non-debt-creating capital flows. Foreign direct investment, however, is highly concentrated in a few countries. In 1996, for example, Algeria, Angola, Côte d'Ivoire, Egypt, Ghana, Morocco, Nigeria, South Africa and Tunisia accounted for over two thirds of FDI flows to Africa, with Nigeria alone absorbing about a third of the total. FDI flows are also highly concentrated with respect to country of origin and economic activity. France, the United Kingdom, Germany and the United States are the major investors, and oil, gas, metals and other extractive industries are the key investment targets. Flows are likely to be affected by the Asian crisis now that some developing Asian countries, particularly Malaysia, have become significant investors in the region in recent years.

For 1998 growth in Africa as a whole is not expected to be much better than in 1997. The Asian crisis will directly affect a number of countries with increased trade links with that region. Export expansion may also weaken on account of the indirect effect of the crisis on the continent's major trading partners in Europe and North America. The prices of commodities that are of interest to Africa are likely to be depressed. Prospects for higher oil prices are not promising and may not favour improved economic performance of major economies, such as Algeria, Angola, Egypt, the Libyan Arab Jamahiriya, Nigeria and Tunisia. The crisis will mean somewhat smaller earnings from exports of raw materials, such as ores, and more competition for such products as rubber and copper. Countries that will be affected in this way include the Democratic Republic of the Congo, Ghana, South Africa and Zambia. In addition, it is not certain that the effects of El Niño have worked themselves out.

3. Transition economies

The major economic development in 1997 was the turnaround in the transition economies as a group, and in the economies of the Commonwealth of Independent States (CIS) in particular, after years of declining output following the break-up of the USSR. It was attributable to a strengthening of the incipient recovery in a number of countries together with the bottoming out of a persistent decline in economic activity in the Russian Federation. There continued to be much divergence among countries, with a fall in GDP of over 7 per cent in Bulgaria at one extreme and a rise of over 11 per cent in Estonia at the other (table 7). At the subregional level, the marked deceleration in growth in Central and Eastern Europe is in sharp contrast to the spectacular acceleration in the Baltic States and to some extent in the CIS.

The favourable developments in 1997 are a reflection of the success of economic reforms and gradual economic consolidation in an increasing number of countries, which allowed them to take advantage of the stronger than expected growth in Western Europe's import demand. Outside the CIS, and with the exception also of Albania, Bulgaria, the Czech Republic and Romania, growth remained strong or accelerated in 1997, notably in Croatia, Poland, Slovakia and the three Baltic States. The sharp slowdown following currency adjustment in the Czech Republic, widely regarded as one of the leading reform countries, was a major disappointment. The economy was shaken by a serious currency crisis which affected economic activity and disrupted the financial markets.

The setback was even more severe in Albania, Bulgaria and Romania, where output fell considerably. Albania continued to be affected by the financial crisis that flared up in March 1997 with the collapse of numerous large-scale pyramid schemes. Bulgaria has so far suffered the most. The speculative attack on the currency in 1996 was accompanied by a run on the banking system and a fiscal crisis, and prompted a drastic policy response which included the introduction of a currency board in July 1997 and a comprehensive programme of structural reforms. As a result, output declined for the second consecutive year. In Romania, delays in the implementation of fiscal and structural reforms together with considerable loosening of monetary policy led to a drop in output and a resurgence of inflation.

Within the CIS, output in 1997 declined only in Turkmenistan and Ukraine. Accompanying the acceleration of growth in a number of countries, notably Azerbaijan, Belarus, Georgia, Kyrgyzstan and Uzbekistan, was a turnaround in the Russian Federation, which is by far the largest economy in the region and also the principal trading partner of the other CIS countries.

Table 7

TRANSITION ECONOMIES: SELECTED ECONOMIC INDICATORS, 1995-1997

	GDP			Consumer prices			Current account balance *($ million)*		
	Change over previous year[a] *(Percentages)*								
Region/country	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*[b]
Central and Eastern Europe	6.1	4.1	2.9	..	..	..	-1083	-13212	-13194
of which:									
Bulgaria	2.9	-10.1	-6.9	33.0	311.1	578.7	-26	16	441[c]
Croatia[d]	6.8	6.0	6.5	3.7	3.5	4.0	-1283	-881	-1300
Czech Republic	6.4	3.9	1.0	7.9	8.7	9.9	-1362	-4292	-3156
Hungary[e]	1.5	1.3	4.4	28.5	20.0	18.4	-2480	-1678	-981
Poland[e, f]	7.0	6.1	6.9	22.0	18.7	13.2	5455	-1352	-4280
Romania	7.1	3.9	-6.6	27.7	56.8	151.7	-1774	-2571	-2118[g]
Slovakia	6.9	6.6	6.5	7.4	5.5	6.5	646	-2098	-1500
Slovenia	4.1	3.1	3.8	9.0	9.0	8.8	-23	39	100
Baltic States	2.1	3.7	6.5	..	..	..	-816	-1425	-1236
of which:									
Estonia	4.3	4.0	11.4	28.8	14.9	12.3	-185	-423	-317
Latvia	-0.8	3.3	6.5	23.3	13.2	7.0	-16	-279	-325
Lithuania	3.3	4.7	5.7	35.5	13.1	8.5	-614	-723	-594
CIS	-5.5	-4.4	0.7	..	..	..	8145[h]	9699[h]	1268[h]
of which:									
Belarus	-10.4	2.8	10.4	244.2	39.1	63.4	-567	-503	-641
Republic of Moldova[i]	-1.9	-7.8	1.3	23.8	15.1	11.1	-115	-214	-252
Russian Federation	-4.1	-3.5	0.8	131.4	21.8	11.0	9979	11601	3032
Ukraine	-12.2	-10.0	-3.0	181.7	39.7	10.1	-1152	-1185	-870

Source: ECE, *Economic Survey of Europe 1998 (No.1)* (United Nations publication, Sales No. E98.II.E.1), table 3.1.1 and appendix table B.15, with updates provided by ECE.

a For consumer prices change from December to December.
b Full year except for the Baltic States and the listed CIS members, which are January-September.
c January-November.
d Revised data for current account.
e Current account balance has reference to transactions in convertible currencies, but only for 1995 in the case of Hungary.
f Including non-classified current account transactions.
g Official forecasts.
h Total for the four countries listed.
i Excluding Transnistria for GDP and consumer prices.

Disinflation continued in 1997, in spite of serious setbacks, notably in Albania, Belarus, Bulgaria and Romania. The reduction in inflation was widespread and varied considerably from country to country, but was particularly pronounced in the Baltic States and the CIS countries. Particularly noteworthy was the steep decline in the Russian Federation, from an annualized quarterly rate of 400 per cent in early 1995 to 2.8 per cent in the last quarter of 1997. In one or two countries, however, the lower inflation rate reflects a reluctance to implement price liberalization and is an indication more of the problems yet to come than of the success of stabilization policy.

With the exception of Bulgaria, Slovenia and the Russian Federation, all countries continued to run current account deficits, which became a matter of concern in the wake of the Asian crisis and prompted some countries to introduce measures to curb their expansion, even though the deficits were not excessively large as shares of GDP. The persistently high and increasing deficits were of particular concern in Croatia, Slovakia and the Baltic States.

Most countries in the region were not directly affected by the Asian crisis to any important extent, primarily either because they still have relatively closed economies or because they have made substantial progress in implementing policies to correct macroeconomic imbalances in earlier years. Following the collapse of equity prices in Hong Kong, China, in October 1997, only stock markets in the Russian Federation, Ukraine and Estonia suffered similar losses. In the first two of those countries, structural weaknesses in the banking system combined with financial market pressures arising from fiscal imbalances increased their vulnerability to changes in market sentiment.

For 1998, prospects are somewhat mixed. Vigorous growth is expected to continue in the three Baltic States, but with a slight slowdown in Estonia. As regards countries in Central and Eastern Europe, of those which suffered a severe setback in 1997 Albania and Bulgaria are expected to have some positive growth, but in Romania the expectation is for zero growth. A relatively high rate of growth is expected in Hungary and, to a lesser extent, the Czech Republic. In contrast, some slowdown is expected in countries which grew particularly fast in 1997 (Croatia, Poland and Slovakia), because of the need to check the worsening of external imbalances.

The general decline in the prices of some commodities, especially oil, is expected to have an adverse impact on CIS countries, where exports of such goods constitute a significant share of their total exports. Despite the progress made in 1997, the overall economic situation in the Russian Federation remains fragile and highly uncertain. Because of high exposure to foreign capital (particularly to short-term portfolio investment for financing the budget deficit), the economy is at risk from contagion and much will depend on the stability of the financial markets and the behaviour of foreign portfolio investors. Moreover, recent economic instability in the Russian economy has increased the risk of a setback in 1998.

The uncertain prospects for the countries in the region stem from various sources, some of which are inherent in the ongoing process of fundamental structural changes. There remain key areas of instability which make the economies vulnerable to various disturbances and shocks. These may result not only from external developments such as the East Asian crisis, but also from institutional and structural weaknesses that pervade most of these economies.

C. Prospects for recovery and uncertainties

The current Asian financial and economic crisis is more serious, in terms of its scope and repercussions, than any other crisis in the past two or three decades, including those in Latin America. The recent Mexican crisis of 1994-1995 was rather isolated and limited, and its impact was quite localized and relatively short-lived. In contrast, the East Asian financial crisis had a significant impact on capital markets not only in the South, but also in the North, and is the major cause of the slowdown in global growth, even though its full effects have yet to be felt. The importance of this crisis is indicated not only directly by the number of countries which are seriously affected, but also by their close ties in trade and financial flows with major economies in the region – China; Hong Kong, China; Taiwan Province of China; and above all Japan.

There is considerable uncertainty regarding the speed of recovery in East Asia. The experience of Mexico has given rise to expectations that recovery could be rapid. In that country, industrial production bottomed out four months after the crisis and had fully recovered its initial level ten months later. If this experience were to be

Table 8

GDP GROWTH IN SELECTED OECD COUNTRIES IN 1997: COMPARISON OF ACTUAL GROWTH WITH FORECASTS BY VARIOUS INSTITUTIONS

(Percentages)

Country	*LINK*	*ECE*	*OECD*	*EU*	*IMF*	*NIESR*	*NRI*	*UNCTAD*	***Actual***
United States	2.6	2.5	3.6	2.3	3.0	2.8	2.6	2.9	3.8
Japan	1.5	1.6	2.3	1.8	2.2	2.0	1.1	1.9	0.5
Germany	2.5	2.0	2.2	2.2	2.3	2.5	1.8	2.2	2.2
France	2.5	2.2	2.5	2.1	2.4	2.6	1.8	1.9	2.3
Italy	1.1	1.2	1.0	1.4	1.0	1.1	0.6	1.2	1.3
United Kingdom	3.2	3.0	3.0	3.0	3.3	3.0	2.7	2.5	3.4

***Source*:** Table 1 for actual growth rates; *TDR 1997,* table 9.

replicated, there should already have been signs of recovery in February 1998 (since the crisis broke out in September 1997). However, output and exports in most countries in Asia are still falling and the declines are spreading to other countries that had initially been spared.

Another important difference is that Mexico suffered from a clearly overvalued exchange rate, and that the composition of its imports was heavily biased in favour of consumer goods, associated with a rapid expansion of credit. Devaluation was thus able to provide for expenditure switching, while the collapse of the banking system reduced domestic absorption. The bailout of the banks brought a large increase in the public debt and in debt service, which required fiscal austerity that further reduced domestic absorption. Recovery was achieved primarily because the United States supplied the needed financial package without unnecessary delay, and robust expansion in that country provided a major market for the goods of its NAFTA trading partner.

In East Asia the problem was not one of excessive consumption; private savings were high and there were fiscal surpluses. There was a long-standing payments deficit in a number of countries that was aggravated by a downturn in external demand, a fall in export prices and a strengthening of the dollar. The real problem was the increasing vulnerability to external shocks brought about by excessive reliance on unhedged short-term foreign borrowing to finance the deficits, and its use by domestic financial institutions to fund property and finance companies. The collapse of currencies has brought massive capital losses on foreign exposure for banks and firms, forcing them to reduce lending and spending and to restructure balance sheets. They have thus had difficulty in obtaining even short-term working capital to finance production and exports. Widespread bank and corporate insolvencies have decimated the productive capacity and financial fabric of the economy, reducing its ability to adjust to the crisis through output and export expansion.

Mexico responded to its financial crisis by acting quickly to restructure the banks, taking their bad loans onto the books of a special government agency, creating a facility for the short-term financing needs of productive enterprises and providing new capital through the sale of banks to foreign owners. In Asia this policy has not been pursued; banks and enterprises have been largely left alone, but they are unable to operate effectively. Lastly, the major economy in the region – that of Japan – unlike that of the United States at the time of the Mexican crisis, has fallen into a full-scale recession and is unable to provide a stimulus to Asian recovery.

Recovery is thus likely to be much slower than it was in Mexico. A crisis of over-investment and financial fragility tends to be more difficult to unravel than one of over-consumption. Restructuring of corporate and bank balance sheets takes much longer than realigning consumer spending. Moreover, the crisis has come on top of a number of structural weaknesses in South-

Table 9

ALTERNATIVE FORECASTS OF GDP GROWTH IN 1998 FOR SELECTED OECD COUNTRIES

(Percentages)

Country	*LINK*	*ECE*	*OECD*	*EU*	*IMF*	*NIESR*	*NRI*	*UNCTAD*
United States	2.7	2.5	2.7	2.6	2.9	2.6	2.7	2.3
Japan	0.0	0.1	-0.3	2.3	0.0	0.8	-0.6	-1.3
Germany	2.6	2.5	2.7	3.2	2.5	2.4	2.4	2.3
France	3.0	2.8	2.9	3.1	2.9	2.8	2.8	2.5
Italy	2.4	2.5	2.4	2.5	2.3	2.0	..	2.2
United Kingdom	2.3	2.0	1.7	2.1	2.3	2.2	2.1	2.1
Memo item:								
European Union	2.5	2.7	2.7	3.0	2.8	2.6	2.2[a]	2.6

Source: United Nations, University of Pennsylvania and University of Toronto, "Project Link World Outlook" (mimeo), post-LINK meeting forecast (May 1998); ECE, *Economic Survey of Europe 1998 (No.1)* (United Nations publication, Sales No. E.98.II.E.1); OECD *Economic Outlook* (June 1998); Commission of the European Communities, *European Economy, Supplement A* (October 1997); IMF, *World Economic Outlook* (May 1998); National Institute of Economic and Social Research (NIESR, London), *National Institute Economic Review* (April 1998); Nomura Research Institute (NRI, Tokyo), *Quarterly Economic Review* (May 1998); and table 1.

a Total OECD.

East Asia that were already threatening to decelerate the growth of exports and output. As noted in some detail in *TDR 1996*, growth has relied excessively on foreign resources and the easy stage of export promotion was coming to an end. Without effective policies designed to diversify the manufacturing base, upgrade industrial production and increase productivity, it was argued that the region would suffer from erosion of competitiveness, interruption of capital flows and loss of growth momentum, particularly in view of the emergence of low-cost competitors in labour-intensive manufactures, such as China and India. Even though exchange rate movements have been helpful in restoring competitiveness, these structural weaknesses remain, and the crisis and contraction in the region have certainly made it more difficult to deal with them.

The prospects of the affected countries cannot be divorced from developments in the entire East Asian region, including Japan, China and the first-tier NIEs. The crisis will certainly have serious consequences for growth dynamics and integration in the whole region, which have been referred to as the *flying geese* process. In this process countries at different levels of industrialization and development are expected to move together on the basis of a progressive upgrading of their industries, through intraregional trade and investment which help locate production according to comparative advantages. In the context of the flying geese paradigm, the recession in Japan can be expected to have important implications for the sustainability of the growth process in the East Asian NIEs.

Equally important, given the increased integration of the global economy, can the rest of the world enjoy satisfactory growth if the economies in East Asia, including both first- and second-tier NIEs and Japan, falter? The crisis has greatly increased the complexity of the conditions that underlie short-term forecasts, and even more so longer-term projections. Even before the financial turmoil started, projections for 1997 by various international organizations and research institutions for OECD countries consistently underestimated the growth of the United States economy but overestimated that of Japan (table 8). Their forecasts for 1998 clearly reveal a great degree of uncertainty for Japan, the figures ranging from -1.3 per cent to 2.3 per cent (table 9). With the growing interdependence of countries as regards trade and capital flows, forecasting errors for one country can have significant implications for the forecasts relating to others. ■