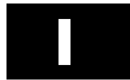

GLOBAL ECONOMIC DEVELOPMENTS AND IMPLICATIONS FOR THE ESCAP REGION

OVERVIEW

The world economy exhibited several welcome developments in 1999. The United States of America managed to sustain a remarkable growth momentum, robust consumer demand and a tight labour market did not undermine domestic price stability, and the stock market avoided any major correction despite recent volatility. These positive developments in the United States coincided with the budding economic recovery in Japan, the maintenance of reasonably healthy growth in a large part of Asia, and positive trends in production and employment in several of the Asian economies hit by the crisis underpinned by falling interest rates, fiscal stimulus, higher export earnings and reserves, and improved investor and market confidence. All these developments combined to raise global growth estimates by almost one percentage point in real terms during the second half of 1999, compared to forecasts made at the beginning of 1999. The improvement in global economic performance and outlook expected for the year 2000 provides a sharp contrast to the relatively bleak prospects of the world economy as perceived by many at the beginning of 1999.

However, the relatively brighter picture envisaged for the year 2000 will have to be tempered by a number of possible downside risks. Most notable among them is the sustainability of the exceptionally strong growth in the United States economy and of the economic recovery in Japan. The upturn in oil and, to a lesser extent, commodity prices should give a boost to a large number of developing countries, but it may also induce some monetary tightening to contain the risk of inflation, constraining global and regional economic expansion in the process. Cross-border capital flows remain highly risk-averse with considerable interest spreads and volatility, notwithstanding the easier financial conditions worldwide. Among other concerns are the large and rising private dissavings, the potential of a drastic correction in the stock markets in the United States and the slow pace of restructuring in labour and product markets in several European Union (EU) members. At the same time, developing countries will have to make substantial progress in implementing a variety of structural reforms, including in the financial and corporate sectors. There is also the need for human and institutional capacity-building, as well as for better social security and social protection for all.

The year 1999 marked another year of robust economic performance by the United States, with unemployment at a record low and remarkable price stability. EU displayed signs of a gradual improvement in output from the latter part of the year. Inflation continued to remain at very low levels and unemployment also began to decline gradually in EU last year. On the back of a succession of large fiscal stimuli, the Japanese economy exhibited encouraging indications of revival in the latter part of 1999, after five quarters of negative growth. The global stock markets continued to suffer from periodic bouts of volatility in investor sentiment, but did not suffer any major upset in 1999 as a whole. Indeed, many markets showed respectable gains during the year, with the Japanese stock market being especially buoyant.[1]

The Asian crisis and its reverberations continued to be the primary focus of attention in both official and academic circles during much of 1999. Nevertheless, there was growing evidence that

[1] The Nikkei 225 stood 39.6 per cent higher in United States dollar terms on 3 November 1999 than its level on 31 December 1998.

economic recovery among the crisis-hit countries had entered a more positive phase from the first or second quarter of 1999; several of them had experienced a deep contraction in output and employment during 1998. The extent and pace of restructuring in the financial and corporate sectors would exert an important influence over the patterns of economic growth and diversification in East and South-East Asia in the near to medium term. Gross domestic product continued to expand at or near its recent trends in most other Asian developing countries.

Reflecting in part these positive developments, world trade showed a small increase in value terms in the first half of 1999, compared to the same period of the previous year. Rising oil prices and greater firmness in a number of commodity prices provided a further impetus to the nominal gains in world trade during the second half of 1999. Remarkable stability in producer and consumer prices, by and large, prevailed in the world economy during 1999, except notably in Central Asia and the Russian Federation. Inflationary pressures had been subdued since the early 1990s. Given the strong policy stance to preserve price stability, particularly among developed countries, the outlook for a continuation of this global trend remained favourable for the coming year.

The return of financial stability and improved growth prospects were accompanied by signs of a modest recovery in capital flows to the developing countries, including those in the Asian and Pacific region during 1999. The earlier fears of a generalized credit crunch in the wake of the financial crisis in the Russian Federation proved unfounded. Nevertheless, the gross volume of such inflows (totalling $103.6 billion up to August 1999) would only be marginally higher than the previous year's level of $148.5 billion, which represented a precipitate decline from the pre-crisis inflow to all emerging markets, averaging $252.2 billion a year in 1996-1997.

Against these favourable developments, however, the major economies of Latin America weakened perceptibly and slipped into recession, in part the result of financial market turmoil that had hit them in late 1998 and early 1999. The Central Asian economies showed only fitful progress in dealing with longstanding structural and financial sector problems; they continued to suffer from constrained access to foreign capital markets. The economy of the Russian Federation rebounded with surprising vigour after the turmoil of 1998 but with few signs of a breakthrough on the domestic fiscal front or in the renewal of foreign investor confidence. In Africa and West Asia, economic performance and prospects remained mixed. As in previous years, political problems and military conflicts had posed a major impediment to sustained restructuring and durable economic progress in a number of developing countries in Africa.

This chapter reviews the broad macroeconomic trends in the developed and developing economies in 1999. An assessment will also be made of the implications of the trends in global trade and financial flows for the ESCAP region.

RECENT GLOBAL MACROECONOMIC TRENDS

Developed countries

Table I.1 summarizes the salient features of the global economy in recent years. Perhaps the most noteworthy aspect has been the tremendous resilience of the United States economy. Its undiluted strength added to the growth rate for the global economy in 1999; it also played a significant role in the rapid turnaround of the crisis economies in Asia. Indeed, contrary to widespread predictions of an imminent slowdown in the American economy, growth in output was sustained at just under 4 per cent per annum in 1999, and for the two preceding years as well. Such expansion, which was noticeably above the recent long-term trend, took place in an environment of remarkable price stability. In addition, from the various indicators now available, actual performance is likely to remain strong so that by April 2000 the current period of economic growth in the United States will have been the longest on record. Furthermore, unemployment at 4.1 per cent in October 1999 had declined to its lowest level since the 1960s.

Some analysts suggest that the United States economy has been reaping the huge benefits from significant investments in information technology and

Table I.1. Selected indicators of global economic conditions, 1996-2000

		1996	*1997*	*1998*	*1999*[a]	*2000*[b]
Economic growth (percentage change of GDP)						
World		3.0	3.2	1.6	2.6	2.8
Developed economies		2.9	2.6	1.8	2.5	2.2
Japan		3.9	0.9	−2.9	0.9	1.0
United States of America		3.4	3.9	3.9	3.9	2.4
European Union		1.7	2.5	2.7	2.1	2.6
Developing economies		5.7	5.5	1.2	3.3	5.1
Economies in transition		−0.1	1.7	−0.4	1.6	2.2
Growth in volume of trade (percentage)[c]						
World		6.8	9.9	3.6	3.7	6.2
Developed economies	Export	6.3	10.3	3.2	3.0	6.2
	Import	6.5	9.2	4.8	5.9	5.9
Developing economies	Export	8.8	11.4	4.9	2.4	5.6
	Import	8.3	11.4	−1.3	1.1	7.2
Commodity prices (annual percentage change; US dollar terms)						
Non-fuel primary commodities		−1.2	−3.3	−14.8	−7.2	3.4
Oil		18.4	−5.4	−32.1	27.7	7.8
Inflation rate (percentage)[d]						
CPI in the developed economies		2.4	2.1	1.5	1.4	1.8
CPI in the developing economies		14.6	9.2	10.3	6.7	5.8
Exchange rates (nominal units per US dollar; 1995 = 100)[e]						
Yen per US dollar		115.6	128.6	139.1	125.9	126.7
Deutsche mark per US dollar		105.0	121.0	122.8	127.5	121.4
Euro per US dollar					0.86-0.94[f]	

Sources: United Nations, “Project LINK World Outlook: summary”, 1 November 1999; IMF, *World Economic Outlook* (Washington DC), October 1999; and *OECD Economic Outlook* (Paris), June 1999.

a Preliminary estimate.
b Forecast.
c Exports and imports (goods and services).
d Developed and developing economies ratios weighted at purchasing power parity.
e Period average.
f Exchange rate between January and August.

other new or productivity-enhancing technologies.[2] Such capacity-building has simultaneously raised the long-term rate of growth and kept inflationary pressures muted. Flexible labour and product markets have also played a part in sustaining growth with price stability. Higher productivity gains and subdued cost pressures have been reflected in the strong growth of corporate earnings over the last two to three years, notwithstanding a temporary hiccup in late 1998. This served to underwrite increased levels of business investment and the upward movement of stock market price indices. Such had been the rise in stock market prices in the United States that the price-earnings ratio in early 1999 was close to 30, approximately double its average between 1970 and 1990.[3]

The substantial capital gains, in turn, supported high levels of household consumption. But as mentioned in *Survey 1999,*[4] the wealth effects of

[2] For a discussion of recent productivity trends in the United States economy, see Richard Herd, “United States: riding out the boom”, *OECD Observer,* No. 217/218, Summer 1999.

[3] *OECD Economic Outlook,* June 1999, p. 20.

[4] *Economic and Social Survey of Asia and the Pacific 1999* (United Nations publication, Sales No. E.99.II.F.10).

rising stock market prices had also contributed to a relatively sharp reduction in the household saving rate. In the middle of 1999, for example, the average household in the United States was spending more than its disposable income.[5] The fall in private savings was offset only partially by the government's budget surplus, thus contributing to a large deficit in the external current accounts. Moreover, high levels of capital expenditure by the corporate sector and rising consumption outlays by households had together generated a strong demand for credit, leading to a rapid growth in total bank lending and the money stock. Partly as a result, yields on both corporate and government bond rose by around 1.5 percentage points between the third quarter of 1998 and the third quarter of 1999. The financial markets therefore expected inflation to pick up modestly at some point in the near future, given the low level of unemployment.

While the sustained, overall strength of the United States economy bears eloquent testimony to sound policies, a number of other factors also played a supportive part over the last two to three years. The cumulative gains in equity values clearly enabled individuals to maintain consumption expenditure at high levels and corporations to invest in capital equipment beyond what might otherwise have been possible. Low commodity prices and the sustained strength of the dollar contributed to the prevention of inflationary pressures. The latter, in turn, contributed to, as well as benefited from, restrained real wage gains, despite a tight labour market.

A major issue of worldwide interest and concern has been the sustainability of American economic growth over the next few years. Typically, a slowdown occurs when low unemployment and tight labour markets cause wages to escalate faster than productivity; inflation picks up and interest rates have to be increased. Many analysts maintain the view that, despite recent productivity gains in the United States, skill shortages and wage pressures are likely to emerge, especially with the unemployment rate as low as 4.1 per cent. Apart from the possibilities of a wage hike and higher inflation, there are other concerns. These include the large and rising volumes of private dissavings and a high current account deficit, which was estimated at over 3.5 per cent of GDP in 1999. The sustainability of stock market price indices would be another possible area of risk, as already noted.

The strength of the American stock market, however, is not an unmixed blessing. Most categories of stock price indices in the United States have kept on rising over the last few years. A wide range of stocks issued by established or new enterprises, especially those engaged in the development or application of new technologies, can remain buoyant, feed self-sustained optimism and rising stock values, and contribute to the strong growth of the economy. But when high stock values are associated with increasing levels of net dissavings and credit extension to (and indebtedness of) the private sector, then a restoration of household savings to the long-term trend average can trigger reduced consumption and lowering of corporate revenues and earnings, with an adverse impact on growth. Equally, a fall in household dissavings independent of any decline in the stock markets could precipitate a major decline in consumption and corporate sales and earnings, leading to a fall in stock market prices and further adverse effects.

The private sector financial balance in 1999 fell to about −4.7 per cent of GDP in the United States;[6] such a deficit in the private sector financial balance had never exceeded 1 per cent in the United States over the previous five decades.[7] Further increases in dissaving are regarded as unsustainable as they would lead to inordinately large private debt levels possibly triggering substantial increases in borrowing costs. At some stage, therefore, private savers could be expected to rebuild their savings and reduce their spending, not least to lower the debt-service burden. Whether consumption and thus GDP growth would decline gently or abruptly in consequence is very difficult to predict.

Thus far, the general mix of domestic policies, and monetary measures in particular, has been highly successful in smoothly steering the American economy through the financial turmoil of the past three years and in maintaining the momentum of growth in output and employment without the penalty

[5] *OECD Economic Outlook,* June 1999, p. 40.

[6] *OECD Economic Outlook,* June 1999.

[7] *The Economist,* 25 September 1999, p. 15.

of overheated cost pressures and unsustainable debt accumulation. The policy challenge appears to be in ensuring a gentle descent and slowdown in economic growth to a more manageable and sustainable level (of between 2.5 and 3.5 per cent) without provoking a large sell-off in the stock markets. The risk is that monetary gradualism may not be entirely adequate to restrain optimism and consumer spending, and corporate enthusiasm about business investment and rationalization, including through mergers and takeovers.

Turning now to EU, some of the euphoria generated by the introduction of the euro on 1 January 1999 dissipated as the new currency weakened significantly against the dollar. In hindsight, the depreciation proved a blessing in disguise as it reversed, to some extent, the weaknesses in economic performance that had characterized many of the EU economies prior to the introduction of the euro. Growth indeed picked up in the 11 economies of the euro zone in the latter part of 1999, in part due to improved price competitiveness. Unemployment levels also began to decline slowly in the 11 economies of the euro zone. Elsewhere in Europe, too, growth in 1999 was higher than had been forecast at the beginning of the year, partly on account of the economic expansion in the euro zone itself and partly because of other favourable factors, including the supportive strength of the American economy.

Despite this recent improvement, growth performance within EU has been considerably weaker than that of the United States since the early 1990s. Its record was also poorer than that achieved by most EU members themselves in the 1980s. The 11 economies of the euro zone are faced with a range of difficult policy issues in sustaining higher growth trajectories in the short and medium term. On the fiscal side, the Maastricht treaty requires further fiscal consolidation; member countries have to eliminate their structural deficits progressively so as to ensure fiscal positions close to overall balance or to achieve a budget surplus by 2002. This leaves the task of managing the pace of growth almost exclusively to monetary policy, the mandate of the European Central Bank (ECB).

Monetary policy stance in the euro zone is now concerned with all the 11 member countries in monetary union; it cannot therefore be tailored to deal with specific conditions and circumstances in individual countries. Moreover, inflation is to be kept within the target band of 0–2 per cent per annum; ECB has no mandate to pursue higher growth in output and hence employment. The relatively weak performance until recently of the larger economies in the euro zone, especially Germany, Italy and, to a lesser extent, France, contrasted with the rapid economic growth in some of the smaller member countries such as Finland, Ireland, Portugal and Spain. However, ECB raised its refinancing rate by 0.5 percentage points to 3.0 per cent in November 1999. Another supply-side factor that might serve to constrain or impede the achievement of higher growth in EU relates to the extent and pace of restructuring in labour and product markets within the 11 economies of the euro zone despite considerable progress made in these respects.

By and large, unemployment in EU persisted at historical highs with only minor reductions during the recovery in 1997-1998, and in 1999. Longer-term supply factors, such as labour and product market rigidities, remained at the heart of the problem. This was especially true in Germany, where part of the unification costs had been met by levies on wages, thereby raising the cost of labour. The lower productivity of workers in the former German Democratic Republic was another factor in keeping unemployment high. However, several major steps to address these issues, taken recently by the Government of Germany, have boosted business confidence in the country; the pertinent measures included a reduction in pension contributions by employers, early retirement options and an expansion of youth training facilities and programmes. In comparison, the French economy performed better, partly because it did not have to meet the high fiscal costs as in Germany on account of unification. As a result, the extent of fiscal consolidation that had to be made prior to the introduction of the euro in France was smaller as a percentage of GDP. The poorer performance of Italy could also be attributed largely to previous fiscal profligacy; the fiscal consolidation required over the span of two years amounted to some 9 per cent of Italy’s GDP. Furthermore, both Germany and Italy had been more heavily exposed financially and otherwise, and were thus more vulnerable to the severe financial and economic crisis in Asia and in the Russian Federation.

Outside the 11 economies of the euro zone, growth picked up in the United Kingdom of Great Britain and Northern Ireland in the second half of 1999. The slowdown in late 1998 and early 1999 was occasioned by the weakening of external demand; in turn, this could be attributed to the strengthening of sterling and the consequent sharp decline in net exports. Interest rates were reduced in April and June 1999 to achieve some economic stimuli; core inflation stayed well below its target rate of 2.5 per cent. Thereafter, economic activities picked up fairly rapidly so that interest rates were raised marginally in September and then in November 1999 to choke off any incipient inflationary pressures. The brevity of the recent economic slowdown in the United Kingdom provided a sharp contrast to previous experiences. This achievement can be attributed primarily to a policy-induced environment of low inflation which, in turn, has allowed interest rates to be adjusted more quickly and often in response to marginal changes in economic activities. Extensive labour and product market reforms carried out in the 1980s have also facilitated speedier outcomes of policy changes.

As a whole, any significant improvement in growth performance in the 15 economies of the European Union in the year 2000 and beyond will depend greatly on the extent and pace of structural reform in the largest economies. First of all, further labour market reforms that would help to reduce structural unemployment could be expected to raise output fairly quickly. Reforms in the product markets, such as in telecommunications, retailing and utilities, and greater flexibility in zoning laws could also achieve similar results. Other than in the United Kingdom, progress in such areas of policy and structural reforms has not been speedy in the larger EU economies.

The slow pace of reform has possibly also impeded or constrained a faster and wider absorption of information technologies and other new technologies in many of these economies. Such technologies greatly improved the performance, as well as the resilience, of the United States economy in the 1990s, as discussed in some detail previously in this chapter. A possible stimulus to economic performance relates to the gradual convergence to higher income levels in the poorer EU economies; the process could promote increased competition and greater efficiency in EU as a whole. But such income convergence and the associated efficiency gains are likely to eventuate in the long run. On balance, it is unlikely that EU as a whole will become an alternative to the United States as a source of significant demand for exports from developing countries over the next few years.

Turning now to the ESCAP region, there is increasing evidence that the Japanese economy has finally bottomed out, with much of the recovery so far gained being a direct result of a series of major fiscal stimuli provided by the government in 1998 and 1999. Output growth was estimated at just under 1 per cent in 1999, compared to a contraction of almost 3 per cent the year before. However, these fiscal packages did not promote higher consumer spending or even higher consumer confidence. Unemployment, at 4.6 per cent in September 1999, remained stubbornly high by Japanese standards, while low levels of capacity utilization and large inventories persisted in the manufacturing sector, especially in activities less exposed to international competition.[8] In addition, the recent appreciation of the yen has compounded some of the current difficulties.

There was no let-up in the pace of decline in business investment as companies grappled with and sought to reduce overcapacity and large volumes of inventories. Overcapacity was responsible not only for the significant slack in the economy but also for making cost-cutting efforts an indispensable, ongoing feature of Japanese economic life. Such efforts, in turn, tended to add directly to deflationary pressures, aggravate indirectly the bad loan problems in the financial sector, and lower consumer confidence. There was a marked improvement in the performance of the banking sector in 1999 but it is commonly felt that a full resolution of the substantial amount (in absolute terms) of non-performing loans will take considerable time.

On a brighter note, business confidence showed credible signs of improvement and the rate of new bankruptcies slowed down noticeably. Nevertheless, policy makers continued to face a formidable array of challenges in initiating and sustaining the ongoing process of economic rationalization for stronger and more durable growth

[8] Bank of Japan, *Monthly Report of Recent Economic and Financial Developments,* September 1999.

performance in the near to medium term. The multidimensional reforms will not only involve widespread re-engineering of business corporations and lay-offs of workers for enhanced cost efficiency but also require considerable restructuring and consolidation of the financial sector. In macroeconomic policies, a critical area of concern is the rising fiscal deficit emanating from several large public spending packages to stimulate the economy. On current assumptions, the deficit will be over 9 per cent of GDP in both 1999 and 2000.[9]

A noticeable reduction in such a high level of fiscal deficit will not be a viable proposition until the recovery has taken hold, given the need to support economic turnaround through fiscal means. Monetary policy has been supportive of the expansionary fiscal stance, but limited scope exists for further easing of monetary conditions, especially with overnight rates of interest being close to zero. However, financial market concerns over the expanding volume of public debt have already been reflected in upward pressures on long-term interest rates in Japan. It has been suggested in this connection that part of the fiscal deficit should perhaps be monetized. If the central bank were to purchase and hold more government bonds, yields would not need to rise to provide the needed premium for private investors to hold more public debt. In the process, the money supply and financial system liquidity would expand, and inflationary expectations would rise; these would then serve to counter or weaken some of the recent strength acquired by the yen, sharpening export competitiveness in the process.

These debates have underlined the difficult choices and trade-offs facing policy makers in Japan. Against this backdrop, it is clear that structural reforms would play a critical role in determining the depth and durability of Japan's economic recovery. The problems of the banking sector were discussed at some length in *Survey 1999.* The recognized need for faster progress with the banking sector's restructuring, recapitalization and consolidation is highlighted by the prospective replacement in March 2001 of the blanket deposit insurance scheme currently in operation with a more limited system. The banking sector plays a greater role in Japan than in any other developed economy. As such, it is of vital importance that the sector regains profitability in its core activities so as to provide the fullest support for Japanese economic revival.

The prospects of successful financial sector consolidation and recapitalization are intimately linked to the resolution of the problems within the corporate sector; the latter depend, in turn, upon the effectiveness and timeliness of both public and private sector measures to reduce excess capacity, large inventories and overmanning in manufacturing. Progress in these areas has not been as speedy as is desirable. Taking all these factors into account, it is unlikely that the Japanese economy will grow appreciably faster than the 0.9 per cent expected for the 1999 fiscal year (ending 31 March 2000).[10] A further major fiscal package equivalent to $172 billion was introduced towards the end of 1999. This should prevent the economy from sliding backwards in 2000. However, it is the structural reforms and the reinvigoration of consumer confidence that would have a more lasting bearing on economic performance in Japan over the medium term.

Australia, one of the three developed countries of the ESCAP region, has performed strongly in recent years. Rising consumer expenditure contributed to another vigorous rate of economic growth of over 3.4 per cent in 1999. On the other hand, the after-effects of the Asian crisis served to widen the current account deficit to over 5 per cent of GDP. Sound macroeconomic fundamentals prevented a further weakening of the Australian dollar, despite relative stability in domestic interest rates. Some degree of economic slippage is possible now that investment expenditure has started to weaken in the face of poorer export prospects. In New Zealand, the economy moved out of the recession of 1998, and output growth was expected at around 2.2 per cent in 1999, with a possible acceleration in 2000 if world economic expansion continues at rates currently projected. The effects of the Asian crisis and the attendant volatility in domestic financial markets were substantially moderated during the latter part of 1999. In fact, the New Zealand economy has been enjoying renewed competitiveness and rising business and consumer confidence. The latter reflects the considerable progress made so far in restructuring corporate and household balance sheets, a process which is inevitable after a recession.

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[9] *OECD Economic Outlook,* June 1998.

[10] Recent private sector forecasts suggest a GDP growth rate of 1 per cent for the fiscal year ending in March 2000.

Developing economies

The worst periods of output contraction ended during the first or second quarter of 1999 among the economies hit by the crisis in the ESCAP developing region. The economic consolidation and recovery phase appear to have begun firmly, with the Republic of Korea showing the most dramatic improvement in levels of production, exports and employment. The turnaround process had these common characteristics. First, there was the reversal of the extreme depreciation in the exchange rates which had persisted until the middle of 1998. Second, inflationary pressures were initially contained and then substantially moderated, and this allowed interest rates to fall significantly from the very high levels which had existed up to mid-1998. Third, a rapid turnaround was achieved in the balance of payments, initially based upon a sharp compression of imports but lately reinforced by buoyant export earnings despite the increased outflows resulting from a revival in import spending. Fourth, foreign exchange reserves were built up in the process, to higher levels than before the crisis in some cases. Fifth, domestic and international investor confidence and external perceptions of local credit risks improved significantly. However, the steady recovery in stock prices and a narrowing of international bond yield differentials were also accompanied by considerable instability in the financial markets of the crisis economies in the latter part of 1999. This was partially a reflection of the slow pace of progress with financial and corporate sector restructuring, the continuing overhang of substantial levels of non-performing loans, corporate indebtedness and excess capacity. Such volatility was also due to the ripple effects of other factors, notably the political turmoil in Indonesia, uncertainties as regards the value of the yen and fluctuations in the perceptions of foreign investors not necessarily related to objective conditions.

Economic performance remained encouraging outside the crisis economies of the ESCAP developing region, as has also been the case in the recent past. The rate of output growth in China is estimated at 7.2 per cent for 1999; this is marginally lower than the rate for the previous year but is clearly healthy by regional standards. India achieved a slightly lower GDP growth in 1999 than in 1998. The country benefited considerably from a strong performance in agriculture and exports, particularly of computer software. Inflationary pressures also abated in India during the year. Growth in output and incomes among most other developing countries in the region was not dramatically different from recent trends.

The Asian crisis induced a steep drop in capital flows to many Latin American countries. Monetary policy in most of the larger economies of that region was tightened so as to stem the outflow of capital. The problems created by resultant higher interest rates were made much worse by the sharp decline in commodity prices that had occurred during 1998 and that persisted into 1999. The overall outcome was a fall in export earnings and larger current account deficits in most Latin American economies. Output growth consequently turned negative during 1999 in the five largest economies (namely Argentina, Brazil, Chile, Colombia and Venezuela). Only the Mexican economy had recorded some positive gain in GDP during the 12 months to mid-1999, albeit at a decelerating pace. Even with some recovery in production during the second half of 1999, aggregate GDP for the region is likely to have contracted by one percentage point for the year as a whole. This estimate presumes no further disruptions in Latin American financial markets and assumes that economic growth will continue at its recent pace in the United States. The recent rise in oil prices, the general pickup in commodity prices and some easing of monetary conditions in the region suggest the likelihood of positive growth in 2000.[11]

African and West Asian economies are primarily commodity-dependent. For these economies, integration with the world economy, other than through trade flows, remains negligible or limited and developments in the external financial markets tend to have a diluted bearing on their economic performance. In 1998, export earnings had declined sharply and, as in Latin America, there was a concomitant widening of the current account deficits in many African and West Asian economies. In Africa, the consequent deficits were funded mainly by official development assistance

[11] *Financial Times,* 5 November 1999.

(ODA); external deficits in West Asia had been funded largely by drawing down foreign exchange reserves.

GDP growth in most of Africa was expected to be about 2–3 per cent in 1999; this was about the same pace as that realized a year earlier, notwithstanding somewhat firmer commodity prices in the latter part of 1999. There was, on the other hand, considerable intraregional variability attributable to economic and other factors; the latter included political and civil unrest. Regarding the former, some improvement in foreign exchange earnings, as well as marginally easier access to external finance, should be the experience of the larger countries of North Africa, and of South Africa, in 1999. These economies are at comparatively higher development stages; they are also more closely integrated with the global economy, including EU, in terms of both trading and financial linkages. Many of the less developed economies in Africa continue to suffer from acute structural problems, including large fiscal deficits, inefficiency in production, market rigidities, inadequate infrastructure and human resources, and debt-service burdens that have long been unsustainable. The recent initiative designed to address the latter problem among highly indebted poor countries should provide them with relief over the medium term, but its benefits and impact are expected to be incremental. In the short run, therefore, economic performance in the African developing region will continue to depend heavily upon commodity prices.

In West Asia, the economic outlook has recently become much better than it has been for some time because of the sharp increase in the price of oil exports. Oil production levels and unit values are the major determinants of economic performance of most West Asian economies. Such windfall gains by no means lessen the pressing need for policy adjustments and economic restructuring in at least three main areas: wide-ranging fiscal reforms; the diversification of output and the promotion of higher value-adding activities; and a sizeable redirection of public spending for human resources development and skill enhancement. These are essential to improve domestic efficiency and flexibility in both factor and product markets. Such reforms and restructuring are also indispensable for ensuring and sustaining higher trajectories of (equitable) output growth and greater diversification in the medium and long term.

On balance, the developing countries as a group could record an appreciable improvement in economic performance in 2000, compared to that of the preceding year. This assessment has to be tempered by the following considerations, some of which were discussed at length earlier in the chapter. On the external front, there are still appreciable uncertainties concerning the economic performance of the United States, EU and Japan in 2000 and the years immediately beyond. On the domestic front, the durability of the growth of the developing countries, and diversification in their output and employment in the near to medium term, will depend on their success in implementing multisectoral policy reforms and restructuring. At the same time, local human resources and institutions will need to be built up and strengthened to handle more satisfactorily the increasingly complex requirements of integration into the emerging knowledge-driven global economy.

TRADE AND CAPITAL FLOWS

Trade

The sustained and buoyant growth in world trade (both exports and imports of goods and services) has been one of the most striking features of the global economy in the 1990s; this has been discussed at some length in several previous issues of the *Survey.* Between 1990 and 1997, for example, world trade in goods and services increased by 52 per cent in dollar values, from $4.3 trillion to $6.5 trillion. In volume terms, the average growth rate of global trade, at 6.7 per cent annually, significantly outpaced the expansion in global production, at 3.0 per cent per annum, during the same period. By 1998, the ratio of world trade in goods and services to global GDP had increased from 19 per cent in 1990 to 23 per cent.

The growth trends in world trade, however, decelerated sharply in both value and volume terms in 1998; and so did the rate of global production. A sharp decline in trading volumes in the wake of the crisis in Asia, accompanied by lower commodity prices, contributed to the steepest decline in the nominal value of world trade since 1982, growth in volume terms being 3.6 per cent in 1998, and 9.9 per cent a year earlier (tables I.1 and I.2). The price of manufactured goods also fell but by less than that of raw materials, thus causing significant

Table I.2. External trade of selected economies, 1997-1999

(Billions of US dollars)

	Exports			*Imports*		
	1997	*1998*	*1999 (Jan.–Sep.)*	*1997*	*1998*	*1999 (Jan.–Sep.)*
World	5 377	5 324	4 072	5 462	5 389	4 190
Developed economies	3 610	3 622	2 790	3 609	3 687	2 910
Japan	421	388	302	389	281	221
Developing economies	1 558	1 499	1 140	1 611	1 463	1 121
ASEAN	330	303	249	336	254	209
China	183	184	83[a]	142	140	75[a]
Hong Kong, China	188	174	126	209	184	130
India	34	34	17[a]	41	43	21[a]
Republic of Korea	136	132	102	145	93	84

Source: United Nations, *Monthly Bulletin of Statistics*, January 2000.

[a] January–June.

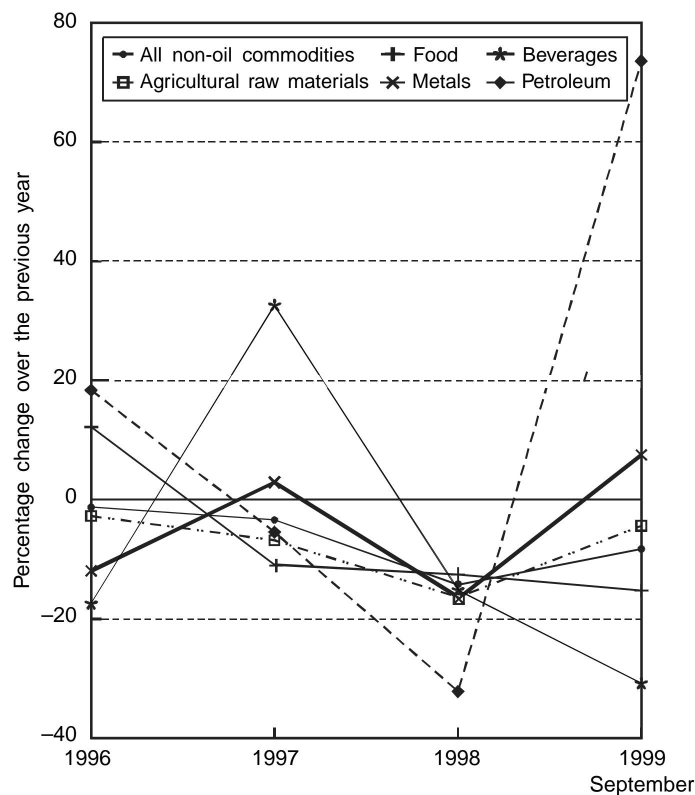
losses in the terms of trade for countries producing raw materials, and fuel exporters in particular (terms of trade declined by 20.2 per cent for these exporters relative to 6.9 per cent for developing countries as a group). Up to the third quarter of 1999, world trade had grown marginally in value terms compared to the same period in 1998; as a whole, the recovery from the contractionary level of the previous year's trade values and low growth in volume is expected to be modest in 1999. A faster pace of world trade will be more likely in 2000.

The above estimates embody a combination of diverse movements. Domestic production and exports were picking up in the crisis economies of Asia, and so the value of imports could be running significantly higher in the second half of 1999. On the other hand, however, a reduction in import demand in Latin America can be expected, given the contraction in output in the region in 1999, as discussed earlier. Among the developed countries, the United States economy has been the source of much of the buoyancy in import demand over the past several years. Economic growth remains robust in 1999, but it is unlikely that there will be any significant increase in United States import demand for the year compared to that of 1998. Asymmetrically, however, a slowdown in this economic powerhouse could have a sharp impact on import demand, and on the import of consumer goods especially. This is perhaps the biggest and most uncertain element in global trade in the coming years. A stronger performance in EU and Japan could provide a boost to world trade growth in both volume and value terms, but is unlikely to compensate for any major decline in import demand in the United States.

The recent trends in global trade deserve a few comments. The significant depreciations in the exchange rates of the Asian crisis economies since late 1997 have improved their export competitiveness, but this was not reflected in higher levels of actual export earnings until well into 1999. The positive impact was delayed because of weakened external demand for all major commodity groups; such weaknesses had become evident in 1998 and persisted well into the middle of 1999. The export prices of manufactured goods, with only some minor exceptions, were also affected adversely by the regional and global economic slowdown and poorer demand and, perhaps, price competition among developing country exporters.

These unfavourable price trends were reversed, most dramatically in the case of oil, from March 1999 onwards (figure I.1). By November 1999, for

Figure I.1. Changes in world primary commodity prices, 1996-1999



Source: IMF, *International Financial Statistics,* November 1999.

example, oil prices were almost 100 per cent higher than the levels prevailing up to mid-1998. This upturn was largely the result of production cuts by the members of the Organization of the Petroleum Exporting Countries. Other commodity prices, especially those of food and non-food agricultural commodities, also experienced a renewed upswing, albeit of a much more modest magnitude; export prices of metals were beginning to firm up as well. Lower stocks and inventories of commodities and recovery-led increases in demand were the major causes of the reversal and upturn in commodity export price trends in the latter part of 1999.

At present, the gains in oil prices are tied in with production restraints. Their impact in terms of higher export earnings can be large only with a sustained expansion in external demand to offset the lower volumes traded. Some exporting countries could opt, in the first instance, to replenish reserves; the windfall gains in export earnings may not translate into higher imports for some time. In the oil-importing countries, on the other hand, higher oil prices could lead to lower non-oil imports, especially of consumer goods, as oil demand is relatively more price-inelastic. The hikes in production costs and domestic prices resulting from higher prices of oil and other commodities could conceivably trigger a tighter policy stance to reduce fiscal and external account deficits, and choke off any incipient inflationary pressures. This could affect overall economic performance in both the developed and the developing regions.

Box I.1. Globalization after the Seattle debacle

The establishment of WTO represented a major success of the international community in creating a rules-based system pertaining to some important aspects of the globalization process. However, the Third WTO Ministerial Conference, held in Seattle in November and December 1999, which was to advance the process further, could not come up with an agreed agenda for a new round of multilateral negotiations because of sharp divergences between the developed and the developing countries, and within them, on a wide range of issues. Some of the major stumbling blocks are briefly discussed below.[a]

A second round of negotiations on trade liberalization during 2000 had been mandated under the Agreement on Agriculture. Several developing countries and the United States wanted the negotiations to aim at a progressive elimination of export subsidies and a substantial reduction in domestic support. Other WTO members, including EU, Japan, Norway, the Republic of Korea and Switzerland, emphasized non-trade concerns and the multifunctionality of agriculture. A large number of developing countries, which have been heavily dependent on agriculture for employment and output, wanted a consolidation and extension of the special and differential provisions in various agreements, including the Agreement on Agriculture. On the other hand, the possible increases in world food prices emanating from lower agricultural subsidies from the developed countries was a matter of significant concern for the net food importers among developing countries. There were still other WTO members who wished to see substantial cuts in the persistent barriers to their agricultural trade, especially the high tariff peaks and tariff escalation on processed agro-products and manufactured goods.

A process of comprehensive negotiations was favoured by, among others, EU, Japan and a number of developing countries in Asia and Latin America which are exporters of agricultural products. This would serve to diffuse attention away from the politically sensitive issue of agriculture and offer scope for the cross-sectoral give-and-take that is essential to achieve ambitious results. But many other countries had not expected or did not favour a comprehensive approach; they felt insufficiently prepared for this purpose. Moreover, fundamental differences persisted over the inclusion of the so-called four Singapore issues: investment, competition policy, transparency in government procurement, and trade facilitation.

Indeed, many developing countries preferred to adopt a minimalist agenda for negotiations, focusing largely on a range of issues involved in the implementation of the WTO agreements already reached. One of these issues, for instance, related to the scheduled liberalization in textiles and clothing. The process apparently had not led to a significant removal of quota barriers in the developed importing countries, and market access was considerably negated by such measures as transitional safeguards and restrictive rules of origin. In addition, many WTO members (including Japan, the Republic of Korea and some European countries) were strongly convinced that anti-dumping investigations were being utilized to impede trade flows and reduce competition. Also, developing countries often felt excluded from the creation of international standards with which they were expected to comply fully, even though these were beyond their own technical ability or financial capacity. Furthermore, they sought a review and, where necessary, amendments or tightening of WTO rules in the pertinent agreements, including those on subsidies and countervailing measures, and trade-related investment measures in order to give them more policy flexibility and greater security of market access.

Another deep fissure was in the area of international labour standards on which the United States and EU were keen to push for further action. Developing countries, on the other hand, suspected protectionist motives, especially if trade sanctions were to be imposed to enforce compliance with agreed labour standards. An informal proposal at Seattle envisaged the establishment of a joint ILO/WTO working forum on trade, globalization and labour issues. The forum would be outside the WTO structure, be open to the relevant international organizations, including the World Bank and UNCTAD, and would promote a better understanding of the substantive issues involved through the facilitation of interactive dialogue between governments.

[a] For further details, see “The Seattle crisis and post-Seattle strategy”, paper prepared by the Group of Fifteen, Federation of Chambers of Commerce, Industry and Services, Cairo; and Anwarul Hoda, “Imperatives for South-South cooperation in the multilateral trading system”, paper presented at the ESCAP Seminar on Interregional Cooperation in Trade and Investment: Asia – Latin America, Bangkok, 15 and 16 February 2000.

Trade-related aspects of intellectual property rights were another important area of focus at Seattle. Many developing countries wanted the scope of protection to be extended to include such items as handicrafts and agricultural products. Other matters of concern included the lengthening of transitional periods, especially in the case of pharmaceuticals (from 2000 to 2003), the possible exemption of the World Heath Organization list of essential drugs from patentability, and developing countries' own (technical and financial) capabilities to survey and record all available agricultural resources before 2005.

There were major procedural problems too. Initial negotiation in small groups of participants (usually major economies) was a common practice during the time of the General Agreement on Tariffs and Trade, but there were genuine fears in Seattle that the compromises reached through a similar process could undermine the interests of those who did not participate. A new modality was needed to ensure greater internal transparency and inclusion, given the much larger and diverse membership of WTO. The disruptions at Seattle also underlined the need for greater external transparency through, inter alia, more timely and extensive dissemination of information, as well as the greater involvement of all stakeholders, including civil society organizations.

It is against this backdrop of sharply divergent views that the tenth session of UNCTAD was held in Bangkok in February 2000. UNCTAD is not a negotiating forum and there was therefore no expectation that agreement would be reached on specific issues. Nevertheless, it is worth noting that the Bangkok Declaration which came out of this session agreed that globalization was an ongoing process that presented opportunities for countries to benefit, but also raised the risk of marginalization of countries, in particular the poorest countries, and of the most vulnerable groups everywhere. It was also agreed that globalization could be a powerful force for development, if it was properly managed. More specifically, the conference emphasized commitment to a multilateral trading system that was fair, equitable and rules-based, and that operated in a non-discriminatory and transparent manner and in a way that provided benefits for all countries, especially developing countries. That would involve, among other things, improving market access for goods and services of particular interest to developing countries, resolving issues relating to the implementation of WTO agreements, fully implementing provisions on special and differential treatment, facilitating accession to WTO and providing technical assistance. The future pattern of globalization and distribution of its benefits will be largely determined by the extent of the implementation of these commitments.

The buoyant expansion in world trade and the deepening interdependence among countries led to considerable efficiency gains. These have served to underpin the high rates of global and regional economic growth for most of the current decade. But it is also apparent that the benefits from the globalization of goods, services, finance and ideas have been highly uneven. The substantial anticipated gains have proved elusive or modest for many developing countries, particularly the least developed countries and other disadvantaged economies. Moreover, the downside risks of policy liberalization and globalization are real even for the strongest developing economies; they are also far greater than was presumed generally, as has been demonstrated by the experience in East and South-East Asia and Latin America (see box I.1).[12]

[12] UNCTAD, *Trade and Development Report, 1999* (United Nations publication, Sales No. E.99.II.D.1).

Capital flows

Among the ripple effects of the financial crisis in Asia was the ensuing turbulence in the Russian Federation and in Latin America and, temporarily, even in the financial markets of developed countries. Initially, alarms had been sounded by many observers about the breadth and the depth of the impact of the Asian crisis on the global economy. Indeed, fears were raised of a possible global recession through a generalized credit crunch and the reversal of capital flows to emerging markets in developing countries. The latter apprehension was not entirely unfounded. The net private capital flows to emerging markets were estimated at $66.2 billion in 1998, compared to $148.8 billion in 1997. Those channelled to the five Asian crisis economies, namely Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand, were $29.6 billion and $22.1 billion respectively during these two years.[13]

[13] IMF, *World Economic Outlook* (Washington DC), October 1999, table 2.2.

In the event, however, the highly adverse repercussions as anticipated did not materialize. There was a fairly rapid return to stability in most financial markets, including those of the crisis economies. The impact of the crisis on global growth, with its ripple effects was short-lived (table I.1). A generalized credit crunch did not materialize and, by the third quarter of 1999, cross-border capital flows had recovered more or less to their level of 12 months earlier. Gross private financing to emerging markets in the developing region stood at $103.6 billion as of August 1999, compared to $148.5 billion for the whole of 1998 (table I.3).

Thus, the evidence suggests that the contagion of financial crises can indeed spread to virtually all corners of the globe. Their overall effect, however, can be contained partly by acquired depth and sophistication of global financial market centres, and partly by policy responses at both the international and the national level. For example, the highly developed state of the financial markets in the United States underpinned the attraction of dollar-denominated assets (such as government bonds and corporate equities). Besides, policy initiatives in the form of the three reductions in interest rates in October and November 1998 bolstered fragile investor confidence at an especially vulnerable stage.

Largely as a result, the stock and bond markets in the United States had recovered virtually all their losses by the end of 1998; the former also reached record levels in the first half of 1999. There were some downward movements and renewed bouts of nervousness but, by and large, the overall market sentiment remained bullish. However, as the United States economy continued to grow strongly for much of 1999, the downward trend in interest rates was reversed so as to pre-empt overheating. Indeed, the strong pace of expansion of the United States economy and relative weakness of the EU economy led to expectations of still higher interest rates in the former and lower interest rates in the latter. Such expectations probably played their part in the depreciation of the euro, thus enhancing somewhat euro-zone export competitiveness in the course of 1999. But there were certain adverse developments within EU itself. The money supply expanded towards the third quarter of 1999 at a faster rate than originally expected and, in addition, signs of inflation in asset prices were emerging, especially in the stock markets. All this culminated in the imposition of a half-point increase in the refinance rate by ECB in November 1999.

Initially, Japan was worst affected by the crisis in Asia; the yen also weakened considerably in the aftermath. The successive packages of fiscal stimuli and large injections of liquidity served to reduce the nominal interest rates to almost zero and, at the same time, to raise bond yields significantly in Japan. The latter effect, coupled with a weaker yen, however, induced a substantial flow of external funds into Japanese financial assets; the process thus generated large gains in stock market prices as well as a considerable strengthening of the yen against

Table I.3. Gross private financing to emerging market economies, 1996-1999

(Billions of US dollars)

	1996	*1997*	*1998*	*1999*[a]
Total	218.4	286.1	148.5	103.6
Asia	118.5	127.5	34.1	38.2
Percentage Asia	54.3	44.6	23.0	36.9
Equity[b]	127.7	162.9	88.1	72.1
Asia	62.3	68.5	16.4	27.8
Percentage Asia	48.8	42.1	18.6	38.6
Loan commitments	90.7	123.2	60.4	31.6
Asia	56.2	58.9	17.7	12.0
Percentage Asia	62.0	47.8	29.3	38.0

Source: IMF, *World Economic Outlook* (Washington DC), October 1999.

[a] Up to August.

[b] Comprising bond issues, other fixed income and equity issues.

the dollar. An appreciating yen at this particular juncture poses several adjustment problems. It could hamper the economic recovery in Japan via reduced export competitiveness. The consequent stagnation in corporate earnings and profitability could also limit consumption expenditure and ratchet up savings rates for precautionary purposes, adding to deflationary pressures. An appreciating yen could also necessitate adjustments in the exchange rates of major currencies across the globe, which might be an additional source of instability in the international financial markets.

The achievement of historically low rates of inflation in the developed economies is a striking feature of the 1990s; this stands in contrast to the relatively large volatility in the costs of money across space (exchange rates). The maintenance of low inflation is certainly a desirable objective of policy. However, it may have a bearing on the volume and pattern of capital flows from the developed to the developing countries. One particular concern in this regard is the induced fall in the prices of assets which serve as collateral for bank lending. A rise in real interest rates caused by a period of declining inflation can have a large negative impact on the value of such collateral. In turn, this could lead to a tightening of credit conditions, affecting both domestic and cross-border lending.

The experience of Japan since the early 1990s indicates that asset price deflation can exert a negative impact on the liquidity position of the banking system and induce highly risk-averse behaviour in lending operations. Such risk-averse intermediation, by and large, has characterized international financial markets in both the capital-exporting and the capital-importing economies in recent times. This is well illustrated by the trends in private financial flows to emerging markets (table I.3). The gross volume of such inflows in 1999 is unlikely to have exceeded the previous year's level by any substantial amount. The terms and conditions involved have also proved more onerous.

One bright feature in the above context of risk preoccupation is the improvement in the share of private capital flows to the emerging markets in Asia. The relative proportion reached almost 37 per cent as of August 1999, compared to 23 per cent for the whole of 1998. Such a relative gain translates into only a marginal improvement in absolute terms and implies a corresponding tightening of the flows to other emerging markets outside Asia.

The patterns of foreign direct investment (FDI) flows have exhibited rather different characteristics. Contrary to most expectations, the global volume of gross FDI grew from $464.3 trillion in 1997 to $643.9 trillion in 1998 in spite of difficult economic and financial conditions; such flows are projected to have expanded further in 1999.[14] This observed buoyancy in FDI was confined totally to transactions among developed countries. To a considerable extent, it was driven by cross-border merger and acquisition activities in many diverse fields; these have ranged from resource-based industries in oil and gas to corporate enterprises in banking, finance, and information and communications technologies. As long as merger and acquisition activities represent a consolidation of sunk investment, they are replacing possible new investments in the fields or industries under consideration, regardless of the modalities or sources of financing.

The upward trend in the share of developing countries in world FDI flows was reversed by a fall of some 4 per cent in the volume of FDI channelled to these countries, the gross amount being $165.9 billion during 1998, compared to $172.5 billion a year earlier. The largest cut was experienced in Asia, totalling some 12 per cent (or $10.5 billion), with Hong Kong, China; Indonesia; Malaysia; and Taiwan Province of China bearing much of the fall.[15] Nevertheless, under the circumstances, FDI flows have remained surprisingly resilient in several of the crisis economies as well as in the rest of Asia. In fact, the Philippines, the Republic of Korea and Thailand were among those countries which recorded a considerable increase in FDI inflows in 1998.

Merger and acquisition activities are relatively cost-effective for transnational corporations because of the ready availability of good productive assets at low or heavily discounted prices in the countries affected by the crisis. They also proved a convenient substitute for investments in new projects.

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[14] UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development* (United Nations publication, Sales No. E.99.II.D.3).

[15] Ibid.

IMPLICATIONS FOR THE ESCAP REGION

Trade

The patterns of world trade were reviewed at some length earlier in this chapter. The decline in the value and volume of trade flows was evident in 1998 and persisted into the early part of the following year; the downward trend appears to have been halted towards the middle of 1999. The recent increase in world trade in value terms embodies a sharp rise in oil prices, aided by an upturn in the export unit values of several categories of commodities. It was also underpinned by a measurable trade expansion fuelled by the recovery of exports from the crisis countries of Asia. Within the ESCAP region as a whole, for example, exports rose in both volume and value terms during the first half of 1999, compared to the levels prevailing in the first half of 1998 with this trend persisting into the second half of 1999.

The United States economy continues to provide much of the demand for exports from the region. EU and Japan, while showing welcome strength, are unlikely to add appreciably to the overall earnings through exports from Asia, as discussed previously. Indeed, the pace of economic recovery within EU is expected to be modest and could easily falter as a result of the recent increase in interest rates; at the same time, the depreciation of the euro could dampen the demand for imports. The appreciation of the yen, on the other hand, has generated some buoyancy in imports into Japan independently of the strength of the economic recovery; but the continuing weakness of consumer demand could be an offsetting factor. Intraregional trade, the engine of growth in the early 1990s, has remained sluggish thus far, although it should expand considerably with a broader and deeper recovery in the crisis economies.

On the supply side, higher prices for oil, if they persist, may increase production costs in oil-importing countries, which constitute the overwhelming majority of ESCAP countries. Higher prices of non-oil commodities should translate into higher earnings of a sizeable number of ESCAP economies, even with unchanged export volumes, especially given the relatively price-inelastic nature of short-run demand for such commodities. The greatest buoyancy currently visible on the supply side is in manufacturing, though. Several of the regional suppliers of electronic goods and other manufactured products within the crisis countries have been able to boost their production and exports significantly. This upswing is largely attributable to their enhanced competitiveness though crisis-induced currency depreciation and the persistence of strong United States demand for electronics goods in general, and for computers in particular. The strong cash flows so garnered have combined with lower domestic interest rates to attenuate somewhat the financing problems associated with the credit crunch in these countries.

Another element of the silver lining is manifested in concerted efforts made by many regional manufacturers, especially those in the crisis countries, to improve their efficiency and flexibility, including in capital mobilization and utilization and in ensuring leaner inventories and payrolls.[16] All these have contributed to enhancing productivity and export competitiveness. The present buoyancy in manufacturing and trade should continue well into the year 2000 on the basis of current demand and supply-side parameters. Once the initial stages of economic recovery and the associated trade expansion have been successfully completed, however, any broader-based increases in output capacity and exports will require much greater support from the domestic financial system within the crisis economies. It is in this connection that various caveats apply. In particular, the persistent constraints on bank lending cannot be relaxed without a satisfactory resolution of the bad loan problems, widespread corporate insolvency and high levels of corporate indebtedness.

Another set of qualifications relates to widened market access for export from the developing economies of the region, the least developed countries especially. Despite the success of the Uruguay Round, market access has not been increased for developing countries' exports in line with initial expectations. Export penetration from those countries is still hampered by persisting restrictions on market access, especially those concerning tariff peaks and tariff escalation on products of major interest to them, as well as the reinforced non-tariff barriers. This is particularly true in the case of agricultural commodities, processed primary products and

[16] *Financial Times,* 18 November 1999.

labour-intensive low-technology manufactured goods. The non-tariff barriers may involve linking market access to importing countries' environmental regulations unilaterally applied at the level of both products and processes as well to labour standards. Developing countries of the region, as elsewhere, will have to remain fully engaged in global trade negotiations in order to ensure that their access to export markets is not restrained by international agreements.

Capital inflows

A recovery is under way in aggregate flows of private finance to emerging market economies, as already noted earlier in this chapter. However, the flows in 1999 are unlikely to have surpassed the level of the previous year by any significant margin and will remain much lower than the corresponding volume in 1997 (table I.3). Remarkably, the volume of private financial flows to Asia in the first eight months of 1999 exceeded the amount channelled to the region for the whole of 1998 despite a reduction in loan commitments. Furthermore, the share of Asia in external private capital flows appears to be gradually increasing, albeit out of a drastically reduced total. However, only a relatively small number of Asian economies have been the destination of such flows; this characteristic geographical concentration seems to have become stronger in the post-crisis months.

When the extended period of relatively easy access to private capital came to an abrupt end among the crisis economies in 1997, the financing gap was largely bridged by official flows (from the IMF-led rescue packages). Within the subsequent 18 months, most of these economies were able to convert large deficits in their external current accounts into surpluses. Market sentiment concerning the crisis economies, and Asia more generally, showed a marked improvement following the build-up of external reserves, the containment of inflation, the resumption of export and GDP growth and, in the case of Indonesia, the improvement in the political situation. These were some of the factors leading to the revival of private capital flows into the region.

The spreads on international bond issues have begun to narrow for the crisis economies and for Asia as a whole. The risk premium declined from an unserviceable peak of 800 basis points in the third quarter of 1998 to 400 basis points by the first quarter of 1999. By and large, this downward trend continued as the year unfolded, even though the premiums involved were still much higher than those of the pre-crisis years. This positive development notwithstanding, access to such cheaper capital is now even more concentrated than before; it is available only to the highest-rated borrowers. Such enhanced concentration reflects lenders' fears of being forced to roll over existing lines of credit, or to provide new ones, should external financing problems arise again in the near future.[17]

The reduction in risk premium provides access to much less expensive funds as a means of restructuring the existing portfolio of external liabilities and lowering the overall cost of future debt servicing. While initially this option may apply only to the best borrowing entities, there could be positive spillover for others. But the easier access on improved terms should not lull policy makers into any sense of complacency. Although the events of 1997 and the hardships suffered in the aftermath are too recent to be forgotten, it is useful to remind policy makers that they have to keep perpetual vigil on the volume, terms and use of external private capital.

In the above context, it is also necessary to take note of the volatility that has been observable in the financial markets of the ESCAP region, including those in the crisis economies. There was a steady appreciation in exchange rates and rise in stock market indices up to the middle of 1999. Thereafter, both of these rising trends experienced a period of weakness, although a degree of financial stability was returning to most regional markets towards the latter part of the year. These changes in market sentiments did not appear closely related to movements in the so-called macroeconomic fundamentals; they tended to reflect the heightened volatility that has become a hallmark of global financial markets of late. In particular, the closer integration of international capital markets means greater correlation between selling and buying orders over different markets; and these

[17] Bank for International Settlements, *69th Annual Report,* June 1999, p. 38.

orders may have little or limited relevance to the state of developments in individual markets of emerging economies. Given the considerable impact that sudden or frequent changes in foreign investor sentiment can have on exchange rates and stock prices, on the cost and availability of financing, and on overall financial and economic stability of individual countries, the vital importance of continually monitoring the domestic and international financial markets and of fine-tuning policy instruments to deal with any destabilizing developments cannot be overemphasized.

The comparative resilience of FDI flows into the region has been already noted, but there are some issues lurking behind the aggregate numbers. The recent patterns of Japanese FDI may serve to highlight some of the issues. The overall level of investment outflows from Japan declined by 7 per cent to $24 billion in 1998, or to approximately half of the corresponding volume during the early 1990s. Indeed, even the figure actually recorded as FDI from Japan during 1998 could contain a large element of intra-company loans (extended by the parent corporations in Japan to their foreign subsidiaries or affiliates). The principal rationale for such loan transactions was to stabilize the operations of the subsidiaries or affiliates in the aftermath of the crisis; the very low interest rates prevailing in Japan and the steep depreciation in the exchange rates of the crisis economies were other facilitating factors. At some stage, these subsidiaries or affiliates will require fresh equity support. It thus remains to be seen whether the loans from transnational corporations in Japan will be converted into additional equity investment. Given the (domestic) financial pressures on Japanese transnational corporations the prospects for any significantly enlarged FDI flows in the form of new equity from Japan to Asia are not very promising in the immediate future. Similar observations may hold true for FDI flows from other sources.

A significant part of FDI flows into the region has been through mergers and acquisitions. Such FDI may have a beneficial effect on the host economy in terms of increased efficiency in production, technology transfer, and so on, but does not create new capacity. To that extent, the developmental impact of FDI is likely to be less than in the past.

It is clear that the process of recovery has been under way among the crisis economies of the ESCAP developing region from the early part of 1999. The region should see further improvement in its performance during 2000, given respectable growth in the major global economies, the ongoing restoration of some economic strength in Japan and the absence of heightened financial turmoil and corrections. From the preliminary indications available, output growth from the developing countries as a whole should accelerate from 1.2 per cent in 1998 to about 3.3 per cent in 1999, and further to 5.1 per cent in 2000. The overall rate of growth of developing countries within the ESCAP region should exceed that exhibited by the developing countries as a group. However, major uncertainties lie ahead in the realm of domestic reforms and the international environment, as discussed earlier.

CONCLUDING OBSERVATIONS

The economic linkages among countries have become far more complex and less predictable with greater policy liberalization and financial integration. In the past, there used to exist, by and large, a symmetrical, follow-on relationship between the developed and developing countries. The economic performance in the latter mirrored closely the cyclical stages in the former. This appears to have changed radically from the early 1990s, when the recession in the developed countries left many developing economies largely untouched, and especially those in Asia. Growth in intraregional trade and investment provided a crucial impetus for such resilience in regional economic performance.

On the other hand, economic performance among developed countries seems to have become more sensitive to the unfolding difficulties in their major trade and financial partners and markets within the developing region. Among other indications of this enlarged degree of vulnerability were the contagious changes in world trade and the decline in world economic growth in the immediate aftermath of the Asian crisis. But the impact has been uneven.

The financial turmoil in Asia caused a large repatriation and relocation of financial resources from the developing and other countries to dollar-denominated assets as a safe financial haven. This movement partially fuelled the growth momentum of the American economy. The transmission mechanisms operated through the enhanced buoyancy in the stock and bond markets, substantial capital gains, strong consumer confidence and increased household spending. The inflow of financial resources was also instrumental in raising the exchange rate of the dollar and muting inflationary impulses despite a tight labour market, providing a boost to consumer spending.

It is unlikely that the flow would be reversed significantly if the rate of growth in output and employment in the American economy were to falter for whatever reason. This asymmetrical relationship possibly rests on the very nature of financial markets as they exist now. The integration of capital markets has tended to inflate the value of, and the premium on, less risky assets such as United States treasury bills and other government-guaranteed papers. At the same time, such integration has facilitated a shift of resources in real time and with relative ease into, and out of, individual markets within the global economy. The process is well illustrated by the Asian crisis starting from July 1997, and then financial problems in the Russian Federation and elsewhere in 1998 and 1999. In practice, all this means that funds move rapidly out of developing countries with the slightest signs of trouble, but the reverse process takes considerable time even after objective conditions improve. How to deal with this asymmetry poses a major policy challenge for the international community.[18]

A fallout of the integration of financial markets has been a concurrent and noticeable increase in variations in both foreign exchange rates and the volumes of capital market transactions. The magnitude of such instability rose during the 1990s generally, but more so following the crisis. Market-based, daily fluctuations in exchange rates hitherto were confined largely to developed economies. They have now virtually become the norm in the more open developing economies as well, following the abandonment, by an increasing number of these countries, of fixed or quasi-fixed exchange rates in the aftermath of the Asian crisis. This phenomenon poses new policy issues and a dilemma for several reasons. First, many developing economies had become accustomed to exchange rate stability stretching back several years. Such stability remains a critically important anchor for investment, trade, financing and other business decisions. Second, market sentiment has tended to overshoot, exaggerating the degree of economic uncertainty at any particular point in time. Third, market perceptions do not often reflect closely, or are not primarily a consequence of, changes in the so-called macroeconomic fundamentals: inflation, the budgetary position, the balance on external current accounts, rates of interest and the level of foreign exchange reserves. The understanding of how market sentiment is formed in the private sector, and how it can be influenced by public policy responses, particularly in developing economies and emerging markets, remains rather nebulous.

Increased volatility in stock market prices, largely a result of reactions of private sector market participants, presents a broadly similar dilemma for governments. A prolonged upward movement in share prices raises several inevitable questions about its sustainability. A “market correction” is inevitable if an observed upswing does not represent a secular change in investors’ portfolio preferences, or if it does not embody a lasting rise in rates of return. The magnitude of such an adjustment in market sentiment, however, could be more pronounced than necessary as a result of collective panic and widespread liquidation orders; a soft landing may not always prove feasible under the circumstances. The highly deleterious effects of such a financial bubble on financial and macroeconomic stability, and on production and employment in the real economy, need no further reiteration in the light of the Asian crisis.

A connected issue pertains to government policy towards inflated prices of financial and real-estate assets within the private sector. Two questions, among others, are urgent: at what stage should such private sector bubbles be contained, and what measures are needed to ensure a soft landing to minimize their ripple effects. There are no painless answers, no easy short cuts. Financial

[18] See *Survey 1999* for a discussion of some thoughts on the international financial architecture needed to deal with the adverse impact of financial market integration on developing countries.

sector management requires a better grasp of the quantum increases in its technical intricacies, fostered by closer interlinkages among financial markets in different parts of the world, but other equally important prerequisites include more detailed and up-to-date information for monitoring and decision-making purposes, a talent for forming fine judgements on the choice of policy instruments, and institutional capacity to implement policy decisions.

The Asian crisis brought in its wake terrible hardship for millions through aggravated poverty, loss of employment and earnings, and reduced access to social services, including health and educational services. This has underscored the need for enhancing social security protection for all and, in particular, providing protection for the vulnerable through the provision of safety nets. However, enhanced social security protection will probably require additional public expenditure at a time when government budgets are already under severe pressure to provide the resources required to solve financial sector problems. The fiscal implications of increasingly vocal demand for improved social security protection, while integrating into the world economy with all its attendant vulnerabilities, will emerge as an increasingly significant challenge for developing countries.