stressing that the current context and circumstances are not identical to those of previous oil price shocks. Absolute oil prices in the spot markets have certainly risen sharply in the recent past, by nearly 60 per cent between October 1998 and October 1999, and by a further 51 per cent between October 1999 and October 2000. But even at these levels, they are far below the pace of price increases, for example during the second shock in 1979/80. In real terms, the current prices are roughly comparable to what they were in the mid-1980s. However, the recent price rises are bound to have a negative impact in the short term since oil prices had remained much lower for most of the last 15 years.

Higher oil prices mean reduced consumer purchasing power, given unchanged income and consumption patterns in the short run. According to one set of calculations, an increase in oil prices from $20 to $30 per barrel would result in a loss of consumer spending in the United States of about $20 billion overall; this amount is equivalent to between 0.2 and 0.3 per cent of GDP, a magnitude no more than the margin of error in most economic forecasts.[15] A $5 increase in oil prices would increase inflation in OECD countries by between 0.2 and 0.4 percentage points. In oil-importing developing countries, higher fuel prices would put pressure on production costs and could add to inflationary pressures if higher costs were passed on to consumers. Higher fuel prices could also constrain overall demand by reducing disposable incomes. However, there is at present no consensus that high oil prices are here to stay and, barring any further intensification of political tension in West Asia, oil prices are expected to ease in the spring of 2001.[16] The Organization of Petroleum Exporting Countries (OPEC) itself has indicated that it would like to see oil prices stabilize within a range of $25 to $28 a barrel, and it would attempt to produce oil at a level consistent with this objective. In view of this uncertainty, governments need to keep a watchful eye to minimize the adverse consequences of high and volatile oil prices.

15 *The Times,* 3 October 2000.

16 International Energy Agency forecast, *Bangkok Post,* 10 November 2000.

NEAR-TERM POLICY ISSUES

Several countries adopted floating rate regimes in the wake of the economic crisis in the region and many currencies experienced fairly large depreciations in 1998. Most of these currencies, however, regained some of the lost ground in 1999, allowing interest rates to come down and helping to keep inflationary pressures muted. Most of the crisis currencies, among many others, have weakened again from the second half of 1999, thus amplifying further the “flow through” effects of higher oil prices and rendering more probable the emergence of inflationary pressures in due course. Exchange rate weakness raises new and complex policy issues.[17]

The adoption of some form of inflation targeting as a replacement for fixed exchange rate arrangements (see box I.1) is a possible option. That, in turn, raises a number of policy concerns.[18] For one thing, the exchange rate itself is a major element in inflation. Given the high share of imports in production cost and/or consumption in most countries, the exchange rate cannot be excluded entirely from the policy matrix. Another concern is whether the inflation target range adopted is the “right” one. This issue has three aspects: (1) whether the authorities can live with it in the context of the evolving domestic political and social conditions; (2) whether the target is consistent with the needs of longer term structural change in the economy, involving shifts of resources between different uses; and (3) whether the authorities have adequate flexibility and instruments to deal with unexpected shocks, such as the recent rise in oil prices.

Moreover, a mechanical adherence to inflation targeting could lead to frequent modifications in the monetary policy stance and to possible fluctuations in the inflation rate itself in the interim period leading up to the targeted horizon. In other words, the efficacy of the new policy approach remains to be tested with no guarantee that it will lead to a superior outcome in terms of investment and output levels over the medium term. It also remains to be

17 Briefly discussed in *Survey 2000,* p. 21.

18 See papers presented at the Bank of Thailand’s International Economic Conference on Practical Experiences on Inflation Targeting, Bangkok, 20 October 2000.

Box I.1. Inflation targeting

Following the 1997 crisis, several economies in the ESCAP region adopted floating exchange rate regimes. In consequence, the use of a fixed exchange parity as a nominal anchor for monetary policy has been replaced in certain instances, for example the Republic of Korea and Thailand, with some form of inflation targeting. There has been a move in this direction since the early 1990s in a number of developed countries.[a]

Inflation targeting has been defined as "a framework for monetary policy characterized by the public announcement of official quantitative targets (or target ranges) for the inflation rate over one or more time horizons and by explicit acknowledgement that low, stable inflation is monetary policy's primary long-run goal."[b] In defining inflation targeting as a framework for monetary policy rather than a precept, there is an implication that it is not simply a mechanical rule, but rather a policy approach in which various factors are taken into account in the pursuit of the inflation target. In other words, inflation targeting is a form of conditional discretion available to the central bank in which the discipline of a clear objective, as embodied in an inflation target, is combined with flexibility as to how it should be achieved. The inflation targeting approach is, therefore, wider than the use of the fixed exchange rate parity or adherence to money supply growth as policy tools.

An important feature of inflation targeting is that it tends to go hand-in-hand with central bank independence. The theoretical case for central bank independence is based upon the problem of time inconsistency. Governments often face pressures that tend to bias them in favour of tolerating the risk of increased inflation. These biases emerge on account of the lags associated with monetary policy decisions. The benefits of long-run price stability lie in the future whereas the costs (including political costs, such as electoral unpopularity) that have to be borne in attaining it lie in the present. Given these inconsistencies, governments are more likely to defer such costs and, in the process, build in a semi-permanent bias towards inflation. An independent central bank, on the other hand, specifically given the task of achieving and maintaining a particular level of inflation, and appropriately empowered to do so through political consensus, is expected to be able to counter such a bias.

A further feature of inflation targeting is the need for openness and accountability. The central bank announces a formal target for inflation in a public document. Thereafter, both the general public and the financial markets have to be kept fully in the picture about the plans, objectives and decisions of the central bank with regard to the attainment of the target. In turn, the central bank is held accountable for its decisions and their outcome. This means that both the public and financial market participants know the environment in which they are operating along with an official view as to how that environment might evolve within a defined period ahead.

How does inflation targeting operate in practice? There are, of course, many influences bearing on inflation, such as the exchange rate, import prices, growth in wages and earnings, improvements in productivity, distribution bottlenecks and the fiscal regime, to name only the main ones. None of these is amenable to direct control by the central bank. As far as the central bank is concerned, the main policy tool available to it is the interest rate, usually the discount or repo rate, through which it provides liquidity to the financial system and determines the term structure of interest rates. All other influences have normally to be taken as given. The volume and cost of liquidity are, however, expected to influence a number of different macroeconomic variables with a bearing on inflation.

Increases or decreases in the interest rate are expected, for instance, to achieve changes in the growth rate of monetary aggregates, the yield curve, expectations of inflation, the size and components of the output gap, asset prices and exchange rate forecasts. Taking all these factors into account and making allowance for the lags in the impact of monetary policy and its imprecise transmission mechanisms, the authorities can determine a time path with a probability distribution of future inflation and the associated risks and uncertainties and calibrate their interest rate changes to accord with the chosen inflation target.

In virtually all countries that have adopted inflation targeting, the policy approach has been successful. Inflation targets have in most cases been achieved or surpassed. However, a more objective assessment of the efficacy of inflation targeting must await the completion of, at least, a full business cycle since in most countries the targets have been introduced in periods of

(Continued overleaf)

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[a] Australia, Canada, Finland, New Zealand, Spain, Sweden, Switzerland and the United Kingdom.

[b] Ben S. Bernanke and others, *Inflation Targeting. Lessons from the International Experience* (Princeton University Press, 1999).

(Continued from preceding page)

considerable economic slack. Furthermore, many countries, both developed and developing, without explicit inflation targeting have also experienced low inflation in recent years. The advent of inflationary pressures in the future and how the inflation-targeting countries fare in dealing with them will show more realistically the effectiveness of inflation targeting as an alternative to other policy frameworks.

Finally, what relevance does inflation targeting have for developing countries or economies in transition? The determinants of the inflationary process in these economies are substantially different. Import prices play a more significant role in the consumer price index in developing countries. The exchange rate is thus a major element in inflation. In addition, in many of these countries the fiscal deficits have been monetized, which reflects relatively undeveloped domestic financial markets, and this phenomenon plays a central role in monetary expansion. Moreover, in such countries inflation rates have been chronically high for a considerable period. An inflation target, if pitched too low, would suffer from a lack of credibility. But there is, in fact, no simple method of determining what would be an appropriate inflation except by reference to the actual experience in the immediate past. If so, historical inflation would become embedded in the target and monetary policy alone would not be able to alter inflationary expectations significantly. Moreover, if inflation were very high to begin with, interest rates would have to rise to high levels and probably result in major output losses and unemployment before affecting inflation. The social and political costs would be excessive in return for the benefit of price stability. A mechanical adherence to an inflation target accompanied by constant “fine tuning” on the monetary policy front could lead to fluctuations in the inflation rate itself and distortions in the structure of relative prices with adverse implications for the real economy.

For inflation targeting to be operationally effective it must satisfy a number of conditions. It should be politically acceptable; be consistent with the needs of longer-term structural change in the economy; and should have flexibility in dealing with external shocks such as an oil price rise or a deterioration in the terms of trade. For most developing countries these conditions would be very difficult to satisfy with a single number as the inflation target. A relatively broad range for future inflation might therefore be preferable as a policy option. While this may not have the same direct appeal of a single number, it could lower inflationary expectations over time.

seen whether inflation targeting would be conducive to greater stability in the financial and stock markets themselves. Market participants will need time to become accustomed to that new policy framework where it is being implemented.

Weaknesses in the region’s stock markets have paralleled the volatility in exchange rates in the region. With the exception of China, most stock markets fell precipitately from the beginning of the year – with declines up to the end of November 2000 in the range of 40-50 per cent in Indonesia, the Philippines, the Republic of Korea and Thailand, and within 10-20 per cent band in Hong Kong, China; and Malaysia. These falls reflect stock market volatility around a bearish sentiment the world over dating from April-May 2000. During the same period, for instance, in the United States NASDAQ (where many of the ICT companies are listed) had declined by over 33 per cent.

The comparatively larger setbacks in stock market indices in the ESCAP region reflect not only the rapid growth of market valuations of ICT-related enterprises in 1999 and their resultant larger weights in these indices, but also the sharply differing behaviour of shares of ICT and non-ICT companies over the last two years. ICT companies, for instance, have acquired price/earnings ratios several times higher than those of the non-ICT companies and have been far more volatile.[19]

The most likely explanation for these phenomena is that the commercial introduction of new technologies very often poses a variety of new risks, some of which come to light only ex post facto. In addition, the ICT sector in most countries comprises a large number of small companies. Their survival rates in a rapidly developing sector have tended to be short and variable, thus giving rise to large fluctuations in the stock prices of all companies in the ICT sector. The bearish sentiment currently enveloping many stock markets can probably be attributed to the initially exaggerated expectations that the introduction of any new technology brings in its wake. Inevitably, the inflated valuations are then

[19] IMF, *World Economic Outlook* (Washington DC, September 2000), pp. 70-80.

"corrected", in some instances over-corrected, in the light of actual performance and outcomes. While this was primarily true of ICT companies in 2000, non-ICT companies (for instance banks), have also been negatively perceived and assessed on account of their exposures and linkages to ICT companies. Furthermore, recent sober appraisals suggest that the performance of individual ICT companies, or even of the ICT sector as a whole, is unlikely to exceed historical norms over the long term.

While the short-term rise and fall of stock prices is a normal market phenomenon, the onset of a prolonged bearish market sentiment is not entirely without some negative near-term side effects. As in the United States, most ICT companies in other parts of the world (including those in the developing countries of the ESCAP region) have financed their investment needs by riding on the buoyant stock markets in which ICT shares have commanded considerable premiums. As the appetite of investors for risk appears to have diminished, however, this financing route has clearly lost some of its attractiveness in recent months. To the extent that such financing was fairly priced, it was an efficient method to allocate capital for the introduction and wider diffusion of ICT in the economies of the region. To the extent that speculative bubbles were involved in the financing process, there was a diversion of capital from other uses and then the build-up of excess capacity in the ICT sector, with all the attendant risks of a shake-out of these companies in the not too distant future. This poses a new policy challenge for reviving and stabilizing the stock markets. In the short term, alternative ways of financing investment expenditures need to be explored.

It should also be stressed that exchange rate and stock market weaknesses, those within the ESCAP region in particular, are a manifestation of the interrelated issues of financial and corporate sector reform and restructuring. There is a perception that progress in this area has slowed over the last several months, partly because of political and administrative difficulties, but perhaps more as a result of the sheer size and complexity of the problems.

It is estimated, for instance, that the final cost of resuscitating the banking systems of the crisis countries could amount to as much as 50-60 per cent of GDP in Indonesia, 40 per cent in Thailand, 15 per cent in the Republic of Korea and 12 per cent in Malaysia.[20] Moreover, there is a fear that some proportion of the so-called "performing" loans may need to be restructured in due course, involving banks in further losses. Thus, the problem of financial and corporate sector reform is far from being solved in several countries.

There are no simple and speedy remedies for dealing with these problems. Broadly speaking, countries in the region need to re-commit themselves to, and persevere in, the pursuit of structural reform. They also need to strengthen the institutions dealing with the reform process. Market confidence can be damaged significantly if the perception gains ground that reform fatigue has set in. In such a scenario, the implementation of even the existing reform agenda would become much more difficult. It needs to be emphasized that a well-functioning financial sector and better corporate governance are not simply ends in themselves: these institutional prerequisites have large externalities as they reduce the risks of business financing, thus helping to draw a bigger pool of both investors and entrepreneurs into the economy. It is thus important to accelerate the pace of corporate and financial sector reform.

As the APEC forum assembled in Brunei Darussalam for its annual summit meeting in November 2000, members faced a significant new development. A number of Asian governments were looking at bilateral deals to maintain the momentum of trade liberalization, especially in view of the fact that progress on global and regional trade liberalization appears not to have been satisfactory. In theory, these would not be contrary to APEC, whose open regionalism can accommodate such narrower trade deals.

There are two reasons why bilateral free trade agreements appear to be attractive. First, there seems little prospect of a new round of trade negotiations at WTO in the near term after the Seattle debacle. Developing countries are unhappy over the positions of many developed countries in carrying out their commitments in the areas of textiles and

[20] Bank for International Settlements, *70th Annual Report,* June 2000, pp. 46-50. See also Dominic Casserley and Greg Gibb, "Banking in Asia", *Asia-Pacific Development Journal,* vol. 7, No. 1 (June 2000).

Box I.2. The accession of China to the Bangkok Agreement[a]

The Bangkok Agreement was signed in 1975 at the initiative of ESCAP. The Agreement aims at promoting intraregional trade through preferential tariff arrangements among the member countries, Bangladesh, India, Lao People's Democratic Republic, Republic of Korea and Sri Lanka. So far two rounds of trade negotiations have taken place and the schedule for the third one is being planned by the ESCAP secretariat.

A recent development could have a profound impact on the patterns of trade and, by implication, investment relationships among the Bangkok Agreement countries. China informed ESCAP in January 2001 that its accession to the Bangkok Agreement had been ratified. As of 1999, the value of exports from China to other Bangkok Agreement countries rose to just over 5 per cent of its total merchandise export value from 1.39 per cent in 1990. Imports from those countries to China went up from under 1 per cent of total imports in 1990 to almost 11 per cent in 1999 (see table).

[a] First Agreement on Trade Negotiations among Developing Member Countries of the Economic and Social Commission for Asia and the Pacific (Bangkok Agreement).

The main benefits for the other countries from China's membership arise from the tariff concession accorded by China. For example, it is willing to import 634 imports from Bangladesh, the Republic of Korea and Sri Lanka at concessional tariffs. The margin of preference on those items, compared with most-favoured-nation duty, ranges from 10 to 84 per cent.

The estimated effects on trade creation are quite considerable. The export value of selected food items from Bangladesh and Sri Lanka to China, for example, is expected to rise by 25 and 16 per cent respectively. The corresponding increases in the value of selected manufactured exports from these two countries are more modest, at 18 and 7 per cent. The trade-creation effects as regards exports from the Republic of Korea are comparatively much smaller, amounting to about 9 per cent for selected food items and 7 per cent on certain manufactured products.

The accession of China most certainly makes membership of the Agreement a worthwhile goal to pursue for many other countries of the region. With India already a member, the Bangkok Agreement countries together have a market of more than two and a half billion consumers. Pakistan is already into the process of accession and Fiji, the Islamic Republic of Iran, Mongolia, Myanmar, Nepal and Viet Nam are actively considering accession.

The value of China's merchandise exports to and imports from the Bangkok Agreement countries

(Millions of US dollars)

	Bangladesh	*India*	*Lao People's Democratic Republic*	*Republic of Korea*	*Sri Lanka*	*Total Bangkok Agreement countries*	
						Value	*Percentage*[a]
Exports	701	1 162	22	7 808	259	9 952	5.1
Imports	14	862	10	17 228	9	18 087	10.9

Source: IMF, *Direction of Trade Statistics Yearbook 2000* (Washington DC, 2000).

[a] Exports to or imports from the Bangkok Agreement countries as a percentage of China's total export or import value.

agriculture, as well as over the use of anti-dumping procedures to limit imports from the developing countries. At the same time, there are strong differences of views regarding the treatment of labour and environmental standards in any future round of trade negotiations. Second, the region's ASEAN Free Trade Area (AFTA) is also experiencing its own problems. In particular, Malaysia is to delay until 2005 the phased abolition of tariffs on automobiles, although AFTA is still on track for zero tariffs on 90 per cent of manufactured goods traded within the core group of members. But failure to keep liberalization on track is a clear setback, thus enhancing the attractiveness of bilateral agreements. However, it is important to ensure that an increase in the number of bilateral trade pacts does not undermine regional trading arrangements and reduce pressure for a new round of negotiations at WTO itself. In this context, China's accession to the Bangkok Agreement is a welcome development (see box I.2).

Regarding reform of the international financial system, fitful progress has been made in some areas; there are also concerns regarding the proliferation of working groups set up by different agencies and the apparent lack of coherence among them. In this context, the newly established Financial Stability Forum is a step in the right direction. But urgency is clearly lacking in its deliberations and the process of international financial system reform continues to pose a huge and critical challenge for the international community. The absence of more concrete progress, as in the case of trade liberalization, has encouraged some countries to strike out on their own. The Chiang Mai initiative by ASEAN is a case in point. Under this initiative, ASEAN members, plus China, Japan and the Republic of Korea, agreed to set up a swap facility to provide liquidity for mutual support in times of need. Here again, care must be taken to ensure that such initiatives do not lead to a weakening of the resolve of countries to participate actively and meaningfully in multilateral initiatives in this area.