DEVELOPED COUNTRIES OF THE REGION

Australia, Japan and New Zealand

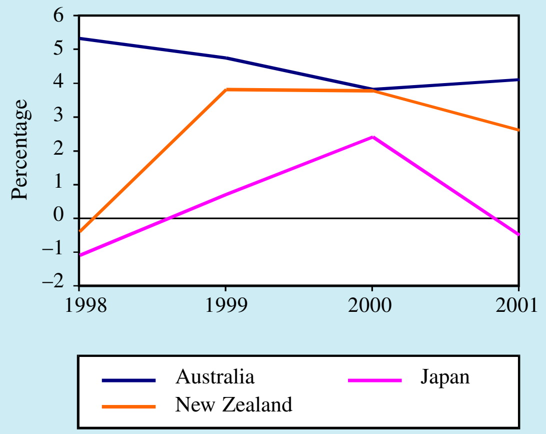
Overview and prospects

The external slowdown had an adverse impact in 2001 and domestic stimulus measures proved insufficient

Notwithstanding their diverse structural characteristics, economic growth in the developed countries of the region slowed from 2000 to 2001. While external factors were primarily responsible for this weakened performance, domestic influences also played a part, particularly in Japan. The sharp decline in world demand came with dramatic suddenness in the later part of 2000 and continued unabated in 2001, thus reducing the contribution of net exports to output in all three countries. This did not apply to Australia which actually saw growth accelerate in 2001. In New Zealand, measures to stimulate domestic demand were not able to offset the externally generated contraction fully, so that GDP growth fell off by 1.2 percentage points; Japan slipped into its third economic recession within the last decade (figure II.31).

Figure II.31. Rates of GDP growth of developed countries in the ESCAP region, 1998-2001

Australia, Japan and New Zealand



Sources: ESCAP, based on IMF, *International Financial Statistics,* vol. LIV, No. 10 (October 2001) and *World Economic Outlook* (Washington, December 2001); and Economist Intelligence Unit, *Country Forecasts* (London, 2001), various issues.

Note: Figures for 2001 are estimates.

As discussed in chapter I of this *Survey,* the global slowdown originated in the United States and, in the initial stages, was largely concentrated in the ICT sector; it was therefore expected that the overall setback might be both shallow and short-lived. However, the consequent spillovers included higher unemployment and losses in business and consumer confidence, which were compounded by the terrorist attacks in September 2001. The generalized global downturn resulted in a reversal of export and output growth and higher unemployment in Japan and several of the economies of East and South-East Asia. These economies account for most of the trade flows of the ESCAP region, effectively intensifying the global slowdown. Given the speed and spread of the external slowdown, domestic activities could not be fully protected through conventional measures to stimulate domestic demand. On the positive side, GDP growth in Australia and New Zealand was still in excess of the OECD average of 2.0 per cent in 2001, although the same cannot be said for Japan.

Uncertain prospects for 2002

Economic performance in all three countries hinges primarily on an improvement in the external environment combined with the impact of the fiscal and monetary policy easing that has already taken place (table II.37), plus any additional measures that might be taken in 2002. With regard to the global economy, current forecasts suggest only a marginal increase in output growth in 2002. However, the outcome for the three economies in 2002 is likely to be driven more by a recovery of growth in the United States than global developments, given their trading patterns and other external links. In this connection, the United States economy is not expected to display vibrancy until the second half of 2002, with GDP growth for the full year registering perhaps a modest decline compared with 2001. Aggregate output in Australia and New Zealand would therefore probably remain flat or expand slightly, while the economic contraction in Japan is expected to continue in 2002.

Major policy challenges ahead

The need to minimize rising unemployment and preserve consumer and investor confidence, via a combination of fiscal and monetary easing with structural reforms, is a major policy challenge in all three countries. Economic performance in Japan has been heavily weighed down by the legacy of the asset bubble collapse of the 1980s and the limited progress in meaningful reform of the domestic corporate and financial sectors. Consumer confidence has been sapped by successive downturns following short-lived recoveries in output. Indeed, a chronic phase of deflation persisted during the period 1999-2001, although the weakness of the yen in recent months might nudge prices upwards somewhat (figure II.32).

Table II.37. Developed countries of the ESCAP region: budget and current account balance as a percentage of GDP, 1998-2001

(Percentage)

	1998	*1999*	*2000*	*2001*[a]
Budget balance as a percentage of GDP				
Australia[b, c]	0.3	0.8	0.9	0.5
Japan[c]	–4.5	–6.8	–7.9	–7.2
New Zealand[c]	1.0	0.4	0.6	0.7
Current account balance as a percentage of GDP				
Australia	–5.0	–5.9	–4.1	–1.9
Japan	3.1	2.4	2.5	1.8
New Zealand	–4.0	–6.5	–5.4	–2.0

Sources: ESCAP, based on IMF, *International Financial Statistics,* vol. LIV, No. 10 (October 2001) and *World Economic Outlook* (Washington, October 2001 and December 2001); and Economist Intelligence Unit, *Country Forecasts* (London, 2001), various issues.

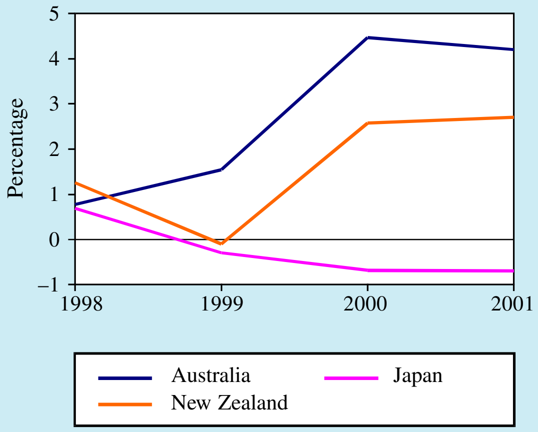
[a] Estimate.

[b] Data exclude net advances (primarily privatization receipts and net policy-related lending).

[c] General government fiscal balance.

Figure II.32. Inflation of developed countries in the ESCAP region, 1998-2001[a]

Australia, Japan and New Zealand



Sources: ESCAP, based on IMF, *International Financial Statistics,* vol. LIV, No. 10 (October 2001) and *World Economic Outlook* (Washington, December 2001); and Economist Intelligence Unit, *Country Forecasts* (London, 2001), various issues.

Note: Figures for 2001 are estimates.

[a] Percentage changes in the consumer price index.

Given the large excess capacity in domestic industry, however, deflationary trends are unlikely to be reversed in the short term. More recently, growing doubts have emerged about the long-term sustainability of the public debt, making economic policy formulation an unusually complex exercise. All things considered, a self-sustaining economic recovery is likely to prove elusive for some time in Japan.

In Australia, a certain amount of reform fatigue is apparent in the important areas of taxation, labour market practices and welfare policies. The Government's avowed reluctance to entertain budget deficits could reduce the scope for further fiscal stimulus in the event that the world economy were to prove weaker than anticipated at present. In addition, the scope for significant cuts in interest rates appears limited, with inflation running near the top of the Reserve Bank's target range and the Australian dollar tending to lose ground vis-à-vis the United States dollar as well as on a trade-weighted basis.

The fiscal situation in New Zealand, while somewhat easier than that in Australia, is likely to deteriorate as growth slows in the coming months. Unexpected demands on the State coffers, such as the bailout of Air New Zealand, have reduced room for fiscal manoeuvre in the short term. Monetary easing has been extended close to its prudential limits following the 11 September 2001 events; further easing could put pressure on the exchange rate of the New Zealand dollar. Given its high trade-to-GDP ratio, New Zealand's economic fortunes are thus primarily dependent upon an upturn in the global economy, particularly in the economies of Australia, Japan and the United States. These countries account for half of New Zealand's exports and are also an important source of tourist arrivals; the tourism industry is a significant source of employment and foreign earnings for the New Zealand economy.

GDP performance

Japanese GDP contraction driven by low consumer and business confidence

A buoyant world economy strengthened economic activity in Japan, with GDP growing by 2.4 per cent in 2000 (table II.38). The expansion, however, was not broad-based as it was led primarily by a spurt in business investment and net exports. Consumer expenditure remained

Table II.38. Developed countries of the ESCAP region: rates of economic growth and inflation, 1998-2001

(Percentage)

	1998	*1999*	*2000*	*2001*[a]
GDP growth rates				
Australia	5.3	4.7	3.8	4.1
Japan	−1.1	0.7	2.4	−0.5
New Zealand	−0.4	3.8	3.8	2.6
Inflation[b]				
Australia	0.8	1.5	4.5	4.2
Japan	0.7	−0.3	−0.7	−0.7
New Zealand	1.3	−0.1	2.6	2.7

Sources: ESCAP, based on IMF, *International Financial Statistics,* vol. LIV, No. 10 (October 2001) and *World Economic Outlook* (Washington, October 2001 and December 2001); and Economist Intelligence Unit, *Country Forecasts* (London, 2001), various issues.

[a] Estimate.
[b] Percentage changes in the consumer price index.

weak, as in 1999, and the economy stalled sharply towards the end of 2000 and at the beginning of 2001 as export growth came to an abrupt end and the ICT investment bubble burst. Compounding the adverse knock-on effects was the collapse of corporate profits to virtually zero in the first quarter of 2001, and most new business investment plans were suspended or cancelled as a consequence.

Consumer and business confidence in Japan has been severely undermined in the last few years by the continuing uncertainties regarding bank and corporate restructuring and their implications for job prospects and domestic demand. Unemployment had reached 5.6 per cent by the end of 2001 and was expected to rise further as companies were forced to restructure in order to survive. Consumer demand could thus remain stagnant into the foreseeable future, with little or no growth in real earnings and chronic uncertainties on the horizon. Another complicating factor against this backdrop is the emerging doubt about the viability of the public debt burden following the implementation of a series of sizeable, but largely ineffective, fiscal stimulus packages. The decline in nominal GDP is perhaps unprecedented in historical terms; by the end of 2002, aggregate output would be 5.4 per cent smaller than in 1997.

Most observers believe that there have not been adequate policy initiatives to deal decisively with the highly complex problems being experienced by the Japanese economy. Cutbacks in investment and falling consumer confidence have been further intensified as a result of stagnant private demand, flagging exports, continuing deflationary pressures and the inexorable compulsion on the financial system to reduce lending to weaker enterprises. More generally, business sentiment was also undermined by an acceleration in the relocation of production facilities abroad, particularly to China in anticipation of its accession to WTO. Meanwhile, the new fiscal stimulus package to be introduced early in 2002 is unlikely to have much of an impact given the dire state of public finances, among other reasons.

Deflation nullified monetary easing

The ongoing deflation has had a strong, perhaps decisive, influence on the Japanese economy in the last three years. There can be few worse combinations for indebted Japanese companies than falling prices and stagnant growth in real output. If present trends continue, downward pressures on prices could be higher in 2002. Thus, for more than two years, these companies will have had to service their loans with ever-falling revenues, and price levels in 2002 could well be lower than those in 1998. Deflation has thus perversely raised the real value of debt for both households and corporations in Japan, drastically weakening corporate balance sheets and, by raising the level of real interest rates, has largely nullified the effectiveness of monetary easing.

Australian growth robust in 2001

In contrast to the rest of the ESCAP region, Australia recorded fairly robust growth in 2001. The country enjoyed its ninth year of continuous expansion, the longest since the 1960s. Output gains during this period averaged just over 4 per cent, comparing very favourably with the performance of other OECD countries. The economy declined from the fourth quarter of 2000 and into 2001 in tandem with the global downturn. However, full year growth in 2001 was higher than in 2000, driven by strong household consumption and private capital spending. There was a fall off in net export earnings, which went up by just over 1 per cent in the first three quarters of 2001, compared with almost 13 per cent in the comparable period of 2000. At the same time, domestic problems such as higher energy prices had a negative impact on household consumption, while the weakening United States economy served to dampen the business climate and lower investment spending. The goods and services tax, introduced on 1 July 2000, created a strong incentive to carry out housing investment in the first half of the year, to be followed inevitably by a sharp decline in the second half. As a result of these negative impulses, industrial production was slightly down on a year-on-year basis by the latter part of 2001, while unemployment had risen marginally from 6.3 to 6.7 per cent in December 2001.

Strong productivity growth underpinned Australian economic performance

Australia's impressive economic performance, particularly over the last five years, and the relatively limited impact of the 2001 downturn, thus far at any rate, can be attributed to strong productivity growth, a close parallel to similar trends in the United States. Some recent research results indicate that about half of the labour productivity can be explained by capital deepening, and around two thirds of capital deepening can be attributed to ICT-related expenditure. Comparatively, such spending has had as large a qualitative impact as that in the United States and is actually well above the average for OECD countries. The investment-driven diffusion of ICT, and the sizeable positive externalities associated with it, should continue to yield benefits on an economy-wide basis, once the downturn ends. It also explains the limited impact of the 2001 slowdown in the country.

Modest price pressures

After rising rather strongly in 2000, inflation flattened out somewhat in 2001. Movements in energy prices were the principal factor behind both the increase and the subsequent improvement in consumer prices during those two years. Changes in the tax regime, including the new goods and services tax, also contributed in part to the upward pressure on prices, estimated to be equivalent to an annualized 2.5 percentage points between June 2000 and June 2001. Flooding in parts of the country early in 2001 raised fruit and vegetable prices sharply, but the increases were reversed as supplies returned to normal. The outlook for inflation is mostly benign, as the effects of the new tax system will have gone out of the index after June 2001. Other positive elements include more affordable energy prices and moderate growth in labour earnings owing to a slight increase in unemployment. The only question mark in the above context is a seemingly persistent weakness in the exchange rate of the Australian dollar.

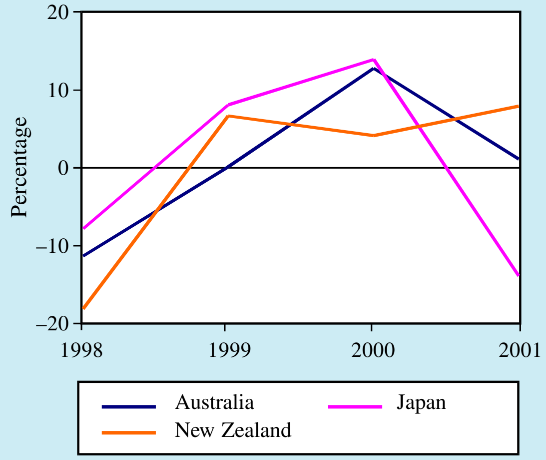
New Zealand's economy showed good growth in 2001

Despite the global slowdown, economic activities remained buoyant in the country in 2001, with GDP expanding at a rate faster than that in OECD economies. This strong performance was primarily driven by government spending and net exports, plus a robust increase in non-residential fixed investment in agriculture, especially in certain new downstream activities in forestry and fishing. The global slowdown had a somewhat delayed effect on New Zealand and was felt only through faltering business confidence in the aftermath of the 11 September 2001 events in the United States.

... and with stable prices

The relatively good economic performance of New Zealand was achieved with monetary stability. Consumer prices rose by around 2.6 per cent a year over 2000-2001, despite a falling local currency and much higher energy prices in 2000. It thus appears that higher import prices have been absorbed by shrinking margins at the wholesale and retail trade levels. However, this process cannot be sustained indefinitely and the weaker exchange rate, if it persists, would have a negative impact on the price situation at some stage. There is a policy dilemma in this connection: the depreciation has been instrumental in stimulating exports and keeping out imports. There are trade-offs involved, however; stimulating exports and maintaining price stability may not be achievable within the same policy matrix.

Figure II.33. Growth rates of merchandise export earnings of developed countries in the ESCAP region, 1998-2001



Source: IMF, *Direction of Trade Statistics* (CD-ROM), February 2002.

Note: Figures for 2001 refer to January-September.

Foreign trade and other external transactions

Foreign trade (as a proportion of GDP) plays a relatively limited role in the economy of Japan compared with other developed countries, and a much smaller part compared with the relative share of trade in the developing countries of the ESCAP region. However, its absolute magnitude is substantial, equivalent to over $800 billion annually in export and import value, and therefore the pattern of Japanese trade has a huge significance for Japan's trading partners, especially the developing countries of the ESCAP region. More specifically, Japan is the world's second largest importer and exporter of ICT components and products and its trade pattern over the last two years is largely a reflection of the global electronics cycle (figures II.33 and II.34). The buoyant electronics markets underpinned external demand for Japanese ICT products and overall exports rose by 14 per cent in 2000. World demand tapered off in the last quarter of 2000 and declined sharply in the first three quarters of 2001, causing a contraction of nearly 14 per cent in export earnings.

Narrowing current account surplus in Japan ...

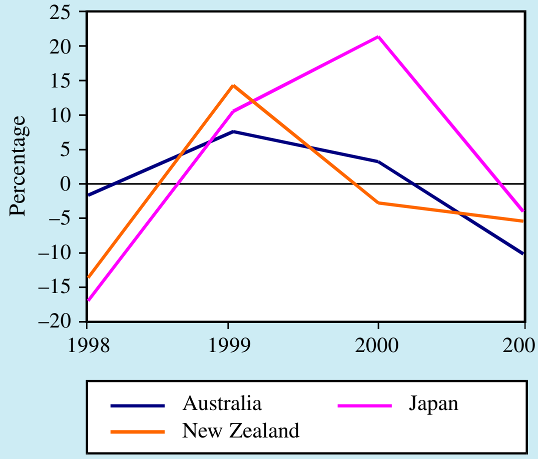
... with import penetration expanding

Imports followed a broadly similar pattern, rising strongly in 1999 and 2000 and falling in 2001. However, a new feature of Japanese foreign trade is the rapid increase in the import penetration of consumer goods. Consequently, the trade surplus declined from 3 to 2 per cent of GDP over the period 1998-2001. With services being in broad balance, the current account surplus has also narrowed, although a strong increase in investment income pushed the current account surplus back above 2.5 per cent of GDP in the first half of 2001. The outcome for the whole year is likely to be lower again, at under 2 per cent of GDP. Japan should nevertheless continue to be a significant provider of global investment funds on a net basis into the foreseeable future, despite the recent narrowing of the current account surplus. Notably, the external reserves of Japan had reached nearly $397 billion in November 2001, the highest in the world.

Trade within the ESCAP region on the rise

The strong expansion of Japanese trade with the Asian and Pacific countries was another feature in 2000, when exports to the region went up by over 28 per cent and imports by 29 per cent. This intraregional dynamism in trade stood in sharp contrast to the more modest growth in trade with the United States and the European Union. More significant, around two fifths of Japanese exports currently go to the Asian and Pacific region, which is the source of a roughly similar proportion of Japanese imports. Such intraregional trade is the clearest manifestation of the "componentization" of the electronics industry in East and South-East Asia, often via Japanese FDI. While such trading links have given Asian economies a high and growing share in a rapidly expanding sector of manufacturing, they have at the same time accentuated their vulnerability to external cyclical forces. The product cycle of electronics tends to be significantly more volatile than that of traditional manufactured goods, as revealed by the crisis of 1997 and the upturn of 1999 and 2000. Consequently, a substantial slowdown in capital investment by corporations would tend to have disproportionately large effects on trade in electronic products as well as on related activities among the suppliers concerned, and vice versa.

Figure II.34. Growth rates of merchandise import spending of developed countries in the ESCAP region, 1998-2001



Source: IMF, *Direction of Trade Statistics* (CD-ROM), February 2002.

Note: Figures for 2001 refer to January-September.

Lower current account deficit in Australia ...

A high rate of export expansion, by almost 13 per cent in 2000, and lower growth in import spending, at just over 3 per cent (tables II.39 and II.40) contributed to a smaller deficit of 2 per cent of GDP in the external current account; the comparable figure was at the high

Table II.39. Developed countries of the ESCAP region: merchandise exports and their rates of growth, 1998-2001

	Exports (f.o.b.)				
	Value (Millions of US dollars)	*Annual rate of growth (Percentage)*			
	2000	*1998*	*1999*	*2000*	*2001 Jan.-Sep.*
Australia	63 128	−11.3	0.1	12.7	1.1
Japan	477 323	−7.9	8.1	13.9	−13.9
New Zealand	12 712	−18.1	6.7	4.1	7.9

Source: IMF, *Direction of Trade Statistics* (CD-ROM), February 2002.

level of 5-6 per cent as recently as 1998-1999. The Australian export performance in the last three years reflects higher earnings from both traditional exports (i.e. coal, meat, metals, wheat and wool) and non-traditional items, including the so-called elaborately transformed manufactures, and services. Imports continue to cover a wide range of items, with expenditure on capital goods displaying one of the highest rates of growth. Approximately 33 per cent of Australian imports are currently sourced from the ESCAP region, compared with around one-fifth in 1997.

Table II.40. Developed countries of the ESCAP region: merchandise imports and their rates of growth, 1998-2001

	Imports (c.i.f.)				
	Value (Millions of US dollars)	*Annual rate of growth (Percentage)*			
	2000	*1998*	*1999*	*2000*	*2001 Jan.-Sep.*
Australia	74 265	–1.7	7.6	3.3	–10.1
Japan	377 152	–17.0	10.5	21.4	–4.0
New Zealand	13 971	–13.6	14.3	–2.8	–5.4

Source: IMF, *Direction of Trade Statistics* (CD-ROM), February 2002.

... as the debt-servicing burden declined

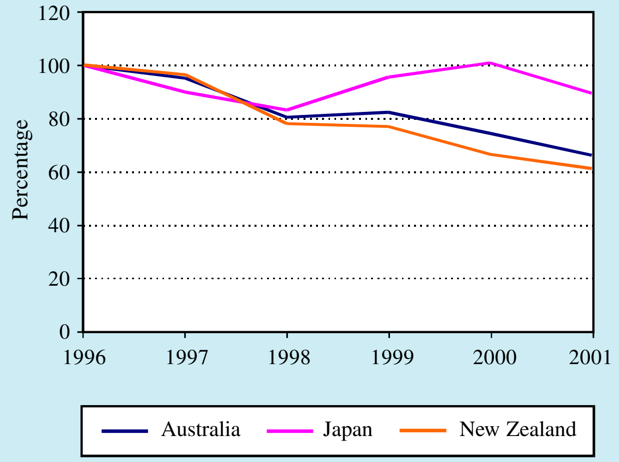
Notwithstanding the persistent current account deficits, Australia's net foreign debt stood at about 49 per cent of GDP, or close to $170 billion, in 2001. Benefiting from lower interest rates, however, the debt-service ratio went down from over 9.5 to 9.1 per cent of foreign exchange earnings from 2000 to 2001. At that level and with a declining current account deficit, external debt is no longer considered an issue of significance. Nevertheless, prolonged weakness in the Australian dollar exchange rate would in effect raise the debt-service burden in local currency, with possible negative implications for the holders of such debt (figure II.35).

New Zealand's current account deficit also shrank

The pattern of New Zealand's foreign trade in 2000 and 2001 displayed a striking resemblance to the experience of Australia. Exports went up in 2000, though less strongly than in Australia, and imports fell, thus narrowing the current account deficit by more than 3 percentage points of GDP. Contrary to trends elsewhere, export growth actually picked up in the first three quarters of 2001, while imports continued to decline. The current account deficit fell to 2 per cent of GDP, compared

Figure II.35. Index of exchange rates against the United States dollar of developed countries in the ESCAP region, 1996-2001

(1996=100)



Sources: IMF, *International Financial Statistics,* vol. LV, No. 1 (January 2002); and *Far Eastern Economic Review,* various issues.

Note: Figures for 2001 are estimates.

with 6.5 per cent in 1999. Unlike Australia, however, New Zealand's exports are still predominantly traditional in nature (e.g. dairy, meat, forestry and fisheries products) and this explains the lagged response of New Zealand's exports to the 2001 global slowdown. Standing at over 50 per cent of GDP in 2001, foreign trade plays a much bigger role in the economy of New Zealand than in Australia. Trade with the Asian and Pacific region accounts for around one third of the total and thus economic activity in New Zealand is closely linked to trading performance in general and to trade with the ESCAP region in particular. However, New Zealand's exports are primarily traditional consumer goods and therefore the downside risks are likely to be limited over the short term.

Key policy issues

Australia and New Zealand faced with cyclical downturns

Among the major policy issues confronting all three countries is the need to counter the sharp and rather sudden deterioration in the external environment in 2001, a setback which could well linger into much of 2002. The decline in GDP growth, if it persists, would bring a host of economic and social problems in its wake. In particular, as public finances come under pressure and unemployment rises, Governments have to grapple with, and reconcile, difficult policy trade-offs, for example stimulating growth through fiscal and monetary measures without putting at risk macroeconomic, and especially price stability. At the micro level, a slowdown often calls into question the functioning of product and labour markets; the viability of particular activities and hence the related human resource skills; the reallocation of resources from slow-moving to more dynamic sectors; and the provision of social protection to the more vulnerable sections of the community, such as the unemployed and older persons.

Serious structural impediments to growth to be addressed by Japan

While Australia and New Zealand have had to grapple primarily with a cyclical downturn, Japan has had to manage a far more serious set of policy issues, in particular, a range of long-term, structural impediments to growth that have had an adverse impact on domestic economic performance over the last decade. In real terms, GDP expanded by barely 1.75 per cent a year in the 1990s, down considerably from an annual average of 4 per cent a decade earlier. Moreover, such a comparatively modest economic performance has major implications for the ESCAP region as a whole, given Japan's crucial role as a market and as a source of both FDI and financial resources for many regional economies. The following paragraphs contain a brief discussion of the principal policy issues facing the three countries.

... as it experiences another economic contraction ...

In Japan, successive cyclical downturns have been superimposed upon structural deficiencies, so that the economy has simply lurched from one setback to another over the last decade. There have been three recessions in the last 10 years, and negative GDP growth in 2001 was expected to persist into 2002. A number of different hypotheses have been advanced to explain the persistence of the economic problems in Japan. The roots undoubtedly lie in the bursting of the asset price bubble in the 1980s and the ensuing massive losses of personal and corporate wealth in the 1990s. The financial sector both contributed to the excesses of the 1980s and suffered subsequently from the chronic weakness of the economy in the 1990s. It magnified each phase considerably in the process. In the 1980s, for example, there were massive increases in bank lending, operating both directly and through a self-reinforcing cycle with rising prices on land (the main collateral for bank lending) and stocks (a component of bank capital). However, the process then operated in reverse with the bursting of the asset price bubble, forcing under-capitalized banks to stop lending, while collapsing land values left many loans devoid of adequate security and effectively non-performing. This process, in turn, largely nullified the impact of expansionary monetary policies as households and corporations were unable to respond to the lower interest rates.

… low consumer confidence and poor productivity growth undermining economic performance and posing new policy challenges

An addendum to the above hypothesis relates to the rather static pattern of productivity growth in Japan, especially in services. An overvalued exchange rate gravely weakened corporate balance sheets and significantly reduced productivity-enhancing investment in the early to mid-1990s. In this connection, it has been argued that the introduction of new technologies is strongly conditioned by the prospects for future demand for them, and any perceived demand insufficiency, say, for services, would result in delays by corporations in introducing new technology. Japan has become the victim of a liquidity trap along with falling profit rates; with nominal interest rates being close to zero and with the emerging deflationary pressures, real interest rates have become too high for corporations to be able to borrow and invest (table II.41). As a result, economic activities have become stuck in a low- or no-growth mode, despite the succession of fiscal packages implemented in the 1990s.

Table II.41. Developed countries of the ESCAP region: short-term interest rates and money supply growth (M2), 1998-2001

(Percentage)

	1998	*1999*	*2000*	*2001*[a]
Short-term interest rates				
Australia	4.7	5.8	6.2	4.2
Japan	0.5	0.2	0.5	0.02
New Zealand	7.3	4.8	6.5	6.2
Money supply growth (M2)				
Australia	8.4	11.7	3.8	8.6[b]
Japan	4.1	3.4	1.1	1.6[b]
New Zealand	14.6	7.8	0.9	13.7[b]

Sources: ESCAP, based on IMF, *International Financial Statistics,* vol. LIV, No. 10 (October 2001); OECD, *OECD Economic Outlook,* No. 70 (December 2001); and Economist Intelligence Unit, *Country Forecasts* (London, 2001), various issues.

[a] Estimate.
[b] January-June.

There has been renewed emphasis on the critical need to bring about sustained recovery in Japan over the medium term, with the economy faltering yet again in 2000 and 2001. For its part, the new Government has unequivocally accepted the reform agenda. It has recognized the pressing reasons for structural reforms to raise productivity growth in the economy in addition to the need to address the question of fiscal consolidation in a credible and realistic manner over the next few years. Among the principal items on the reform agenda are the problems of an insolvent banking sector. There has also been considerable debate about the conduct of monetary policy and what might be an appropriate exchange rate for the yen so as to aid the recovery process. Evidently, however, there are no easy options or shortcuts.

Massive NPL problems and demanding structural reforms

There is general agreement that the most urgent need is for the Japanese authorities to develop a package of reforms in the banking sector in combination with the removal of structural impediments to growth. The impediments include high levels of corporate debt, the lack of consolidation of small businesses and the absence of market forces and competition in the provision of health and nursing care, social welfare and education. Greater flexibility in the labour market and stimulating business start-ups, including through changes in the regulatory regime, are other complementary measures in support of the reform process.

Estimates vary widely as to the true extent of the NPL problem. In April 2001, for example, Japan's Financial Services Agency put NPLs at about 25 per cent of GDP. Thus, it seems unrealistic to assume that a problem of this magnitude can be eradicated within three years, as has been suggested. Nevertheless, the ongoing failure to tackle the NPL problem has led to a series of downgrades of Japanese banks and corporations by international credit rating agencies, setbacks that have in effect nullified the stimulus that was supposed to have been provided by easier monetary conditions. It has also caused a net outflow of yen-denominated assets, primarily as a result of concerns about the solvency of the Japanese banking system. These concerns weakened the yen exchange rate sharply in the later part of 2001 and early in 2002. As of late February 2002, for example, the yen-dollar rate had reached 134, compared with 118 a year earlier, equivalent to a depreciation of around 13 per cent. The yen volatility will inevitably have implications and ripple effects for other economies in the region.

The Australian economy to expand moderately in 2002

In Australia, GDP growth is expected to ease in 2002 to around 3 per cent or over, without the emergence of any significant domestic imbalances; in this context, the underlying inflation is low but the potential inflationary consequences of a weakening exchange rate constitute a downside risk. The range of structural reforms undertaken in recent years has made Australia well prepared to cope with adverse external shocks. Labour market flexibility has improved considerably in recent years, while better industrial relations have been complemented by the introduction of more active job search facilities, which has aided labour mobility. These measures have been reinforced by initiatives to strengthen the economy's innovative capacity, especially in services and in the creation of new jobs. The functioning of product markets has been enhanced by the removal of restrictions on competition that were either accepted or implicit in long-standing legislation and practices in the country.

The tax reform package of 2000 has aided fiscal consolidation by broadening the tax base; it has enhanced productivity as well by the elimination of differential taxation for labour and capital and the abolition of restrictive practices. Some items in the reform programme, such as a new framework for superannuation and the reduction of relatively high personal tax rates, could be delayed as a result of the current slowdown. However, such delays should have no material impact on economic performance in the country. All in all, Australia should be able to see out the current slowdown relatively unscathed and, when it ends, resume the high growth path of the last few years. All this reflects and is predicated on a combination of continued macroeconomic stability, the rapid implementation of structural reforms and greater emphasis on sustaining growth through higher long-term productivity.

New Zealand must boost productivity through investment in education ...

New Zealand has weathered the turbulence of the last few years relatively well and, contrary to what tended to happen in the past, high levels of fiscal deficit and inflation have been successfully avoided. Nonetheless, recent economic performance has fallen short of expectations and certain vulnerabilities remain. The economy is still heavily dependent on traditional agricultural commodities and thus remains strongly exposed to swings in international commodity prices over which it has little control. Although the current account deficit went down sharply in 2001, New Zealand has had a relatively low savings rate, making it dependent upon foreign capital to maintain investment levels. It is therefore vulnerable to swings and shifts in investor sentiment, changes largely unrelated to any domestic events or developments within New Zealand. Furthermore, compared with Australia, overall productivity remains low on account of low economies of scale, the protection given to agriculture in other OECD economies and persistent weakness in New Zealand's terms of trade.

… to counter the disadvantages of its small size

On the plus side, New Zealand has established, with prudent macroeconomic policies, a positive framework for improving savings and investment, thus boosting productivity in the future. The current slowdown could delay progress in these areas to some extent, but the country's competitive position has strengthened considerably following the exchange rate depreciation; market growth could be quite robust with the expected global recovery in late 2002. At the same time, it would be unrealistic to overlook the disadvantages of New Zealand's small size, geographical isolation and relatively limited resource endowment, particularly labour skills. Investment in education and retraining is thus a key priority for the future.