

Economic Developments and Prospects

The year 1999 saw the resolution of the financial crisis in developing Asia and acceleration of global growth, propelled primarily by a buoyant US economy. Led by the newly industrialized economies (NIEs) and the People's Republic of China (PRC), Asia posted strong growth that meant almost tripling the growth rate from the previous year. Prospects for further acceleration of growth in the region in the next two years depend on the sustainability of domestic demand, favorable global economic conditions, and progress in corporate and financial sector reforms in the crisis-affected economies.

In the fall of 1998, many economies in Asia were in recession, capital flows had turned negative, Russia had just defaulted on its official debt, and the outlook for the region and the world economy were generally pessimistic. Stock markets were languishing and there was a very real fear that the world economy would tip into recession. The sharp decline in worldwide economic growth had brought commodity prices to historical lows, with oil prices plummeting by 30 percent. The contagion effect from the Asian crisis was threatening Latin America, where the Brazilian currency, the real, was under siege. European banks, currencies, and stock markets were badly affected by the Russian devaluation and subsequent default during July and August, and the euro currency area appeared to be faltering. In its fall issue of the 1998 World Economic Outlook, the International Monetary Fund (IMF) slashed its forecast for 1999 world growth from 3.7 percent to 2.5 percent, stating, "The risks to this projection, however, are predominantly on the downside. Indeed a significantly worse outcome is clearly possible." The IMF would later downgrade its world growth forecast even further, to 2.3 percent.

A year and a half later the outlook for the world economy is, however, much more bullish. The year 1999 turned out to be much better than anyone had expected. The sharp rebound in global growth has now generated the fear of excess growth and inflation. How was such a turnaround possible?

The turning point was probably October 1998, when the Federal Reserve lowered the discount rate for the second time in two weeks. This sent a strong message to the world financial community that the United States (US) was ready to take whatever measures necessary to stem the threat. Markets responded quickly and enthusiastically. At about the same time, the Japanese government passed legislation to deal with bad loans in the banking system, and a month later, passed a stimulus package that worked to bring about positive growth the coming year. Between November 1998 and April 1999, the European Central Bank also lowered interest rates in tandem with US rates. Lower interest rates in industrial countries were matched by a further relaxation of monetary policy and fiscal policy in the countries that had been hit by the crisis in Asia.

These coordinated efforts on the part of both the industrial world and the crisis-affected developing countries in Asia were largely responsible for the upturn of the world economy in 1999, as it finally shook off the effects of the 1997 Asian crisis and the economic disturbances in Russia and Brazil that followed. Growth resumed in some countries and accelerated in others. The US continued to be the primary engine of growth among industrial countries and showed no signs of a deceleration in growth, as equity markets continued to surge while unemployment and inflation remained low. The misery index—the combination of the unemployment rate and the inflation rate—continued to fall (see figure 1.1).

Strong US growth also helped drive the rest of the North American Free Trade Area, with Canada and Mexico also performing well. Europe ended the year on an increasingly positive note, with Germany and France providing much of the impetus for growth in the region. Some countries in Asia moved to a higher growth path while others emerged from recession. Eastern and Central Europe made a modest recovery, supported by improved conditions in Russia, Poland, and the Czech Republic. The result was robust growth in the world economy and a low inflation rate for both industrial and developing economies.

Despite widespread economic success in 1999, there remained reasons for concern. The current account deficit of the United States remains large and the Japanese internal public debt has increased dramatically the past few years. There is also the issue of how long the “new industrial revolution,” born of the development of the Internet, information technology, and e-commerce, can continue to increase productivity and boost equity prices without causing inflation (see box 1.1).

In contrast to the 19th century industrial revolution, which featured numerous innovations in manufacturing, today’s revolution seems to permeate a wider segment of the economy. However, traditional industries are not benefiting much from these innovations as reflected in a growing disparity in equity markets between the new and older sectors of the economy.

It is difficult to gauge the overall long-run impact of the productivity gains from the new industrial revolution on global growth. In the short run, however, it is probably reasonable to assume that advances in

computer and information technology will help drive growth in industrial countries. The positive synergies from globalization and new technologies should also spread to the more progressive developing countries.

THE WORLD ECONOMY

World GDP growth increased to 3 percent in 1999 and it is likely to improve further, to about 3.5 percent in 2000. World trade volume also increased slightly to 4 percent in 1999, compared with the downturn of 1998 when trade growth moderated to 3.6 percent from 9.9 percent the previous year. World trade volume is projected to grow further, to nearly 6 percent in 2000. In 1999, world inflation declined to its lowest level in 40 years. This exemplary record reflects the intensified commitment among monetary authorities to focus on price stability.

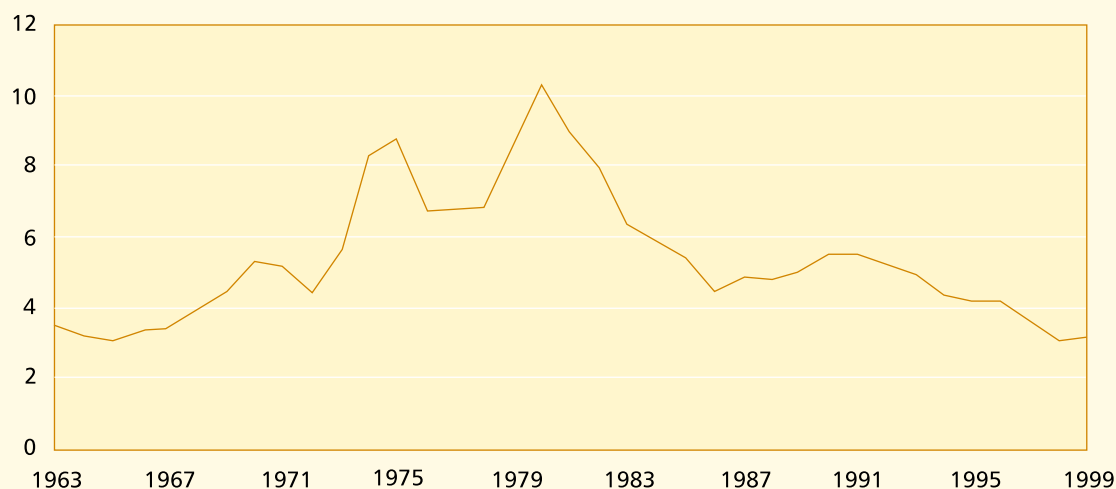
Industrial Countries

GDP growth in the industrial economies rebounded to 2.6 percent in 1999 from 2.4 percent in 1998. The United States and Canada continued to perform strongly in 1999, supported by buoyant domestic demand. Overall growth in GDP in the euro area declined to 2.1 percent in 1999 from 2.8 percent the previous year. In Japan, stimulative macroeconomic policies and the rebound in the Asian economies underpinned a modest economic recovery.

Inflation in the industrial economies was 1.3 percent in 1999, close to the decade low of 1.2 percent the previous year. Productivity increases exerted downward pressure on prices of final goods. Prices of services, which are primarily determined by labor costs, also remained low, because real wage increases lagged behind productivity growth. Inflation in 2000 may escalate to 1.7 percent, largely due to higher oil prices in the first quarter of the year and some modest upward pressure on wages as labor markets tighten further.

While interest rates bounced back in the latter part of 1999 from the crisis-depressed lows of late 1998, equity markets enjoyed stellar performance due to the vigor of output and earnings growth. The tightening of monetary policy by the major industrial economies in 1999 caused nominal bond yields to rise.

Figure 1.1 Misery Index, United States, 1963-1999



Note: The misery index is a weighted average of the CPI inflation rate and unemployment rate.
Source: US Bureau of Labor Statistics.

In 1999 there was a net outflow of capital from Europe into Japan (particularly into the equity market) and the US. The US attracted inflows of \$85 billion in direct investment and \$241 billion in portfolio investment. Direct investment was primarily used for foreign acquisition of US companies. These two sources of inflows, net of outflows, financed the US current account deficit of \$316 billion (3.5 percent of GDP) in 1999. Much of the net capital outflow from the European Union (EU) was spent on foreign mergers and acquisitions and liabilities issued internationally by regional banks. Record levels of foreign investment in Japanese equities took place in 1999 as economic growth prospects brightened. This helped support the yen and contributed to the buoyancy of the Japanese stock market.

The outlook for industrial countries suggests a trend toward convergence of economic growth. Growth in the euro area and in Japan is expected to be higher and US growth similar to that in 1999. Growth convergence within industrial countries will help maintain overall macroeconomic stability within the global economy. Nevertheless, policymakers need to address imbalances in foreign trade among the major regions.

Transition Economies

The transition economies showed clear signs of revival in 1999 as growth of nearly 1 percent was recorded following a slight contraction in 1998. Industrial output was particularly strong in Hungary and Poland, as Eastern European countries benefited from the economic strength of the EU, which replaced Russia as the major trading partner of many countries in this region. Countries that have undertaken structural reforms, such as Hungary, were well positioned to take advantage of improved trade linkages and growing import demand from the EU. For example, the Czech Republic, Hungary, and Poland sent a third of their exports to Germany and two thirds to Western Europe. Hungary and Poland led the region in growth performance in 1999, while in the Czech Republic, strong exports to Germany offset the effect of a strong krona to halt economic deceleration. Boosted by higher oil prices and the 75 percent depreciation of the ruble in the fall of 1998, Russia reported the strongest growth in industrial output in seven years as overall GDP grew by 1.7 percent. The improved performance of the region led to large capital inflows and boosted currency and equity markets. Greater sta-

Box 1.1 New Economy: Much Ado about Nothing?

The New Economy doctrine—sometimes grandiosely labeled as the New Economy paradigm—holds the view that information technology, in conjunction with globalization, has led to a permanent upsurge in productivity of US workers. This has in turn pushed up the growth rate the US economy can achieve without running up against capacity limits. The conventional view, which is based on economic theory and historical evidence, holds that the US economy has a “speed limit” of around 2-2.5 percent growth. The proponents of the new economy believe that the growth potential of the US economy has now been pushed to the range of 3-4 percent, stemming from productivity and efficiency gains arising from information technology and globalization.

What do data tell us about productivity growth in the United States? It is clear from historical

analysis that productivity growth comes primarily from technology and not from improved workforce quality or equipment per worker. Using a method that isolates technology from the other two sources, the evidence suggests that the technology component of US productivity slowed down after 1973 and never really picked up again. There were surges for short periods (1977-1978, 1983-1986, and 1990-1992), but they all followed recessions. The current productivity boom began in 1996, but what differentiates it from the other surges is that it did not follow a recession, and it has not reversed after a few years.

Is the current surge in productivity permanent? Are we in the middle of a new industrial revolution created by the computer, information technology, and the Internet? Several issues must be resolved before we can answer these questions with any certainty. First, the computer has been in use for

many years but productivity didn't accelerate until the early 1990s. Why was there such a lag? It could be because computers were not nearly as productive until they were linked together, either in local area networks or through the Internet, and this interconnectedness took time to develop and to be “sold” to the public. Second, even if the lag can be explained, how has the productivity in a small sector of the economy had such a beneficial effect on the entire economy? Third, and perhaps not quite as important, can the contributions of these three components of the new industrial revolution—the computer, information technology, and the Internet—be separated and analyzed individually?

As we try to answer these questions, we acquire a better understanding of whether this is actually in a “new economy,” and if so, precisely what is raising productivity. A plausible answer to

Source: <http://www.brookings.org>.

bility in Russia, along with increased import demand from the EU, improved current account balances in the region. Inflation also dropped in most countries.

Growth is likely to strengthen further to 2.8 percent in 2000, fueled by accelerating export growth to the EU. The downward trend in inflation and nominal interest rates is likely to continue as risk premiums in these countries decline. Entry negotiations into the EU will continue to dominate the policy agenda for some countries. The political situation in Eastern Europe should continue to improve, which will boost business confidence and foreign investment.

THE DEVELOPING ECONOMIES

Growth in the developing regions of the world improved from 3.2 percent in 1998 to 3.5 percent in 1999.

This was underpinned by the strong rebound in developing Asia, where GDP expanded by 6.2 percent from 2.3 percent in 1998 on the back of strong export growth and a revival of domestic demand. Greater strength in the global economy and the dissipation of the contagion effects of the Asian crisis also contributed to the improved performance of developing countries.

In growth, the NIEs, the PRC, and South Asian economies were the strongest performers among developing countries. Aside from a few countries such as Mexico, growth in Latin America was modest as political uncertainty dampened economic performance and market expectations. In Africa, growth varied substantially. Performance improved in several smaller countries that adopted structural reforms, while growth in the larger countries remained modest.

the first question, why the computer is only now so affecting the economy, is provided by a look at history. Economic historian Paul David argues that it takes decades for new technology to spread to the rest of the economy. His research shows that it took several decades for the technology of the electric dynamo to diffuse sufficiently to raise industrial productivity significantly. The same could be true for computer use in business, reinforced by the new information technology and the Internet.

To look for an answer to the second question regarding how productivity gains may have spilled over from the computer and information technology sections, consider inventory control, more efficient sourcing of inputs by canvassing suppliers, and Internet retailing. Certainly inventory control has been improved by the use of computers, but the cost savings are not great. Input sourcing and Internet retailing may yield productivity advances in the future,

but the savings up to now are small. Instead, it may be that the acceleration in productivity in the 1990s results from productivity gains in the computer industry alone. There is no doubt that a genuine productivity miracle has occurred in this industry, and some evidence suggests that it could have been responsible for the small overall acceleration in productivity in the entire economy. This suggests that there has been very little measurable diffusion of technology beyond computers.

The third question regarding how much each of the three factors have contributed individually to growth may be answered by the sheer strength in productivity in the computer industry. So far, whatever productivity gains have been made probably result primarily from the technology revolution in the computer industry alone and less from the Internet or information technology.

However, it is also plausible that the increased productivity has not been responsible for the reduced

inflation and unemployment and higher growth. The International Monetary Fund (IMF), in its latest *World Economic Outlook 2000* suggests that a strong dollar and lower import costs reduced consumer price inflation between 1996 and 1998, masking the signs of overheating. Moreover, the IMF argues that the financial crisis in 1997-1998 helped boost capital inflows, which in turn helped lower interest rates and strengthen the dollar despite the widening trade deficit, thereby raising demand. The IMF also increased its estimates of trend productivity, suggesting that the surge in productivity in the past few years is not as significant as previously estimated.

Whether the US economy has moved to a higher and seemingly sustainable growth rate, maintaining full employment without inflation, is therefore still debatable. Only time will tell whether the present upsurge in productivity heralded the arrival of the New Economy, or just another spike in the productivity chart.

The Non-Asian Developing Economies

GDP growth in Africa in 1999 was slightly lower at 3.1 percent, down from 3.4 percent the previous year. In the Middle East, GDP growth slowed to 1.8 percent from 3.2 percent in 1998 because of lower oil output. In 1999, growth in Latin America expanded by 0.1 percent as most countries in the region, except Mexico and Peru, experienced recession.

Africa. Growth performance varied across the region, with many of the smaller countries—Cameroon, Côte d' Ivoire, Ghana, Mozambique, Sudan, Tanzania, Tunisia, and Uganda—performing remarkably well, with growth of 3.9-7 percent. Implementing appropriate macroeconomic policies and favorable weather conditions contributed to this relatively strong ex-

pansion. Algeria implemented an extensive set of structural reforms over the past five years, and in Tunisia consistently strong growth was underpinned by healthy export performance supported by fiscal consolidation and a flexible exchange rate policy.

However, growth in three of the largest African economies was modest. Growth in South Africa recovered to 0.7 percent in 1999, only a slight improvement over 0.5 percent in 1998. Renewed financial market confidence; much lower interest rates; and improved prospects for exports, particularly to Asia, contributed to this recovery. Despite rising oil prices following the reduction in Organization of Petroleum Exporting Countries (OPEC) quotas in the second half of 1999, lower oil prices in 1998 and early 1999—and the subsequent reductions in oil production in compliance with lower OPEC quotas—reduced GDP

growth in Nigeria to 0.5 percent in 1999. This was accompanied by rising budget and current account deficits. Morocco also grew slowly, as the economy was adversely affected by a drought that decreased agricultural output.

The implementation of structural reforms in Africa has been constrained by the economic difficulties brought about by depressed non-oil commodity prices in recent years, and this continued in 1999. However, increased attention to privatization efforts, public sector reforms, and other structural measures have in part been instrumental in improving the business and investment environment in some countries. Positive developments in trade and political cooperation have included the common external tariff implemented by the West African Economic and Monetary Union, bilateral trade agreements between the EU and some African economies, and plans for free-trade areas in Eastern and Southern Africa.

Latin America. Many of the countries in this region experienced negative growth in 1999 following the 1998 Brazilian currency crisis. The recession and devaluation in Brazil—a major export market for the rest of the region—combined with political instability in some countries to cause regional GDP growth to slow in 1999 to 0.1 percent from 2.2 percent in 1998. The three big Latin American countries, Argentina, Brazil, and Mexico, faced varying economic situations. Mexico enjoyed relatively robust growth of 3 percent, while Argentina and Brazil were in a recession, with negative growth rates of 3 and 1 percent, respectively. All three faced difficult conditions in international financial markets: credit conditions hardened, and debt-market access was more difficult following the Brady bond default in Ecuador and the consequent possibility of involving private creditors in restructuring. The region weathered the storm largely through forced adjustment of exchange rate, fiscal policy, or both. Mexico had essentially separated itself from the rest of the region through its strong trade dependence on the US, which accounts for more than four fifths of its exports. Besides Mexico, Peru is the only other country in the region that achieved growth. It took advantage of the recovery in the global demand for industrial materials to expand production and increase revenue in its primary and mining sectors.

Investors' demand for a greater risk premium in view of exchange rate volatility and political instability, have kept real interest rates at extremely high levels in the region. Following the Brazilian devaluation in January 1999, secondary market spreads increased for most of the major developing country borrowers, including Latin America. However, there was a partial recovery later in the year as spreads fell somewhat. The high-risk premium has curbed net capital inflows that are needed to finance domestic investment. Foreign fund flows into local equity and money markets are being deterred because of poor growth prospects and exchange rate risk.

Much of the volatility in the region's currency and equity markets in 1999 resulted from the elections in Argentina, the chance of debt default in Argentina and Mexico, and slow or negative growth through much of the region. The recession in Latin America and large public sector debt service worsened the region's public finances in 1999. Even Chile, which had fiscal surpluses in the past five years, incurred a deficit. Despite the difficult environment, every major Latin American country achieved a primary surplus in 1999.

The Middle East. Many countries in this region emerged from the global financial crisis relatively unscathed. The use of foreign exchange reserves and external portfolios to finance the fiscal deficits and trade balances in the short term were used to avert the contagion effects from other financial markets. In countries with tighter financing constraints, contractionary expenditure policy, exchange rate devaluation, and rescheduling of external debt were used to regain stability.

Saudi Arabia, the main driver of growth in the Arabian Peninsula and the Gulf, did not adjust its spending to the fall in oil prices in 1998, and its government was forced to draw on its substantial overseas assets to meet budgeted spending commitments. Fiscal austerity measures were implemented in 1999 and growth is expected to resume in 2000. Egypt continued to drive growth in the Eastern Mediterranean area. Despite a change in the cabinet in 1999, progress in economic reform and liberalization propelled GDP growth to 6 percent. Growth also increased in Israel, due to greater foreign investment and political stabil-

ity. Foreign direct investment (FDI) in the Middle East and the North Africa (MENA) region continued to lag behind other emerging markets because of the low level of integration with global capital markets. While global FDI inflow rose by 38.7 percent in 1998 to \$643.9 billion, inflows into the MENA region fell by 6 percent to \$7.2 billion and accounted for only 1.1 percent of global levels, down from 1.7 percent in 1997.

The Asian and Pacific Developing Economies

The Asian economic outlook changed dramatically in 1999 (figure 1.2). In the fall of 1998, several economies were in recession, capital flows had turned negative, and the outlook was generally pessimistic. In early 1999, an average annual growth of 4.4 percent was forecast for the region. This was revised to 5.7 percent in the fourth quarter of 1999, and the actual outcomes for the year have exceeded 6 percent.

The recovery has been uneven across developing Asia. Growth in the Republic of Korea (henceforth referred to as Korea) was particularly strong, along with the PRC and India. In tandem with the economic recovery in Russia in 1999, most countries in Central Asia experienced higher rates of growth, although inflation and external imbalances continued to be relatively high.

The faster-than-expected recovery in the first half of 1999 in most of the crisis-affected countries—Korea, Malaysia, Philippines, and Thailand—resulted from stimulative monetary and fiscal policy and increased exports, led by a surge in worldwide demand for electronics. Consumer sentiment also improved, bolstering domestic demand and economic growth. In the second half of 1999, the recovery was supported by continued expansionary policies and progress on implementing structural reforms to deal with the financial crisis.

In the NIEs and in Southeast Asia, either a resumption of growth or increased growth, combined with generally buoyant equity markets, helped improve aggregate demand and consumer confidence. Consumers began to spend after two years of belt-tightening. A decrease in consumer goods prices in some countries further increased purchasing power, partly offsetting selective wage cuts and high unemployment.

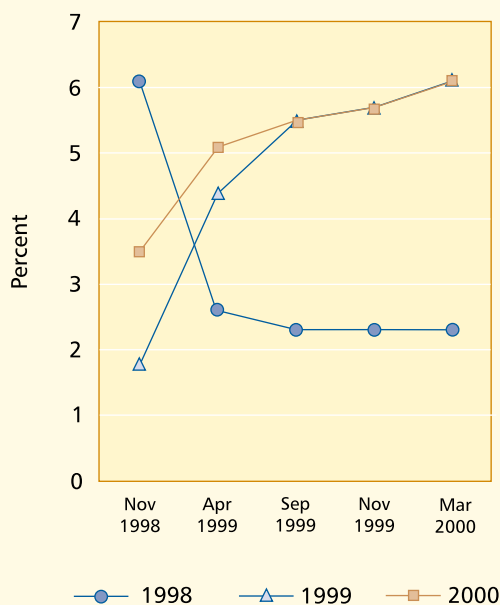
Korea, one of the countries most affected by the financial crisis, led the region with double-digit economic growth in 1999. Stock rebuilding, increases in private consumption and investment, and increased exports boosted Korean production to above precrisis levels. Among the other crisis-affected countries growth ranged from 0.2 to 5.4 percent, as these countries also experienced a stronger-than-expected recovery from the crisis. Growth in the PRC slowed from 7.8 percent in 1998 to 7.1 percent in 1999, as its pump priming of the economy through expansionary fiscal policy weakened and export growth remained modest. South Asia continued to be a strongly performing region with an aggregate growth rate acceleration of 5.5 percent in 1999. Growth in India, the largest economy in the region, was robust at 5.9 percent. A strong increase in industry sector activity was partially offset by weak agriculture output growth. Other countries in the region, including Bangladesh and Sri Lanka, also did reasonably well.

Currency markets in Asia stabilized in 1999 because of structural reforms, interest rate cuts in most of the industrial countries, positive expectations about the Japanese economy, and increased financial commitments from the international community. Consequently, foreign capital started returning to Asia. Private capital flows returned to five crisis-affected countries—Indonesia, Korea, Malaysia, Philippines, and Thailand—with net private inflows of \$5.1 billion in 1999, as opposed to a net outflow of \$38.6 billion in 1998. In the PRC, net private flows slowed from about \$40 billion in 1998 to around \$27 billion in 1999, as FDI eased and debts were repaid. At 6.2 percent, growth in the Asian region is expected to remain virtually unchanged in 2000. Slower growth in the NIEs and the PRC will be offset by more rapid growth in Southeast Asia, South Asia, and the Central Asian republics.

The Newly Industrialized Economies. The NIEs rebounded strongly in 1999. GDP growth was 7.0 percent compared with a contraction of 1.9 percent in 1998. There was slight deflationary pressure as the aggregate price level fell by 0.4 percent.

Despite the overall revival of the NIEs, economic performance varied significantly among countries. After a severe recession in 1998, the economy of

Figure 1.2 ADB's Forecast Growth Rate, Asia, November 1998 - March 2000



Sources: ADB (1998c, 1999b); Kumar (1999); Siregar (1998).

Hong Kong, China posted growth of 2.9 percent in 1999. This recovery was mainly sustained by accelerated growth in government spending, and increased exports of services combined with decreased imports of goods. In Korea, real GDP grew by 10.7 percent in 1999 after declining by 6.7 percent the previous year. Several large fiscal stimulus packages combined with foreign capital inflows and more accommodating monetary policy helped renew domestic demand in Korea. Along with more expansionary monetary and fiscal policy, electronics exports to the US to meet Y2K standards provided a major boost to growth in Singapore. Taipei, China experienced a 15-year low GDP growth rate of 4.6 percent in 1998, although it edged up to 5.7 percent the next year. Some additional growth resulted from a surge in exports of electronic, information, and communication products, which emanated from an expansion of the information technology (IT) sector in industrial countries and Y2K-compliance requirements.

High unemployment rates and low wage growth continued to dampen consumer demand in the NIEs. Private consumption expenditure increased a modest 1.6 percent in 1999 for the subregion, although there were substantial differences among countries. In 1999, high real interest rates and an uncertain business outlook contributed to weak consumption in Hong Kong, China, while in Taipei, China consumption demand was weak compared with previous years. Conversely, in Korea consumption spending increased significantly, rising to 7.4 percent from a decline of 8.2 percent in 1998. In Singapore, consumer demand also increased because of falling unemployment, wage increases in the private sector, and more tourist arrivals.

Inflation in the NIEs in 1999 averaged negative 0.4 percent. In Hong Kong, China deflation continued at a more rapid pace than in 1998 as the consumer price index fell by 4 percent. Fierce price competition, flat rental prices, and a freeze in government fees and most public utility charges contributed to the sustained fall in the consumer price index. Weak world commodity prices (except for fuel), and deflation in the PRC—Hong Kong, China's major trading partner—also kept imported inflation at bay. Singapore's inflation rate was 0.5 percent in 1999, primarily due to weak domestic demand. In Taipei, China, the inflation rate continued to be low, averaging 0.2 percent. Weak domestic demand coupled with the government's strategy of increasing imports helped contain inflation. In Korea, the appreciation of the won contributed to the drop in the inflation rate from 7.5 percent in 1998 to 0.8 percent in 1999, the lowest level recorded in 50 years.

Exports, which had declined in 1998 because of the crisis, staged a moderate recovery and increased by 4.5 percent in 1999 in the NIEs. Net exports of services rose in 1999, led by regional demand for financial and business services. In Singapore, the services balance benefited from regional recovery and more than offset the smaller trade surplus. Consequently, the current account surplus was 18.5 percent of GDP in 1999. In Taipei, China imports of industrial raw materials and capital goods used primarily for export production began to increase at the end of 1999, although imports of consumer goods remained sluggish. Overall, Taipei, China recorded a current account surplus of 3 percent of GDP in 1999. The trade deficit

Table 1.1 Selected Economic Indicators, Developing Asia, 1997-2001
(percent)

	1997	1998	1999	2000	2001
Gross domestic product (annual change)					
Developing Asia	6.0	2.3	6.2	6.2	6.0
Newly industrialized economies	5.7	-1.9	7.0	6.5	6.0
PRC and Mongolia	8.7	7.8	7.1	6.5	6.0
Central Asian republics	3.3	0.8	2.8	3.0	3.6
Southeast Asia	3.7	-7.5	3.2	4.6	5.0
South Asia	4.7	6.2	5.5	6.4	6.6
The Pacific	-3.2	1.2	4.4	—	—
Inflation (change in CPI)					
Developing Asia	4.3	5.5	1.6	3.0	3.3
Newly industrialized economies	3.5	3.9	-0.4	1.8	2.6
PRC and Mongolia	2.8	-0.8	-1.4	1.8	2.0
Central Asian republics	21.4	11.4	21.9	15.1	10.7
Southeast Asia	5.5	21.3	7.4	4.7	4.6
South Asia	5.6	7.1	4.1	5.0	5.4
The Pacific	3.9	9.9	10.4	—	—
Current account balance/GDP					
Developing Asia	0.5	4.1	3.8	1.5	0.5
Newly industrialized economies	1.6	9.3	6.4	3.7	2.4
PRC and Mongolia	3.3	3.0	1.2	-0.4	-0.9
Central Asian republics	-4.0	-4.5	-2.0	-2.4	-2.3
Southeast Asia	-3.4	7.0	7.6	3.3	0.8
South Asia	-1.4	-1.9	-2.2	-3.9	-3.0
The Pacific	-0.9	1.8	—	—	—

— Not available.

CPI consumer price index.

Sources: Appendix tables.

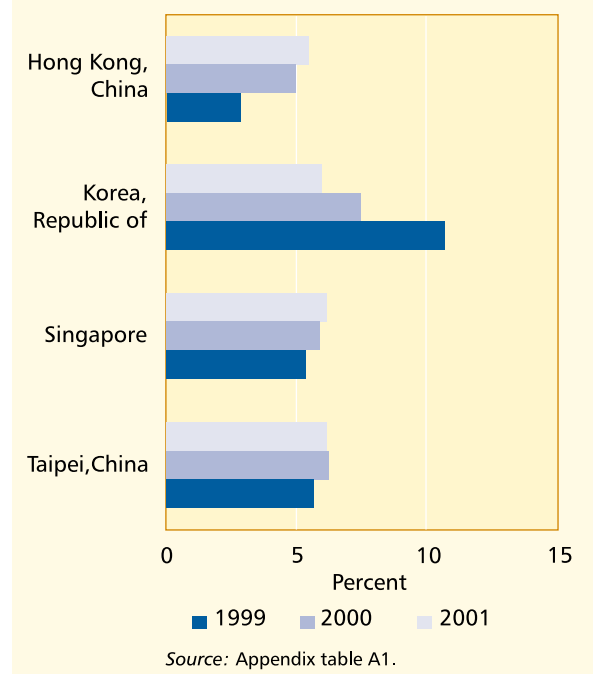
narrowed, as there was a significant rebound in re-exports to and from Asia, especially Indonesia, Japan, Korea, and Singapore. In Hong Kong, China exports recovered but growth was still negative in 1999. In Korea, export growth recovered strongly to more than 10 percent from a 4.7 percent deficit in 1998, as a result of stronger competitiveness vis-a-vis Japan and recovery in Asian markets.

Future economic expansion in the region will be driven by growth in domestic demand, efficiency gains resulting from progress in structural reforms and IT-related exports. GDP growth in 2000 is forecast to be 6.5 percent for the NIEs (see figure 1.3). This growth rate, while quite robust, is still somewhat lower than in 1999, primarily because of a decline in Korea's growth,

where double-digit growth is not expected to be sustained. Export growth in the NIEs is projected to increase more, to 8.9 percent in 2000. This would be the highest growth rate in exports since 1995, but it falls short of the average of nearly 15 percent between 1992 and 1995. A large-scale restructuring of capacities and policy measures to regain competitiveness may be required before the NIEs regain such export dynamism. Import demand will recover sharply as growth returns and the increased exports in turn drive up demand for raw materials and components.

PRC and Mongolia. Despite the Asian financial crisis, the PRC maintained a robust growth rate of 7.8 percent in 1998, and did not fall into recession for two

Figure 1.3 Real GDP Growth Rates, Newly Industrialized Economies, 1999-2001



reasons. First, the PRC has capital controls and a fixed exchange rate, and these policies insulated the economy from the financial turmoil that besieged other countries. Second, the PRC adopted an expansionary fiscal policy in the form of public spending on infrastructure projects. GDP growth slowed to 7.1 percent in 1999, partly because of a tapering of the stimulus from the 1998 fiscal packages. An increase in sales of durable goods and commodity prices in 1999 helped ease deflationary pressures. The economic recovery within the Asian region, which absorbs half of the PRC's exports, helped accelerate export growth to 6 percent in 1999, from less than 1 percent the previous year. This is far short of the rapid export growth recorded before the crisis, but is on a par with many of its competitors in the region. Clearly, some of the deceleration in export growth may be due to greater competition from other regional exporters, which have more competitive exchange rates after the Asian financial crisis. Imports grew by 18.2 percent in 1999,

primarily because of increased demand by export-oriented industries for imports to replenish inventories and to satisfy the demand for investment and consumer goods. The combination of a narrowing trade surplus and a chronic deficit in the services balance reduced the current account surplus to 1.2 percent of GDP.

Interest rates were lowered four times since 1998, to boost consumption and investment spending and ultimately break the deflationary spiral. The relaxation of monetary policy also reduced the debt-service burden of state-owned enterprises.

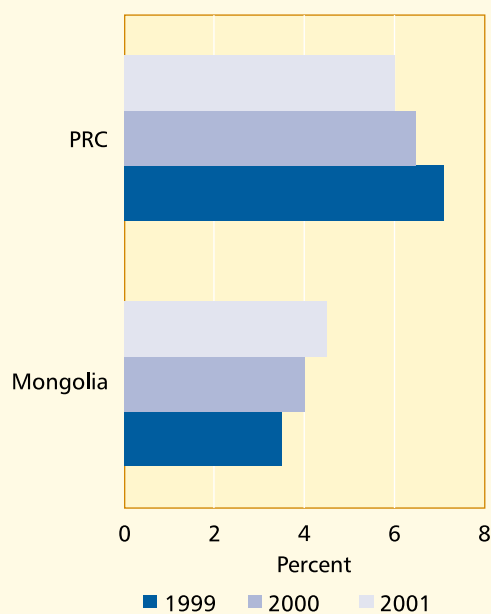
FDI fell 9.7 percent during 1999, and there may have been portfolio capital outflow. Consequently, foreign reserve accumulation was minimal. However, this is not a serious concern because the growth of foreign exchange earnings kept pace with the growth of foreign liabilities, with foreign exchange reserves still five times the level of short-term debt.

Growth in 2000 is forecast at 6.5 percent, primarily due to slowed industry and construction sector activity (see figure 1.4). The PRC's reform strategy over the last two decades has centered on the agriculture and manufacturing sectors, while the service sector has lagged in productivity growth because of heavy protection. Liberalization of the service sector over the next two to five years, as a result of entry into the World Trade Organization, could potentially overhaul the sector and unleash a second wave of dynamic productivity gains, which may spur growth in the medium to long term (see box 1.2).

After several years of a relatively well-managed transition to a market-based economy, Mongolia has faced a financial sector crisis and problems with macroeconomic stabilization. The Asian and Russian financial crises caused a severe drop in FDI and bilateral aid flows. In addition, cashmere, copper, and gold, the main exports, suffered from low world prices, which decreased export revenues. Economic growth remained at 3.5 percent in 1999.

As large enterprises faced cash shortages, a draw-down on bank deposits and a growing volume of nonperforming loans led to a weakening of the banking system. This increased the fiscal liability of the government, as the distressed banks need to be recapitalized. The public sector fiscal imbalance, which has been compounded over the years due to budgetary

Figure 1.4 Real GDP Growth Rates, PRC and Mongolia, 1999-2001



Source: Appendix table A1.

mismanagement, has begun to threaten the government's ability to complete ongoing reforms.

Mongolia's short- to medium-term prospects depend on the success of banking sector reforms, whether fiscal imbalances are addressed, and the strength of export performance. GDP growth in 2000 is forecast at 4 percent, with the main sources of growth expected to be mining and manufacturing. Reforms in the agriculture sector, promotion of small-scale industries, and escalating private sector activity (which constituted 60 percent of GDP in 1998) are expected to stimulate growth.

The Central Asian Republics. The economies of Central Asia grew at 2.8 percent in 1999, up from the previous year's 0.8 percent. Kazakhstan implemented major policy adjustments, including floating its currency, the tenge. Stabilization of commodity prices and prudent fiscal policy provided breathing space for implementing reforms, which helped the economy grow to 1.7 percent in 1999, compared with a 1.9 per-

cent contraction the previous year. The Kyrgyz Republic's economy was in the middle of a major fiscal and financial adjustment process, but the GDP growth rate in 1999 was 3.6 percent, up from 2.1 percent in 1998. The engine of growth was the agriculture sector, which grew by 8.7 percent. Tajikistan made substantial progress in macroeconomic stabilization and its transition to a market economy in 1998. Its three-year IMF reform program is largely on track. However, GDP growth was only 3.7 percent in 1999, considerably lower than the 1998 rate of 5.3 percent, reflecting stagnant growth in both agriculture and industry. Uzbekistan, the country with the largest population in Central Asia, is following its own gradual reform program. Foreign exchange controls, the country's policy of self-sufficiency, and rudimentary financial markets all impede more rapid economic progress. GDP growth in 1999, at 4.4 percent, was the same rate recorded in 1998.

Future economic performance in the Central Asian republics will depend on Russia's continued economic recovery and improvement in international commodity prices (see figure 1.5). The extent to which the respective countries are affected by these two factors varies considerably. Political stability will also play a role in the future development of these former Soviet republics.

The Southeast Asian Economies. The V-shaped recovery in the crisis countries in this region can be viewed partly as a snapback given the sharp negative growth the previous year. Nevertheless, various positive factors, both domestic and external, contributed to the recovery, including increased consumption, stock rebuilding, massive fiscal stimulus, and loose monetary policy. New policy measures to address corporate and financial sector problems also supported the recovery, and helped contain and even reduce the level of nonperforming loans. The recovery was stimulated also by the strengthened Japanese economy and increased financial resource flows from the international community, which resulted in improved balance-of-payments position in most of the subregion. Together with inflows of foreign aid and progress on foreign debt rollovers, capital flows were stabilized, and confidence in these countries was restored. The availability of fiscal surpluses, a legacy of

Box 1.2 The People's Republic of China's Entry into the World Trade Organization: Who Wins and Loses?

With merchandise exports of nearly \$200 billion in 1998, the People's Republic of China (PRC) is the ninth largest exporter in the world. The PRC is expected to join the World Trade Organization (WTO) in 2000, an event of major economic significance for the Chinese and global economy. One of the major obstacles to the PRC's 13-year bid to gain accession to WTO was cleared in November 1999, when the United States and the PRC signed a bilateral trade agreement detailing a far-reaching set of commitments that the PRC will have to meet as a WTO member. Although the PRC will now have to negotiate similar agreements with the European Union and several other smaller trading partners before it can join WTO, the agreement with the US is pivotal, because the concessions it extracted from the PRC are likely to satisfy many other countries. The terms of the bilateral agreement with the US include the following

- *Agriculture:* Overall tariffs for all agricultural products are to be cut from an average of 22 percent to 17.5 percent by January 2004, with even lower rates for beef; cheese; wine; and a range of fruits, including grapes, oranges, apples, cherries, and almonds. Moreover, market access will be further enhanced by a progressive increase in quotas on

bulk commodities such as corn, cotton, rice, soybean oil, and wheat, and the elimination of health and hygiene standards that are not based on scientific evidence. The PRC has also committed itself to eliminating export subsidies and liberalizing domestic trade in agriculture by allowing private entities to engage in importing and distributing agricultural products without going through state trading enterprises.

- *Industry:* Average tariffs on all industrial products are to be cut from the 1997 average of 24.6 percent to 9.4 percent by 2005, with sharper reductions for tariffs on automobiles (from 80-100 percent to 25 percent by 2006), chemicals, wood, and paper. Quotas for fiber optic cables and other products are to be eliminated upon the PRC's accession to WTO, and most of the remaining quotas will be increased before being phased out by 2005. The PRC will also join the Information Technology Agreement and eliminate tariffs on semiconductors, computers, and all Internet-related equipment by 2005.

- *Services:* The PRC is committed to eliminating most foreign equity and geographical restrictions on its service sectors within two to six years. It will also accede to WTO's Basic Telecommunications and Financial Services agreements. The Basic Telecommunications agreement will

allow up to 49 percent foreign ownership in mobile, domestic, and international land and sea services within five to six years and 50 percent ownership in paging and value-added services within two years. The Financial Services agreement will phase out all geographical restrictions on foreign insurers within three years and expand their scope of activities to include group, health, and pension policies within five years. The PRC will also allow 50 percent foreign ownership in life insurance joint ventures and 100 percent ownership in reinsurance and nonlife insurance within two years. Foreign banks will gain full market access within five years and will be able to conduct local currency transactions with Chinese enterprises and individuals within two to five years. Joint venture firms with minority foreign stakes will also be able to underwrite domestic- and foreign-currency-denominated securities.

- *Trading and distribution rights:* The PRC will grant full trading and distribution rights to foreign firms within three years of accession to WTO. This will give foreign firms the right to import and export directly without Chinese intermediaries, and to handle wholesaling, retailing, maintenance and repair, and transportation.

Source: Institute for International Economics (1999).

past prudent policies, and a favorable external environment permitted the easing of fiscal and monetary policy and reduced interest rates without causing volatility in foreign exchange market.

After an initially tenuous start, Southeast Asia's recovery has proved more rapid and broad-based than anticipated. All the countries in the subregion registered growth in 1999 (see figure 1.6). The GDP growth rate for the subregion was 3.2 percent in 1999, in sharp

contrast to a negative growth of 7.5 percent in 1998. Nevertheless, domestic consumption and investment, on average, remained well below precrisis levels.

In the first half of 1999, the recovery in global demand for semiconductors, which emanated from preparations for achieving Y2K compliance, led to a surge in exports from Malaysia, Philippines, and Thailand. Among the crisis-affected countries, only the Philippines escaped negative export growth in

Foreign firms will also be able to engage in such auxiliary services as leasing, air courier, warehousing, packaging, and advertising.

These sweeping reforms are likely to have far-reaching domestic and international implications. In the short term, many analysts expect the reforms to lead to a considerable loss of output and a sharp increase in unemployment. For instance, in farming, cuts in tariffs and increases in tariff quotas will probably result in a substantial increase in wheat imports, as domestic prices remain far above world market prices. This will bring about a sharp reduction in output and an increase in unemployment. The auto industry will probably experience a similar sharp reduction in output and jobs, as the new WTO regime slashes tariffs and allows foreign carmakers to provide financial assistance to buyers. This may cause rationalization of the fragmented and inefficient car industry that currently has more than 100 manufacturers of vehicles and components. Many domestic vehicle makers will not survive the cost cutting needed to remain competitive.

WTO membership also will bring far-reaching changes to the financial sector. As foreign banks will eventually be allowed to conduct local currency business with both Chinese firms and individuals, competition within the domestic financial sector is certain to intensify.

Domestic banks will need to improve their banking practices and strengthen their balance sheets. Otherwise, they could face a loss of deposits to foreign banks that have fewer nonperforming loans and can, therefore, offer higher interest rates to depositors.

However, over time the efficiency gains from reallocating both capital and labor to more competitive sectors within the Chinese economy should more than offset these short-term losses. This should result in increased productivity, profitability, investment, and employment. Accession to WTO would then deepen and accelerate Chinese liberalization and help lock in the tenuous domestic reform process.

What will be the probable impact on the rest of the world when the PRC joins WTO? Apart from increased access to the PRC's internal market, WTO membership would make all investors who use the PRC as a production and export platform feel more secure about access to third markets as well as the domestic market. Foreign retailers and distributors will also be able to sell products and services directly to Chinese consumers for the first time. This will give Chinese consumers greater choice at lower prices. Regional economies are likely to be among the main beneficiaries of the PRC's liberalization measures. Established producers of quality consumer durable goods, including

Japan; Republic of Korea; and Taipei, China, could gain significantly from better access to the region's second-largest market. Southeast Asian exporters of natural resources such as Indonesia and agricultural producers such as Thailand could gain from greater access to the PRC markets, while Indian pharmaceutical manufacturers could potentially gain access to the PRC's highly protected pharmaceutical market. On the export side, the PRC's accession to WTO will make it an even more formidable competitor in labor-intensive products in the world market such as shoes, toys, bags, and textiles. Some regional economies will lose export markets to the PRC in the textile and apparel sector when the Multi-Fibre Agreement quotas are phased out by 2005. Finally, given that the PRC's accession commitments to WTO are considerably more liberal than the commitments of a number of regional member countries, this could prompt a further round of competitive liberalization within the region, as the PRC begins to implement its WTO commitments.

The PRC's accession to WTO should not be seen as a zero sum game where one side loses and the other gains. Although there may be short-term costs for both sides, the long-term benefits from an expansion and liberalization of the world trading system from the PRC's membership would no doubt far outweigh these short-term costs.

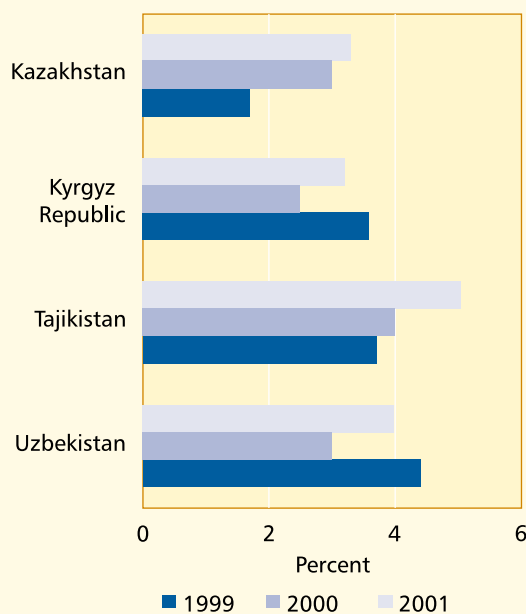
the past two years, achieving an export growth rate of 16.9 percent in 1998 and 18.8 percent in 1999. It was less constrained by the crisis, as it had undergone a major restructuring in the 1980s. Its exports also were more geared to the US market, which remained buoyant.

Consumer spending began to recover in the first half of 1999. In the four crisis-affected countries, consumer confidence indicators stabilized and are improving. Even Indonesia, which lags behind the other

countries in the region in terms of consumer confidence, registered a private consumption growth rate of 2 percent in 1999, while the Philippines and Thailand registered 2.5 percent. Nevertheless, the 1999 level of private consumption expenditures remained below precrisis levels.

Pump priming of the regional economies through large fiscal stimulus packages was used extensively in 1998 and 1999, causing concern that fiscal imbalances

Figure 1.5 Real GDP Growth Rates, Central Asian Republics, 1999-2001



Source: Appendix table A1.

were getting out of hand. Assuming a recovery of 50-60 percent of nonperforming loans in these economies, the cost of fiscal support for bank recapitalization was expected to be about 15 percent of GDP in Malaysia and more than 30 percent in Indonesia and Thailand. Actual recovery rates in 1999 were, however substantially lower.

The improvement in economic performance, combined with the return of portfolio capital to the region, resulted in a surge in the equity market prices by 25.4 percent in dollar terms during 1999. This was significantly above the 6.7 percent and 4.5 percent recorded in the US and world stock markets, respectively. This boosted confidence in domestic markets and stimulated consumption spending.

Price stability continued to improve in the region. In Cambodia, Lao People's Democratic Republic, Philippines, Thailand, and Viet Nam, inflation fell in 1999, reflecting lower food prices. Indonesia displayed a dramatic decline in its inflation rate, from 58.5 percent in 1998 to around 20.5 percent in 1999, because of

lower food prices and unused industrial capacity. A more stable political environment and increased foreign capital inflows also helped stabilize prices, particularly during the second half of the year.

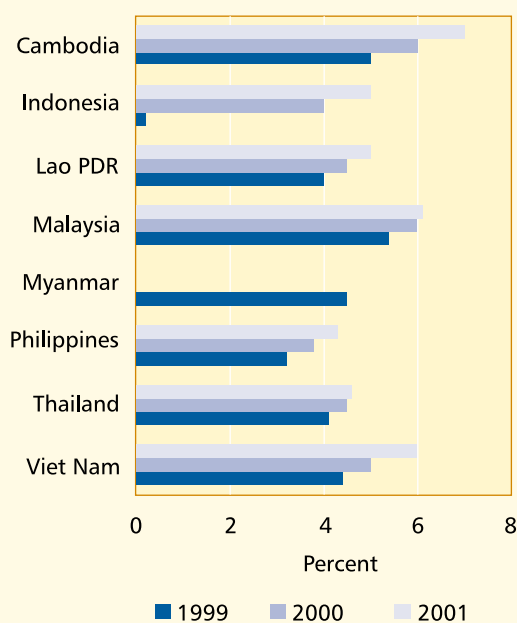
Short-term nominal interest rates across the region remained below precrisis averages, with the exception of Indonesia. Thailand's three-month interest rate of 4.00-4.25 percent in December 1999 is significantly below the 10.7 percent recorded for 1991-1996. The interest rate declines result from improvements in the balance of payments combined with an expansionary monetary policy. Central banks in the region kept short-term interest rates low to keep financial sector reforms on track and bolster demand.

On the external balance, the substantial current account surpluses that accompanied the initial collapse in economic activity lifted foreign exchange reserves to record levels in Malaysia and the Philippines during 1998. Combined with the announcement of structural reforms and macroeconomic stabilization programs, this led to a resumption of foreign capital inflows and boosted investor sentiment. Strong FDI offset the low level of domestic investment somewhat. Import growth tended to outstrip export growth by a large margin in several countries because of rising demand from increased industry sector activity. However, imports continued to decline in Indonesia, so the trade and current account balances in the region's totals changed only slightly compared with 1998.

Growth in 1999 emanated from continued improvement in domestic demand that arose from expansionary macroeconomic policies, combined with improved external demand that resulted from expanded world and intraregional trade. The 2000 forecast for Southeast Asia is for a modest strengthening of growth to 4.6 percent. This upward trend should be supported by the boom in the electronics industry, continued economic growth in the US, likely upturn in euro area, and the possible continued recovery of the Japanese economy.

South Asia. South Asia continues to be a strong performer, largely because of the strength of the Indian economy. Growth in the subregion was 6.2 and 5.5 percent in 1998 and 1999, respectively. In India, the industry sector showed signs of an increase after three years of sluggish performance. Combined with in-

Figure 1.6 Real GDP Growth Rates, Southeast Asia, 1999-2001



Note: 2000 and 2001 forecasts for Myanmar are not available.
Source: Appendix table A1.

increased exports and a weaker performance in the agriculture sector, GDP growth was 5.9 percent in 1999. Pakistan's continued political instability, weak agriculture sector performance, and macroeconomic imbalances constrained growth to 3.9 percent in 1999. In Bangladesh, manufacturing sector activity was seriously hampered because of the floods in the first half of 1999 and political demonstrations. The Maldives recorded 8.5 percent growth, with strong performance in the tourism, fisheries, and construction sectors. GDP growth in Nepal was a modest 3.3 percent in 1999, higher than 2.3 percent growth in the previous year. The recovery of the agriculture and industry sectors supported Nepal's growth momentum. Growth in Sri Lanka decelerated to 4.2 percent in 1999, primarily due to declining industrial output.

Inflation dropped in the subregion during 1999 to 4.1 from 7.1 percent in the previous year, primarily due to increased agricultural production that offset a 25 percent hike in diesel prices in India. Rising business competition put downward pressure on prices, while

the relatively stable exchange rate dampened imported inflation. In Pakistan, the downward trend in inflation continued in 1999 because of tight monetary and fiscal policies, combined with weak aggregate demand growth. Severe floods disrupted industrial production in Bangladesh, which contributed to inflation.

The fiscal balance continued to be a cause for concern in most major countries in the subregion. In India, the gross fiscal deficit of 5.5 percent of GDP is particularly worrisome because the real interest rate on public debt exceeds the GDP growth rate. Not only does the growing fiscal deficit seriously threaten macroeconomic stability, but it will limit the amount of public investment available for physical and social infrastructure required to support an industrial recovery. In Bangladesh, the shortfall in government revenues, combined with expenditures associated with flood-relief programs, further strained the fiscal balance. Structural reforms in the form of tax increases, subsidy reductions, and current expenditure reduction improved the fiscal balance in Pakistan. However, development program spending is expected to rise in the next few years to promote economic growth, which, combined with a decline in foreign aid, will exert pressure on the fiscal balance in the short to medium term.

On the external balance, export growth decelerated in most major countries, with the exception of India. Manufacturing exports, which accounted for 80 percent of India's exports, was stimulated by the recovery in Asia and global trade. The export competitiveness of Bangladesh, Pakistan, and Sri Lanka was adversely affected by the large devaluation of major Southeast Asian currencies. The drop in prices of textile products and non-oil commodities such as tea and rubber also contributed to the export slowdown in Bangladesh and Sri Lanka.

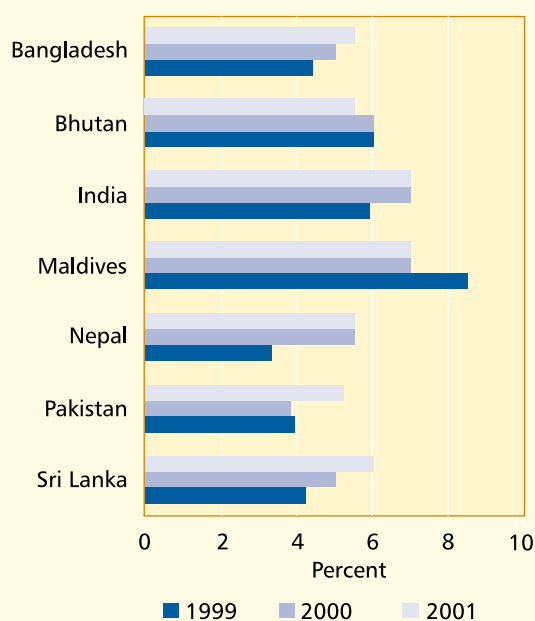
The current account deficit for the subregion widened to 2.2 percent of GDP in 1999 from 1.9 percent in 1998, the highest recorded in the 1990s. Most of this resulted from increased import growth in the subregion, because of the substantial climb in the prices of crude oil and petroleum products.

Political stability and a positive economic outlook for India led to resumed foreign capital inflows into India and raised investor confidence. This encouraged foreign investors to pour in portfolio investment, which recorded a net inflow in 1999 rather than

a net outflow as in 1998. However, a deterioration of the political environment in Pakistan and Sri Lanka slowed the inflow of foreign capital into these countries. FDI decreased to \$225 million in Bangladesh in 1999 from \$317 million in 1998. Most of the inflows were to the natural gas and power sectors, which account for 60 percent of total FDI.

Aggregate growth in South Asia for 2000 is forecast at 6.4 percent (see figure 1.7). Growth in India will increase slightly, with industry and service sector growth remaining strong. Political stability in the region will be essential in determining the course of economic policy in the subregion and the prospects for reaching the per capita income levels attained in the NIEs and Southeast Asia. The opening of domestic capital markets and integration with international financial markets will increase net capital inflows and improve the access to international financial markets. These synergies will help alleviate the negative effects of chronic fiscal deficits, which otherwise would have crowded out private sector investment in a relatively closed economy.

Figure 1.7 Real GDP Growth Rates, South Asia, 1999-2001



Source: Appendix table A1.

The Pacific. The Pacific subregion as a whole grew by 4.4 percent in 1999, compared with 1.2 percent in 1998. Sound macroeconomic management and tight monetary policy in those countries that have their own currency contributed to the improved economic performance in most of the subregion. Papua New Guinea, the subregion's largest economy, experienced an acceleration in real GDP growth of 3.9 percent in 1999, despite intensified macroeconomic instability. Faster growth resulted from higher commodity prices and increased exports. With the exception of Kiribati, Tuvalu, and Vanuatu, all the economies registered faster growth in 1999, including the Fiji Islands, where the recovery in agricultural production and growth in garment manufacturing contributed to a 1999 GDP growth of 7.8 percent. Inflation in the subregion rose to 10.4 percent in 1999, mostly because inflation in Papua New Guinea rose to 16 percent. The government failed to secure external funding to finance fiscal imbalances, and had to rely on domestic financing of the budget deficit and accumulation of arrears on debt-service payments.

The economic prospects in the short to medium term will depend on the success of public sector reforms, sustained macroeconomic stabilization, and private sector development. The potential of this subregion will not be realized unless macroeconomic stability is sustained and improvements made in the economic policy environment. In some countries, economic policy continues to be characterized by lack of transparency and predictability that discourages prospects for both domestic and foreign investments.

RISKS AND UNCERTAINTIES

Recovery in Asia was robust during 1999. The transformation of developing Asia from financial crisis in 1997 and 1998 to the world's fastest-growing region has exceeded all expectations. It took developing Asia less than two years to return to the precrisis level of industrial production. Prospects for 2000 depend on sustainability of domestic demand growth, not only through growth in consumption, but also an upturn in investment demand and favorable global economic conditions. Investment may have to rise as capacity utilization rates go up and capacity restructuring occurs in response to technological advance and com-

petitive pressures. However, this is predicated on an upturn in credit growth, which is still uncertain because bank lending remains weak.

Rapid growth in intraregional trade feeding into increased domestic demand and higher real incomes is also expected. For these effects to prevail in the Asian subregion, the external environment will also have to be favorable. The continued expansion in global GDP and the expected rise in international trade volumes, combined with continued firmness in commodity prices, are crucial in maintaining export growth momentum. The major concern will be the nature of correction in asset prices in the US, the strength of the cyclical upswing in the euro area, and the prospects for Japanese recovery. A favorable external environment requires a soft landing for the US economy as a further tightening of monetary policy accomplishes a smooth transition to slower growth. It also requires a strengthening of the cyclical upswing in the euro area despite more monetary policy tightening by the European Central Bank and a continuation of the Japanese recovery.

Even as domestic demand conditions in the world economy improved, OPEC decided in April 1999 to cut back production. Unless oil prices moderate, another oil shock could derail Asia's recovery as well as the rest of the world economy (see box 1.3).

From a domestic aggregate demand perspective, expansionary domestic policies and rallies in equity markets in developing Asia have helped to improve business and consumer sentiment, and have had a salutary effect on consumption. These factors seem to be offsetting the constraints on domestic consumption imposed by high unemployment rates, slow wage growth, and reluctance of banks to lend. The fiscal expenditures required to fund financial sector bailouts, combined with ongoing development and recurring expenditures, will put additional pressure on government budgets throughout the subregion. The cost of financing these expenditures will increase budget deficits further, pushing up prices and interest rates. Unless handled prudently, these pressures could dampen growth prospects for the Asian region, particularly in the crisis-affected countries where bailouts are the most costly.

It is worth noting that domestic demand and the stabilization of savings ratios are two sides of the same

coin. Where savings ratios fell in 1999, noticeably in Indonesia, Korea, Singapore, and probably Thailand, domestic demand rallied. However, during 2000, the strength of that rally may moderate in these countries, unless asset markets continue their upward trend. In those countries where 1999 saw little or no saving rate decline—Hong Kong, China; Malaysia; Philippines; and Taipei, China—domestic demand is likely to be better supported in 2000.

Another concern is the continued large external imbalance in the US. Some of the funding for the US deficit has come from those seeking a safe haven during the financial crisis. But with the restoration of growth, these funds are beginning to return to Asia and other countries. Convergence of growth between the US and the euro area in the next few years may help raise US exports to that area and cut the deficit. However, if US interest rates must be raised to sustain the capital inflows required to service this debt, it will have a depressing effect not only on the US economy, but also on the rest of the world. It would result in upward pressure on interest rates in Asia and threaten the strength of the economic recovery.

Continued commitment to and speedy implementation of structural reforms is necessary in the crisis-affected countries in developing Asia. In most of the crisis-affected countries, progress in establishing a modern legal and regulatory framework has occurred, but there is more to be accomplished. Public administration reforms are required to improve bureaucratic and corruption-prone administrative procedures. Corporate governance reforms for changing ownership structure of large business groups and adoption of modern financial management techniques remain a priority. The region still has an extensive agenda for restructuring the banking and corporate sectors and making business transactions more transparent and accountable. Progress in implementing these will ensure efficiency in resource allocation and help stimulate investment spending. (The next chapter of this *Outlook* addresses these topics in depth.)

In the case of the Central Asian republics and Mongolia, risks are related to the success of policy measures aimed at completing the transition to a market-based economy and building the necessary institutional structures. Higher energy and primary commodity prices in 2000 and the emergence of a

recovery in Russia, if realized, will affect these economies positively.

Increased investments and innovative policies are required to raise productivity levels and enhance the international competitiveness of the region. Raising labor productivity would entail investments in human resources in education, knowledge, and

skills. Raising the international competitiveness of Asia's developing economies would require adopting and generating new and innovative technologies, which would, in turn, require greater investments in research and development as well as a conducive environment that fosters greater creativity and innovativeness.

Box 1.3 A Crude Reminder: Will Oil End the Boom?

Does the sharp increase in crude oil prices from \$10 a barrel in 1998 to more than \$30 a barrel by March 2000 mean the possible return to the bad old days of stagflation? Simulation exercises for industrial countries reported by the Organisation for Economic Co-operation and Development (OECD) suggest that doubling the oil price from \$10 a barrel to \$20 a barrel raises inflation by less than 1 percent after one year. The OECD simulations also suggest that economic growth can be slowed by between 0.2 and 0.4 percent. The impact will be larger on Japan than the United States and the European Union, because Japan is more dependent on imported oil and exports much less to the Organisation of Petroleum Exporting Countries (OPEC).

So far the actual effect of the oil price increase has yet to be felt on the general level of consumer prices, which are still remarkably steady in the industrial economies. The impact on growth is more difficult to determine but there apparently has been no appreciable growth slump within the OECD in the past few months. One difficulty with estimating the effects of an oil price increase on growth or the general price level is the lag between the increase in prices and the feed-through to the rest of the economy.

A more worrisome possibility is the secondary effect that higher oil

prices might have on policy. In previous oil shocks the increase in prices accelerated inflation, which was then followed by contractionary monetary policy and recession. The effect on oil-importing developing countries was also quite severe.

Is such a scenario likely to reoccur? This will depend on several factors, including pass-through to inflation, the actions of oil suppliers, and the response in demand.

The pass-through to inflation will be lower than during the earlier two oil shocks simply because the oil economy is dramatically smaller.

On the supply side, oil prices increased primarily because OPEC lowered quotas in April 1999, and most members have stuck to the quotas. The response of non-OPEC members to higher prices has been and can be expected to remain marginal. First, putting new capacity into operation takes time and second, the scope for increased supply by nonmembers is limited, even in the long run. Compared with previous oil shocks, there is very little scope for additional non-OPEC supply. There are no more untapped sources such as Alaska and the North Seas once provided. Also, industrial countries are putting enormous pressure on OPEC to increase supply. OPEC probably prefers to avoid the experience that followed the second oil shock, when longer-run adjustments to demand resulted in unusually low oil prices for a decade.

This was reflected in the March 2000 meeting when nine of the 11 OPEC oil ministers agreed to raise production by about 7 percent from current levels. Following this announcement, oil prices declined and are in the range of \$25 per barrel as this *Outlook* goes to press.

Is more oil price volatility likely? In the short run, supply factors probably will not change quickly, because the lag between increased pumping and delivery of the new output to the local service station is still several months. Current prices probably reflect these delays.

Aside from the influence of the weather, demand factors are not very significant in determining price in the short run. Milder weather in Europe and North America with the end of winter tends to moderate demand. Otherwise, the reduction in demand will be insignificant as a few people buy smaller cars, drive less frequently, or turn down their thermostats.

In conclusion it is unlikely that oil prices will start back up, given the higher production quotas recently agreed upon, continued leverage exerted on OPEC and the memories of two previous recessions caused by oil shocks. In addition policymakers presumably have learned from experience, and will be able to adopt macroeconomic policies that deal with the potential inflationary effects of higher oil prices without tipping the world economy into recession.