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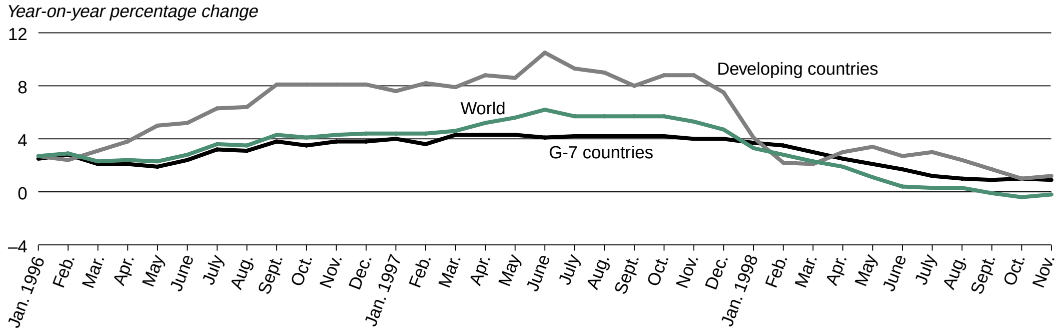
A More Difficult International Economic Environment for Developing Countries

THE *GLOBAL ECONOMIC PROSPECTS 1998/99* report completed in mid-October of last year forecast a second year of slow growth for developing countries in 1999 and underlined that, as the Asian crisis continued to spread, the balance of risks was on the downside. This update revises the growth forecast for developing countries in 1999 downward by 1.2 percent and by 0.6 percent in 2000. Many risks remain, but favorable policy developments in the industrial countries reduce the probability that the crisis will cause a deep global recession. This chapter notes the following four trends:

- There have been important favorable developments in recent months. Interest rate cuts in the United States and Europe since October, and the adoption of large fiscal stimulus and financial restructuring plans in Japan should provide considerable support to demand in the industrial countries in 1999. The U.S. economy has continued to show surprising strength. And there are clear signs that the Republic of Korea and Thailand, assisted by fiscal and monetary policies more supportive of demand, will be the first to emerge from the slump in Asia. Financial markets in the United States, Europe, and some Asian crisis countries are showing renewed confidence.
- But a broad review of the recent data on the external environment—and the slow growth of the larger developing economies—points to even more weakness than anticipated in October. World industrial production showed no growth from August to November 1998 (see figure 1.1). Although a large deceleration of growth in Latin America was incorporated in the October projections, the crisis in Brazil is worse than anticipated. There are now also signs of faltering growth in Europe, and the Japanese economy remains mired in deep recession.
- While there have been important improvements in the condition of the Asian crisis countries, the external environment facing most developing economies has continued to deteriorate, reflecting weaker-than-anticipated commodity prices, world trade volumes, and capital flows. The average price of non-energy commodities is down 6.3 percent, and oil prices remain weak. The year-on-year growth of world trade volumes in the fourth quarter of 1998 is estimated at near zero, and the 1999 forecast for growth of world trade has been cut from 5.7 percent to 4.2 percent. External finance is likely to remain tight, with access largely restricted to the most creditworthy borrowers, and at much higher spreads.
- In most developing countries private investment plans are being scaled back, and restrictive policies adopted to adjust to the reduced ability to import. The deteriorating external environment has also brought domestic weaknesses into sharper focus, including chronic fiscal deficits in several large developing countries, the need for corporate and financial restructuring in many Asian countries, and civil or cross-border conflicts in Europe, Asia, and Africa. Growth forecasts for 1999 and 2000 are down for all developing regions, but the downward revisions are especially pronounced for the oil exporters, Latin America, and the former Soviet Union. In contrast, forecasts for stabilization and growth in the crisis countries of Asia have been upgraded modestly. (tables 1.1 and 1.2).

Figure 1.1 World industrial production slowed in 1998



Note: Calculated as a three-month moving average. World includes G-7, other industrial countries, developing countries, and Asian NIEs. Data for developing countries are based on 12 of the most important, which account for 43 percent of developing countries' GDP and 9 percent of world GDP.
Sources: Datastream and World Bank estimates.

Table 1.1 Global conditions affecting growth in developing countries, 1998–2001

(percentage change from previous year, except LIBOR)

	Current				*Global Economic Prospects 1998/99*			
	Estimate	Forecasts			Estimate	Forecasts		
	1998	1999	2000	2001	1998	1999	2000	2001
World GDP growth	1.9	1.8	2.4	2.8	1.8	1.9	2.7	3.0
Major seven OECD countries[a]	1.8	1.7	1.9	2.1	1.7	1.4	2.1	2.4
Low- and middle-income countries	1.9	1.5	3.7	4.6	2.0	2.7	4.3	4.8
Excluding Eastern Europe and former Soviet Union	2.4	2.1	3.9	4.8	2.5	3.2	4.5	5.0
Memo item								
Low- and middle-income countries per capita GDP	0.3	–0.1	2.1	3.1	0.4	1.1	2.8	3.3
World trade volume	4.8	4.2	5.9	6.2	5.3	5.7	6.2	6.3
Inflation (consumer prices)								
Major seven OECD countries[a,b]	1.3	1.4	1.8	2.0	1.5	1.9	2.3	2.6
United States	1.6	2.3	2.6	2.7	2.0	2.3	2.8	2.8
Commodity prices *(nominal U.S. dollars)*								
Commodity prices, except oil	–15.7	–6.3	1.7	5.1	–15.7	–2.2	3.5	3.2
Oil price (weighted average)	–31.8	–8.2	25.0	6.7	–28.5	9.5	10.0	2.9
Manufactures export unit value[c]	–3.7	1.3	2.6	2.7	–3.8	1.3	2.6	2.7
Interest rates								
Six-month LIBOR (*U.S. dollars, percent per annum*)	5.6	5.0	4.9	5.1	5.5	5.0	6.0	6.0
Exchange rates								
U.S. dollar per German mark[d]	–1.4	—	—	—	–1.1	—	—	—
U.S. dollar per Japanese yen	–7.5	—	—	—	–7.6	—	—	—

a. Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
b. In local currency, aggregated using 1988–90 GDP weights.
c. Unit value index of manufactures exports from G-5 to developing countries, expressed in U.S. dollars.
d. Positive figure is appreciation of local currency versus dollar.
Source: World Bank Development Prospects Group.

Table 1.2 Real GDP growth, 1998–2001
(percent)

	Current				Global Economic Prospects 1998/99		
	Estimate	Forecasts			Forecasts		
	1998	1999	2000	2001	1999	2000	2001
World	1.9	1.8	2.4	2.8	1.9	2.7	3.0
High-income countries	1.9	1.8	2.1	2.3	1.6	2.3	2.5
OECD high-income	2.0	1.8	2.0	2.2	1.6	2.2	2.4
G-7	1.8	1.7	1.9	2.1	1.4	2.1	2.4
G-4 Europe	2.4	1.6	2.6	2.4	2.1	2.6	2.4
Other industrial	3.3	2.7	2.7	2.9	2.9	2.9	2.9
Non-OECD high-income	–1.7	1.6	3.8	4.7	2.0	3.9	4.6
Asian NIEs	–2.1	2.0	4.3	5.0	2.1	4.1	4.9
Low- and middle-income countries[a]	1.9	1.5	3.7	4.6	2.7	4.3	4.8
Excluding Central and Eastern Europe and former Soviet Union	2.4	2.1	3.9	4.8	3.2	4.5	5.0
Sub-Saharan Africa	2.1	2.5	4.0	4.0	3.2	3.8	3.9
Excluding South Africa and Nigeria	3.3	3.6	4.5	4.4	4.1	4.7	4.4
Asia and Pacific	2.9	4.1	5.2	5.9	4.8	5.8	6.1
East Asia and Pacific[b]	1.8	4.0	5.5	6.3	4.8	5.9	6.3
Excluding China	–8.4	–0.9	2.9	4.3	–0.4	3.1	4.4
South Asia	5.2	4.4	4.8	5.2	4.9	5.6	5.7
Europe and Central Asia	–0.3	–1.5	2.3	3.6	0.1	3.4	4.3
Central and Eastern Europe	2.2	2.3	3.8	4.6	4.0	4.5	4.8
Former Soviet Union	–3.4	–5.5	0.6	2.4	–4.3	1.7	3.1
Middle East and North Africa	1.5	0.7	2.5	3.3	2.8	3.1	3.5
Maghreb	4.1	2.8	3.9	3.9	4.0	4.1	3.9
Mashreq	4.3	3.2	3.6	4.1	3.9	4.1	4.2
Developing GCC[c]	–1.9	–2.4	0.6	2.0	0.8	2.0	2.5
Latin America and the Caribbean	2.0	–0.8	2.5	3.9	0.6	3.3	4.1
Memo items							
East Asia Crisis-5[d]	–7.7	0.3	3.5	4.5	0.1	3.2	4.5
Low- and middle-income, excluding ASEAN-4	3.0	1.7	3.8	4.7	3.0	4.5	4.9
World, excluding East Asia Crisis-5[d]	2.2	1.8	2.4	2.7	1.9	2.7	3.0

a. Including Central and Eastern European countries and republics of the former Soviet Union.
b. Excluding the Republic of Korea.
c. Gulf Cooperation Council (Bahrain, Oman, Saudi Arabia).
d. Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand.
Source: World Bank Development Prospects Group.

Implied in the annual projections is a pattern of acceleration in world trade and economic activity over the course of 1999, from the low point recorded at the turn of the year. This outlook is contingent upon stabilization in Asia (which could add 2–3 percent to world trade growth in 1999) and continued import growth in the United States and Europe, albeit at a slower pace than in early 1998. These effects would be only partially offset by slowing in other developing regions outside Asia, reflecting the crises in Brazil, Russia, and other countries. Larger developing countries less affected by the crisis, such as China, India, and Mexico, may also slow but will continue to underpin the expansion of world trade.

- The risks to this projection remain weighted toward the downside, although the likelihood of a deep global recession has receded with the policy initiatives undertaken since October.

The Implications of the Crisis in Brazil for Other Developing Countries

The crisis in Brazil is severe but its effects are likely to be contained. Substantial outflows of capital from Brazil, caused in part by a lack of investor confidence in the authorities' ability to implement the original IMF-backed fiscal adjustment program, forced the government to allow the real to float in early January, and the currency has since lost about one-third of its value against the U.S. dollar. In an effort to stabilize the exchange rate and prevent a resurgence of inflation, interest rates have been raised to 45 percent. Large parts of the intended fiscal consolidation measures have now passed the congress, a revised IMF program is in effect, the restoration of confidence has strengthened the currency, which had clearly overshot in February, and monthly inflation rates have moderated.

The positive response of Brazilian equity markets in January and February (up 58 percent in local currency) suggests that investor confidence in Brazil has not deteriorated to the extent that occurred in East Asia immediately after the crisis erupted—although it is also true that the crisis was partly discounted by the market. Furthermore, the sheer magnitude of the devaluation, Brazil's developed industrial structure, and the depth of domestic recession, all point to a powerful traded-goods sector response over the next several quarters. The effects on financial flows to other developing countries have so far been milder than that following the eruption of crisis in Russia or in Southeast Asia, and have been largely confined to Latin America. While significant risks remain, the government has been making steady progress in its fiscal consolidation, in negotiations with states, and in mobilizing international private market support. However, sustained policy performance over the year will be critical to ensure a restoration of market access at more affordable levels.

The most likely scenario, and that adopted in these projections, is for a credible fiscal adjustment program to be launched quickly, with interest rates targeted to keep inflation in control, remaining broadly compliant with the IMF stabilization program. The fiscal program will require the primary balance to move from zero percent of GDP in December 1998 to 3.1 percent in 1999 and higher in 2000, reflecting the higher cost of servicing debt as well as slower growth. Under this scenario, inflation is kept within a 15–20 percent band, real interest rates moderate from current high levels within a few months, and GDP declines by 3–4 percent reflecting a large fall in domestic investment, as well as retrenchment of both public and private consumption. The current account balance is expected to fall sharply in 1999 and 2000 and remain in the range of $15–20 billion. FDI, attracted by accelerated privatization, accounts for the largest share of external financing. Absence of "surprises" affecting Brazilian corporations that have large currency exposures and face high interest rates would help ensure this relatively benign outcome.

The effects on other developing countries are considerable, and work through multiple channels. Direct trade links with Brazil are strongest in Latin America, although the share of intraregional trade is much less than in East Asia (table 1.3).

Table 1.3 Shares of exports and GDP for Brazil, Latin America, and East Asia, 1997

(percent)

Exporter group	Brazil		Latin America		East Asia Crisis-5	
	Exports	GDP	Exports	GDP	Exports	GDP
World	1.0	0.2	5.2	1.0	6.3	1.2
Industrial countries	0.8	0.1	5.5	0.9	4.9	0.8
United States	1.1	0.1	16.4	1.8	7.5	0.8
EU-15 (extra-EU trade)	1.7	0.2	4.9	0.5	6.3	0.6
Spain	3.0	0.2	12.3	0.8	7.6	0.5
Italy	2.2	0.2	5.8	0.4	4.1	0.3
Germany	1.3	0.1	4.0	0.4	5.8	0.5
Japan	1.0	0.1	3.1	0.2	16.6	1.1
Latin America	4.8	0.8	19.1	3.0	3.8	0.6
Argentina	25.9	2.2	34.1	2.9	3.2	0.3
Mexico	0.9	0.2	2.7	0.6	2.5	0.6

Note: Export shares in percent, and share of exporting country or group GDP.
East Asia Crisis-5 is Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand.
EU-15 is Austria, Belguim, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.
Sources: IMF *Direction of Trade Statistics* and World Bank data.

Mercosur members will be hardest hit, with Argentina likely to suffer from the direct trade effect alone a reduction in GDP by approximately 0.3–0.5 percent, depending on the rate of decline in Brazilian imports, while the smaller, more open economies of Paraguay and Uruguay, with 48 percent of their exports going to Argentina and Brazil, are likely to be hit even harder. Direct trade exposure to Brazil among the industrial countries is small—ranging from 1 percent of exports in Japan to 3 percent in Spain. Europe has a larger export stake in Brazil than does the United States (when measuring extra-European Union (EU) export flows, table 1.3). The share of U.S. exports destined for Latin America is larger than that of the EU, but is concentrated in Mexico, which in turn exports little to the rest of Latin America.

Weaker prices in several commodities in which Brazil is an important supplier or consumer will affect several developing countries. Brazil has a large world export market share in iron ore and steel (29 percent), sugar (24 percent), coffee (23 percent), and soybeans (22 percent). The Brazilian devaluation could cause Arabica coffee prices to fall 15–20 percent below precrisis levels.[1] Although Brazil and the broader Latin America region account for only 2.5 percent and 6.5 percent of world oil consumption, respectively, they have constituted 10 percent of the growth in demand over the 1990–96 period. Given the fragile condition of world oil markets at present, further downward price pressures would be likely, adversely affecting the region's principal exporters—Venezuela, Mexico, Ecuador, and Colombia. Most industrial countries would benefit from these price declines.

The modest recovery in private capital flows since last October has been led by Latin American countries but, despite Argentina and Mexico's large recent bond issues, the market has become less receptive since the crisis, and borrowing is likely to remain expensive and confined to the best sovereign borrowers. The Latin America region's refinancing needs are large. In 1998 the region ran a current account deficit of $87 billion, and its debt service is estimated at $65 billion in 1999, excluding Brazil.[2] Commercial bank exposure to Brazil and the broader Latin America region are highest for EU Bank for International Settlements (BIS)-reporting countries, and especially high as a share of bank capital for Germany, the Netherlands, and Spain (table 1.4). However, it appears that prior provisions and government guarantees provide European banks with a shield. The exposure of Japan's banks, although modest, should be viewed in the context of the system's fragile state.

Industrial Countries

The U.S. economy has continued to show surprising strength in recent months. Abnormally low household savings rates and slower corporate earnings point to a significant slowdown.

Throughout 1998 the U.S. manufacturing sector suffered from the Asia-induced slowdown in export markets, the high dollar, and sharply increased competition in both domestic and foreign markets. The service and construction sectors, however, continued to boom, propelled by low interest rates and rapid real income growth, helped by low imported price inflation (including oil prices). Tightness in the U.S. labor market contributed to rising unit labor costs, and to a decline in corporate profits, as intense competition prevented firms

Table 1.4 Commercial bank exposure to Brazil, Latin America, East Asia, and Russia, June 1998

	Brazil		Latin America		East Asia Crisis-5		Russian Federation	
	Claims *(US$ billions)*	Share of bank capital *(percent)*	Claims *(US$ billions)*	Share of bank capital *(percent)*	Claims *(US$ billions)*	Share of bank capital *(percent)*	Claims *(US$ billions)*	Share of bank capital *(percent)*
BIS-reporting countries	85	5.8	296	20.2	210	14.4	76	5.2
United States	17	4.8	64	18.4	17	4.8	8	2.2
EU reporting countries	61	7.3	205	24.7	116	14.0	67	8.1
Germany	13	6.8	40	21.1	27	14.4	31	16.8
Netherlands	7	16.0	20	46.0	12	28.4	4	9.0
Spain	5	5.6	37	44.1	1	0.9	1	0.9
Japan	5	2.1	15	6.0	74	30.0	1	0.5

Note: Claims in billions of U.S. dollars, share of bank capital (1995) in percent; East Asia Crisis-5 is Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand.
Sources: Bank for International Settlements and various central bank reports.

from raising prices. Household savings rates fell into negative territory in late 1998 for the first time, as surging equity prices added to wealth.

Continued weakness in corporate profits is likely to slow employment growth and result in an even sharper deceleration in business investment in 1999 than that seen last year. Furthermore, with price-to-earnings ratios near 30 (versus a historical average of 19), and dividend yields at record lows, the likely slowdown in profit growth increases the probability of a large stock market correction. Little assistance is to be expected from net exports as world trade growth remains sluggish (see below). Owing to the negative wealth effect (or at least the disappearance of positive wealth effects), and less favorable employment prospects as investment slows, personal consumption expenditure is expected to slow sharply from a boom rate of more than 5 percent in 1998.

However, it seems unlikely that the United States will lapse into recession, given the economy's strong momentum at the turn of the year, the leeway afforded to policies by low inflation and the budget surplus, and the 75 basis point easing by the Federal Reserve in late 1998. Although the impact on growth of low long-term interest rates and imported commodity prices on growth will not be as significant as in 1998, these effects will also persist to some extent. The Federal Reserve appears both willing and able to help support consumer and business confidence and to ease the severity of any equity market adjustment. The rise in savings rates is expected to be fairly gradual. Thus, the sharp slowdown in GDP growth is likely to occur later than anticipated in the October forecast. U.S. growth in 1999 is projected at a solid 3.1 percent in 1999 (1.5 percent faster than forecast in October), and then slow to 2.1 percent in 2000.

The European economy grew rapidly in the first half of 1998, but has weakened progressively since, as sluggish export markets forced a significant deceleration. There are underlying sources of strength that suggest that the slowdown in 1999 will be contained and relatively short-lived.

The adverse effects of the fall in Asian imports were more than offset by the strong momentum in European domestic demand and intraregional exports throughout most of 1998. In France GDP rose by 3.1 percent for the year, the fastest rate of growth since 1989. Germany experienced an investment surge but little pickup in consumption. Nevertheless, its growth rate in 1998 was 2.6 percent, equal to the average since unification. Italy's exporters were especially adversely affected by slack demand in Asia, and domestic consumption slowed with the end of an auto-purchase incentive scheme. In the United Kingdom, growth peaked much earlier, in late 1997 and early 1998. The tight labor market gave rise to significant domestic cost pressures, which, together with the appreciation of the pound, led to a sharp turnaround in net exports and a pervasive weakness in the manufacturing sector that subsequently spread to services. Several countries in the European periphery posted very solid growth rates in 1998, a reflection in part of the earlier recovery in core Europe as well as lower interest rates in the runup to European Monetary Union (box 1.1).

Sluggish export markets in the Americas, East Asia, and oil exporters around the world are likely to continue to increase the drag on European output growth in 1999 and contribute to low business confidence. But, driven by domestic demand, core Europe is expected to continue to grow, albeit more slowly, reflecting the early stage of its recovery (ample capacity and low inflationary pressures), looser monetary policies, and the boost from new government employment. Although the Bank of England, having maintained high rates to fight off inflationary pressures until last summer, is expected to continue easing policy rates, the United Kingdom could flirt with recession this year. In Italy, the significant easing of monetary policy implemented in 1998 should help support activity, but growth will be modest this year, given still low levels of consumer and business confidence. Stronger growth is likely to emerge in 2000 as a result of more expansionary monetary policy across Europe and as global demand recovers.

The Japanese economy remains mired in a deep recession and prospects for a quick recovery are dim. The Japanese financial sector saw further deterioration in 1998, prompting the passage of important policy measures. Spurred increasingly by the authorities, Japanese banks are taking steps toward recapitalization, disposal of bad loans, mergers, and cost-cutting. But the process has just begun, the restructuring in the corporate sector is still slow, and the possibility of reversals still exists.

Easier fiscal and monetary policy in 1998 and support of financial sector restructuring failed to arrest several quarters of negative growth. The re-

Box 1.1 Implications of EMU for developing countries

With the advent of the European Monetary Union (EMU) on January 1, 1999, 11 European countries are relying on the European Central Bank (ECB) in Frankfurt to set monetary policy, and gradually adopt the euro as a common currency. The ECB will use both money and inflation-targeting instruments to set policy rates for the EMU-11. Benefits from the union are expected to be substantial, including reduced transaction costs and more transparent pricing for businesses, and increased integration of financial markets across the area as currency risk diminishes and ultimately disappears. The reduction of exchange rate volatility and uncertainty will also imply efficiency gains, encourage mergers across member countries, and cause European assets to become more attractive. However, national governments will be constrained in the macroeconomic policies they can follow to ameliorate the impact of asymmetric shocks (or wide differences in initial business cycle conditions at inception), causing coordination problems across the area. Policies to lower Europe's high unemployment will need to rely on structural reforms.

Developing countries, especially those that trade predominantly with countries in the euro area, could derive significant advantages from the acceleration in European growth in the medium term, from access to lower-cost funds in a deeper and more liquid market, and the opportunity of selling into a larger market. For example, a 1 percent increase in EU GDP could raise exports of selected Central and Eastern European countries by 1.5 percent, Mediterranean basin exports by 1.0 percent, and communauté financière africaine (CFA) exports by 0.6 percent. GDP increases in EU partners could amount to 0.6, 0.3, and 0.2 percent in the three regions, respectively. In the short term, the convergence of European interest rates toward the lower German and French rates implies lower interest rates than would otherwise prevail in the faster growing countries on the periphery, and this will help stimulate growth in partner countries.

EMU will tend to make it more difficult for emerging markets to compete for international capital by increasing the attractiveness of investments in the euro area. If, as many expect, the euro eventually gains a place as a reserve currency and appreciates against the dollar, the impact on individual countries will depend on their exchange rate policy and trade pattern. Countries with currencies closely tied to the euro will lose competitiveness, although the local currency burden associated with dollar denominated debt could ease. The establishment of EMU is also likely to make European companies more competitive, to make intra-European investments more attractive, and to force greater fiscal discipline on member governments, raising the performance bar for firms and governments in neighboring developing countries.

newed bout of recession was the result of the (since reversed) fiscal contraction in 1997, the collapse of the Asian export market, continuation of tight credit conditions, and continuation of depressed consumer and business confidence. The contraction in economic activity in 1998 was greater than expected in *Global Economic Prospects 1998/99*. GDP fell by approximately 2.9 percent in the calendar year, as consumption, business investment, and industrial production all declined sharply, and the effects of the April fiscal stimulus package were late in taking effect. Rock-bottom confidence has reduced the effectiveness of stimulus policies, inducing consumers to save additional infusions of purchasing power, and deterring businesses from investing even when the cost of capital is near historic lows ("liquidity trap"). The deteriorating finances of local authorities, which are responsible for implementing public works, induced them to retain some central government funds earmarked for infrastructure spending.

In November 1998 the government announced a new 24 trillion yen (5 percent of GDP) fiscal package, including corporate and income tax cuts as well as public works. The new measures came on the heels of the 16 trillion yen stimulus package in April, which had little impact on private consumption and public orders in the third quarter of 1998. The underlying budget for 1999 is 4 trillion yen larger than the previous fiscal year. The government has also suspended the Fiscal Structural Reform Law, ensuring that the public sector can continue to run budget deficits after 2005. The primary fiscal deficit is expected to reach almost 7 percent next year. The positive effects of the fiscal stimulus packages on demand will be dampened by the sharp rise in long-term interest rates in recent months, which represent a market reaction to the hugely expanded borrowing requirement and the increasing reluctance of domestic investors to add further to their holdings of government bonds. The large appreciation of the yen in the fourth quarter of last year, since partly reversed, will also add to the pressure on Japanese manufacturers.

Japanese output growth is, nevertheless, expected to trough in early 1999, assuming decisive action continues to be taken to deal with the banking problems and the new fiscal stimulus package has a large effect in stimulating demand. GDP is expected to be lower by about 0.9 percent in 1999, then to show slow growth for an extended period while the restructuring of the financial and corporate sectors proceed. Large portions of the economy will continue to contract as banks dispose of nonperforming loans by forced restructuring. Initially, the main positive force in the economy will have to be an aggressive implementation of fiscal stimulus by the Japanese government. Rapid growth of the public debt-to-GDP ratio will force withdrawal of fiscal stimulus sooner or later.

Inflation has been further dampened throughout the industrial countries. The recession in Japan has generated severe deflationary pressures that discourage aggregate demand and reduce the scope for lowering policy interest rates (which are already near zero).

In the United States and Europe inflationary pressures have been subdued, reflecting the decline in oil and other commodity prices, and the downward pressures on prices and wages in the manufacturing sectors stemming from Asian competition and the slowdown in world demand. In Japan deflation appears to be taking hold. Asset prices have been falling since 1991. Land prices have dropped by approximately 70 percent, and equity values remain less than half their peak at the height of the bubble. More recently, reflecting the widening output gap generated over several years, the prices of goods and services have begun to flatten and fall. Wholesale prices in 1998 fell by more than 2 percent but consumer prices remained flat, indicating that while general deflation has not yet occurred, significant deflationary pressures exist. A deflationary spiral could have severe consequences for aggregate demand. Expectations that prices will fall cause agents to delay consumption decisions. Investment also is deterred because a risk-free positive rate of return is guaranteed from holding a nominal asset, whereas investment in a tangible asset in a recessionary environment is risky. Banks become reluctant to lend as the value of collateral for existing and future loans declines. Deflation raises the cost of servicing outstanding debts, and increases the incentive for debtors to walk away from obligations, thus exacerbating the problem of nonperforming loans in bank portfolios.

The international price of manufactured products continued to decline in 1998. The Manufactures Unit Value Index fell for the third year in succession in 1998. The average annual rate of decline since 1995 has been 4.4 percent, reflecting the appreciation of the U.S. dollar (7.6 percent in real effective terms), the decline in domestic inflation (the G-7 consumer price index has decelerated from 2.0 percent in 1995 to 1.3 percent in 1998), the fall in demand in Asia, and the acceleration of Asian exports in the wake of devaluation. The prices of traded manufactures are expected to stabilize in 1999 and then to rise further as the world economic recovery consolidates in 2000 and 2001.

Current Account Balances and Capital Flows

Industrial countries' current account balance declined from a surplus of $64 billion in 1997 to a $9 billion deficit in 1998, reflecting the collapse in Asian imports, and is expected to decline further in 1999.

A sharp widening of the U.S. current account deficit, from $155 billion in 1997 to nearly $235 billion in 1998, has been a prominent feature of the adjustment to the crisis in Asia, reflecting in part the delayed effects of the dollar's revaluation in the last three years and the strength of domestic demand. Japan's current account surplus increased from $94 billion in 1997 to $123 billion in 1998, a result of the sharp fall in domestic investment, increased savings rates, and the delayed effects of the weaker yen in recent years. The current account surpluses of the large European countries remained steady in dollar terms. The $73 billion swing of the industrial countries' current account into deficit was mirrored by the $86 billion swing of the East Asian crisis countries into surplus (see table 1.5). As export markets weakened and the competition from Asia intensified in the first half of 1998, many developing countries (particularly in Latin America, the Middle East and North Africa, and Sub-Saharan Africa) saw a sharp rise in their current account deficits, which were financed by drawing down reserves, or by increased foreign borrowing in the first half of 1998. In the wake of

Table 1.5 Current account balances, 1997–98

(billions of U.S. dollars)

	Current account deficit[a]		Change in reserves		Net resource flows		Net short-term flows		Other[b]	
	1997	1998	1997	1998	1997	1998	1997	1998	1997	1998
Sub-Saharan Africa	1.7	3.5	–3.1	–1.8	18.8	17.4	3.3	1.0	–17.3	–13.5
East Asia	–3.8	–91.1	2.3	–52.0	122.6	95.6	2.9	–7.4	–131.6	–127.3
East Asia Crisis-5	19.7	–66.1	35.9	–46.2	52.1	38.9	–3.2	–6.1	–65.1	–52.7
Korea, Rep. of	8.7	–42.8	13.7	–31.6	17.5	8.3	–11.9	0.6	–10.6	–20.1
Latin America	65.0	86.8	–10.1	8.0	116.0	83.2	11.0	9.6	–51.9	–13.9
LAC-7	59.5	79.5	–11.5	6.7	106.8	76.5	8.5	0.7	–44.3	–4.4
Brazil	33.7	33.1	7.5	7.2	41.6	15.0	–0.5	–5.0	–15.0	15.9
Middle East and North Africa	–5.3	24.5	–5.6	–0.5	6.9	17.8	–1.6	0.3	–5.1	6.9
Oil exporters	–4.5	24.3	–5.0	0.4	6.2	17.1	–1.3	0.3	–4.4	6.6
South Asia	7.2	4.8	–3.8	–1.7	14.7	12.3	–2.1	1.1	–1.6	–6.9
Europe and Central Asia	19.6	25.0	–6.1	–0.5	59.1	48.6	8.1	5.6	–41.4	–28.7
Russian Federation	–3.3	1.5	–1.7	5.2	15.1	16.3	–1.4	1.5	–15.3	–21.6
Developing countries	84.4	53.6	–26.4	–48.5	338.0	275.0	21.6	10.2	–248.9	–183.1
High-income countries	–96.6	–19.0	28.1	93.0						
OECD	–64.2	8.9	–28.9	–1.3						
World	–74.7	–6.5	1.7	44.5						

Note: The Republic of Korea is included in developing countries' total. East Asia Crisis-5 is Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand. LAC-7 is Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

a. Current account deficit is equal to the sum of change in reserves (negative sign indicates increase in reserves), net long-term resource flows, net short-term flows, and other.

b. Other includes errors and omissions, and assets.

Source: World Bank staff estimates.

the Russian crisis, only low-debt oil exporters in the Middle East were able to increase borrowing, with net long-term capital flows rising from $6 billion in 1997 to $17 billion in 1998.

In 1999 increased risk perceptions in the wake of the Russian and Brazilian crises suggest that current account financing of developing countries will be more difficult, and, together with continued weakness in export markets, this points to slow imports in developing countries as a group. Despite the stabilization in the Asian crisis countries, the industrial countries' current account deficit is likely to widen further, by about $48 billion, concentrated in the United States. The aggregate current account deficit of developing countries would thus fall to about 0.4 percent of GDP, about one-third the average of the 1990s prior to the Asian crisis.

Net long-term flows to developing countries fell from $338 billion in 1997 to $275 billion in 1998, with much of the contraction occurring after the Russian devaluation in August of last year, and are likely to decline further in 1999.

The financial crisis that began in Asia induced a sharp reduction in capital flows to developing countries in 1998 (see table 1.6).[3] While foreign direct investment was resilient, declining moderately from $163 billion in 1997 to $155 billion in 1998, net long-term flows from the international capital markets, including bond issues, bank lending, and portfolio equity, totaled only $72 billion in 1998, the lowest level since 1992 and well below the $136 billion posted in 1997 (see further discussion in chapters 2 and 3). The Russian debt moratorium greatly accelerated the contraction of flows from the capital markets to developing countries, and despite some signs of recovery, flows remained depressed at the end of the year. There were few signs of a halt in the decline in official assistance since the early 1990s; the rise in net official flows in 1997–98 reflected rescue packages to the countries affected by the crisis.

Private capital flows to developing countries are likely to show some recovery in 1999 from current depressed levels, but they will remain well below the levels reached in the precrisis period, and recover at only a moderate pace over the forecast period. Slow growth in global output and trade, recent credit downgrades of sovereign and corporate borrowers which will restrict access to finance,

Table 1.6 Long-term flows to developing countries, 1990–98
(billions of U.S. dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998[a]
Net long-term resource flows	100.8	123.1	152.3	220.2	223.6	254.9	308.1	338.1	275.0
Official flows	56.9	62.6	54.0	53.3	45.5	53.4	32.2	39.1	47.9
Private flows	43.9	60.5	98.3	167.0	178.1	201.5	275.9	299.0	227.1
International capital markets[b]	19.4	26.2	52.2	100.0	89.6	96.1	149.5	135.5	72.1
Foreign direct investment	24.5	34.4	46.1	67.0	88.5	105.4	126.4	163.4	155.0

Note: Although the Republic of Korea is a high-income country, it is included in the developing country aggregate since it is a borrower from the World Bank.
a. Preliminary.
b. Bonds, loans, and portfolio equity flows.
Source: World Bank Debtor Reporting System.

greater risk perceptions in the wake of the Russian debt moratorium and the crisis in Brazil, higher cost of new financing, and heightened concerns of recipient countries over capital reversals will slow capital inflows over the forecast period. However, prospects vary by category of flow. Flows from the capital markets are likely to increase only slowly, so that foreign direct investment (FDI) will remain the dominant form of external finance to developing countries for some time to come.[4]

International Trade

World trade has slowed sharply since the outbreak of the crisis. After growing by more than 9 percent in 1997, world merchandise trade volume slowed sharply to an estimated 4.8 percent in 1998, well below estimates in *Global Economic Prospects 1998/99*, and the slowest advance since the early 1990s. The deceleration in world trade growth during 1998 was rapid and continuous: 8.6 percent in the first quarter compared to the same quarter in 1997, 4.6 percent in the second quarter, 2.0 percent in the third quarter, and estimated at about zero percent in the last quarter. Trade slowed initially in 1998 as domestic demand in the Asian crisis countries and in Japan fell sharply, and as other Asian countries, including the newly industrialized economies (NIEs), felt the effects of the regional crisis. Later in the year, the credit crunch triggered by the Russian crisis in August began affecting imports of a larger set of developing countries, notably in Latin America. Import volumes fell by 18 percent in the Asian crisis countries, by 7.6 percent in Japan in 1998, and by 10–15 percent in Hong Kong (China) and Singapore in the second half of the year. In contrast, the markets in North America and industrial Europe continued to expand during most of 1998, albeit more slowly in the second half (figure 1.2). In the first half of 1998, continued growth in the U.S. helped to sustain Latin America's exports while

Figure 1.2 Real effective exchange rates, June 1995 to December 1998

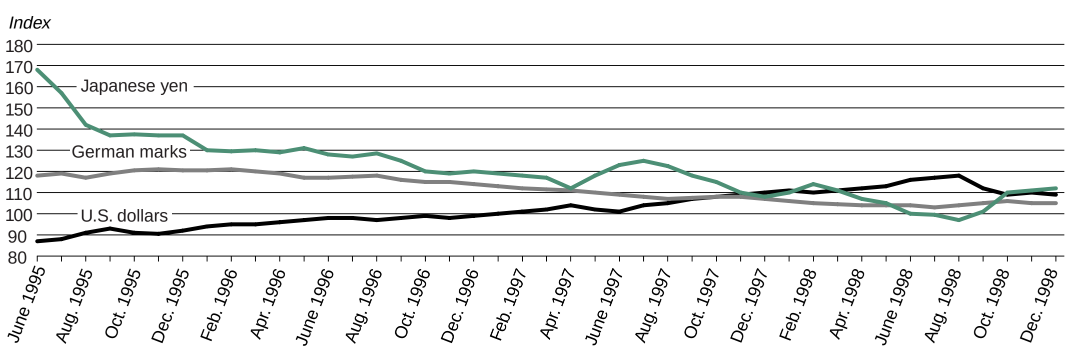
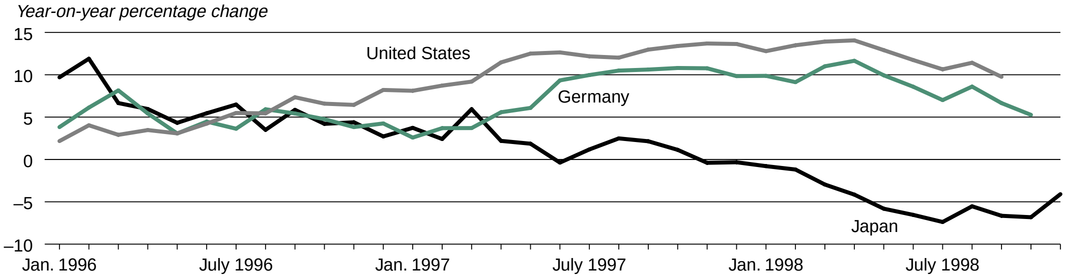


Figure 1.3 Industrial countries' import volumes decelerated in 1998



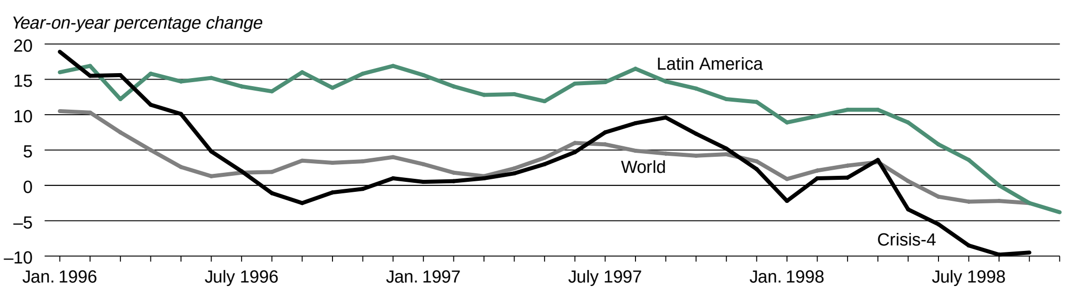
Note: Calculated as a three-month moving average.
Sources: Datastream and World Bank staff estimates.

growth in Europe benefited countries in Central and Eastern Europe and in Africa.

Expressed in current U.S. dollars, world trade fell by an estimated 1 percent in 1998, the first decline since 1993. The fall in trade values was more pronounced in the second half of the year—dropping by an estimated 3.5 percent in the third quarter, compared with a rise of 1 percent in the first quarter (figure 1.4)—due to both the fall in volumes (discussed above) and some declines in trade prices. The 32 percent fall in the price of oil in 1998 cut the value of world trade by $56 billion (66 percent of the total fall). Developing countries' export revenues dropped by 3.7 percent in 1998, which contributed to debt servicing difficulties.

Asian exporters gained market share in third markets. The crisis countries' average real effective exchange rate depreciated by 30 percent in the second half of 1997, enabling exporters to cut dollar prices, grow export volumes rapidly, and increase market share (table 1.7). For example, between January and October 1998, the pace of decline in U.S. import prices of manufactured goods from all developing countries quickened from –3.6 percent year-on-year to –6.1 percent, with prices from the Asian NIEs falling by 9.5 percent in October, compared with a 3.3 percent decline for goods originating in Latin America. The crisis countries' share of U.S. imports rose from 8 percent in the second quarter of 1997 to 8.5 percent in the same period of 1998 (table 1.8). The increased competitiveness of Asian countries contributed to reducing the market share of Latin America (excluding Mexico) in the United States, the region's principal trading partner, and contributed to a sharp slowdown in their export growth in the latter part of

Figure 1.4 Growth in export revenues has plummeted



Note: Calculated as a three-month moving average. Crisis-4 is Indonesia, the Republic of Korea, Malaysia, and Thailand. Latin America is Argentina, Brazil, and Mexico.
Sources: Datastream and World Bank staff estimates.

Table 1.7 Real effective exchange rates, 1997–98

(1990–96 = 100)

	June 1997	Dec. 1997	June 1998	Dec. 1998
Crisis countries	106.6	73.9	73.2	84.4
Indonesia	105.4	62.0	33.0	70.7
Korea, Rep. of	95.1	65.8	75.6	84.8
Malaysia	110.6	80.4	79.2	77.5
Thailand	107.0	72.0	86.6	98.2
Philippines	114.6	89.3	91.8	91.2
East Asia	107.4	87.2	86.5	92.6
Asian NIEs	105.3	98.4	100.5	100.8
Latin America	114.3	116.2	117.7	110.1
Mexico	99.4	104.5	101.9	99.7
Excluding Mexico	116.8	118.1	120.3	111.9
Argentina	107.8	110.9	112.5	105.4
Brazil	116.0	119.7	117.7	105.7
Chile	117.4	117.6	116.0	106.5
Colombia	126.0	112.9	119.6	107.2
Peru	108.6	112.0	111.2	99.2
Venezuela	125.1	135.5	114.8	147.3
Others	107.9	108.4	105.0	100.2
Hungary	114.8	115.6	113.9	110.5
Poland	116.6	114.1	120.0	116.8
India	101.1	99.7	97.1	94.7
South Africa	98.9	96.1	88.8	78.7

Note: Regional aggregates are simple averages.
Source: J.P. Morgan.

Table 1.8 Developing countries' share of U.S. imports, 1997–98

(percentage of merchandise imports)

	Apr.–June 1997	Aug.–Oct. 1997	Apr.–June 1998	Aug.–Oct. 1998
Crisis countries	7.98	7.91	8.52	8.60
Indonesia	1.00	0.94	1.10	1.06
Korea, Rep. of	2.62	2.53	2.58	2.50
Malaysia	1.95	1.90	2.14	2.18
Thailand	1.33	1.33	1.47	1.51
Philippines	1.07	1.21	1.23	1.34
East Asia	21.40	21.55	23.93	23.95
Asian NIEs	9.53	9.00	9.93	9.22
Latin America	13.45	13.49	13.49	13.33
Mexico	9.62	10.15	9.81	10.23
Excluding Mexico	3.83	3.34	3.67	3.10
Argentina	0.25	0.26	0.25	0.21
Brazil	1.13	1.13	1.00	1.07
Chile	0.25	0.25	0.22	0.22
Colombia	0.52	0.49	0.52	0.48
Peru	0.19	0.19	0.20	0.21
Venezuela	1.48	1.02	1.48	0.91
India	0.77	0.85	0.91	0.94

Source: U.S. Department of Commerce.

1998 (table 1.8). The sharp fall in the growth of export receipts in Latin America in the latter half of 1998 was also due to the collapse in the prices of their commodity exports and reduced growth in intraregional trade as countries adopted restrictive macroeconomic policies to adjust to limited external finance. Countries in Central and Eastern Europe, as well as Mexico, were less affected by the Asian competition, reflecting both proximity and specific trading arrangements with Western Europe and North America, respectively.

Slow growth of world trade is projected again in 1999, although there should be significant acceleration throughout the year and into 2000. The geographic distribution of demand is likely to shift in Asia's favor.

The rate of world trade growth is projected to decline from 4.8 percent in 1998 to 4.2 percent in 1999, down from the 5.7 percent growth projected in *Global Economic Prospects 1998/99* (table 1.9). However, world trade volumes are likely to be on an accelerating path throughout the year reflecting continued modest import growth in the United States and Europe, and stabilization in Asia. Import volume growth in the United States and in the four major European countries is likely to slow to 7.2 percent and 4.7 percent, respectively, in 1999 as economic activity cools. In Asia, the decline in Japanese imports is expected to moderate as output stabilizes, contributing to a recovery in developing Asian exports and, with it, a rise in their import volumes. However, import demand is likely to weaken significantly in Latin America as countries in the region undergo strong adjustment in response to lower capital flows and depreciating currencies. Import volume growth is expected to slow in Europe and Central Asia, owing to continuing problems in Russia and Ukraine and slower import demand in Western Europe. The combined effects of reduced capital inflows to India (pending lifting of the embargo) and adjustment measures in Pakistan are expected to reduce import demand growth in South Asia as well. Lower export earnings from primary commodities will affect import demand in Sub-Saharan Africa and the Middle East.

The prospects for world trade growth in 2000–01 are brighter, converging to near 6 percent under baseline assumptions whose main features are an acceleration of output toward potential in

Table 1.9 World merchandise trade, 1991–2001
(percentage change)

Indicator and region	1991–97	1997	1998	Forecasts 1999	2000	2001
World trade growth	6.8	9.2	4.8	4.2	5.9	6.2
World output growth	2.3	3.2	1.9	1.8	2.4	2.8
Import growth						
High-income countries	6.2	8.8	6.0	5.0	5.8	6.2
OECD	5.4	9.4	7.8	5.4	5.5	5.8
United States	8.1	14.7	11.9	7.2	5.7	5.5
EU-15	4.3	7.9	8.6	5.3	5.8	6.1
Japan	6.1	1.7	–5.3	1.0	1.5	4.0
Non-OECD	11.5	5.4	–5.2	2.2	8.3	8.6
Developing countries	9.3	8.9	1.4	1.0	5.9	6.7
Sub-Saharan Africa	3.4	5.7	4.3	4.1	4.4	4.9
East Asia and Pacific	13.4	2.9	–7.5	4.3	7.5	8.7
South Asia	12.6	11.3	6.5	7.1	7.5	7.6
Europe and Central Asia	5.8	9.1	3.3	–2.9	6.1	6.2
Latin America and the Caribbean	14.2	16.3	7.1	–1.8	4.6	5.9
Middle East and North Africa	1.3	10.7	3.3	1.5	4.2	4.1
Export growth						
High-income countries	6.3	9.1	4.8	4.1	5.8	5.9
OECD	5.7	9.5	4.6	4.0	5.6	5.6
United States	7.0	11.6	2.4	2.2	6.6	5.4
EU-15	5.6	8.9	6.2	4.8	5.6	5.8
Japan	2.6	10.3	–1.1	0.9	2.9	3.8
Non-OECD	10.3	7.1	6.0	4.6	7.0	7.7
Developing countries	8.7	10.2	3.9	4.7	6.4	7.0
Sub-Saharan Africa	2.8	9.2	2.7	2.9	5.0	5.1
East Asia and Pacific	15.3	14.1	3.2	5.5	7.7	8.9
South Asia	11.0	8.2	6.4	6.1	7.5	11.7
Europe and Central Asia	5.3	6.2	3.7	3.8	5.8	5.8
Latin America and the Caribbean	9.6	10.9	5.2	6.0	6.2	6.6
Middle East and North Africa	4.2	8.3	3.4	1.7	3.9	3.8
Memo items						
East Asia crisis country imports	11.9	2.6	–17.7	4.6	10.1	10.2
East Asia crisis country exports	12.8	9.3	10.4	6.6	7.9	8.2

Source: World Bank data.

Europe, continued strong growth in the United States, a gradual but persistent recovery in Asia, and some increase in private capital flows to developing countries.

Commodity Prices

Non-energy commodity prices are likely to remain weak, reflecting high inventory levels, and as rapid advances in supply—largely unrelated to the crisis—continue to outstrip demand growth.

Non-energy commodity prices fell virtually across the board in 1998 (table 1.10). The aggregate index dropped by 16 percent for the year as a whole, reaching a low last October before recovering slightly through December. Metals and minerals prices reached a new low in December, ending the year down 33 percent from their peak in August 1995. Food prices recovered about 3 percent of their fall toward the end of the year, but in December remained down 21 percent from their peak in April 1996.

The financial crisis contributed to the decline in primary commodity prices, as currency devaluations and the demand collapse in East Asia reduced world demand and encouraged increased supply originating in the crisis countries. Lower real exchange rates in Asia, although partly recovering, signal a significant and probably durable cost reduction in the production of some commodities, such as rubber, timber, and rice. However, other

Table 1.10 Annual percentage change in oil and non-oil commodity prices, 1981–2001
(World Bank commodity price indexes, nominal U.S. dollars)

Commodity group	1981–90	1991–95	1997	1998	Forecasts 1999	2000	2001
Non-oil commodities	–2.3	4.1	2.2	–15.7	–6.3	1.7	5.0
Agriculture	–3.2	5.6	2.5	–16.2	–5.2	1.8	3.3
Metals and minerals	0.5	0.3	1.2	–16.2	–10.3	2.0	12.2
Fertilizers	–2.5	0.7	–0.1	2.0	–5.2	–4.1	0.0
Petroleum	–4.7	–5.6	–6.2	–31.8	–8.2	25	6.7
G-5 MUV[a]	3.3	3.6	–5.1	–3.9	1.3	2.6	2.7

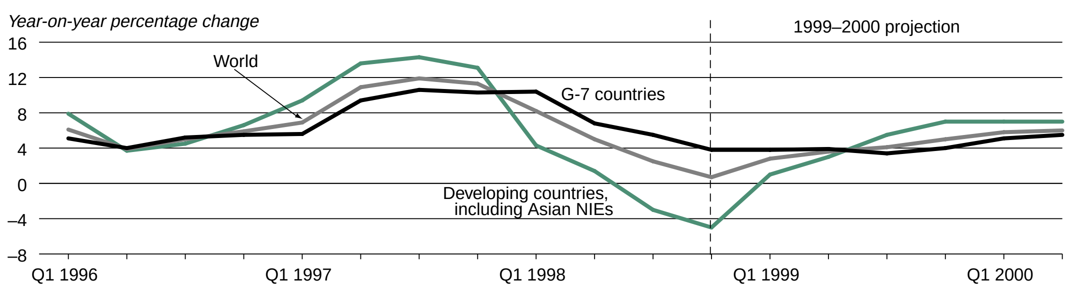
a. Manufactures Unit Value Index.
Source: World Bank.

factors, including improved technology, better economic policies, and increased privatization of production, have had perhaps the greatest impact in increasing the supply across a much wider spectrum of commodities, thus reducing prices. For example, world grain and soybean production expanded well above trend from 1995 to 1997, with grains production rising by 10.5 percent (compared to a long-run trend of 1.4 percent), and soybeans increasing by 13.2 percent (the long-run trend is 3.6 percent). The surge in supplies was greatest in the developing countries, where policies to liberalize markets and privatize production appear to have paid off in higher production. The global supplies of metals and minerals also increased rapidly following the sharp increases in prices in 1993 and 1994. For example, aluminum production increased by more than 10 percent from 1995 to 1997, while consumption grew by a total of 5.6 percent over this two-year period; copper production grew by 12 percent from 1995 to 1997, while consumption grew by 7.6 percent; and nickel production increased by 11.4 percent from 1995 to 1997, while consumption fell slightly.

Reflecting the continuation of sluggish world demand conditions and the delayed effects of recent currency devaluation in important commodity producers, such as Brazil and Russia, the forecast for 1999 is for a further decline of 6.3 percent in non-energy commodity prices. Metals and minerals prices are expected to fall an additional 10.3 percent in 1999, while agricultural prices are projected to decline 5.2 percent. The greater decline in metals and minerals reflects the effects of continued supply increases and the building up of stock levels in spite of falling prices. By contrast, agricultural supplies have already begun to adjust to lower prices and in selected commodities, stocks are already being reduced.

Commodity prices should begin to recover in 2000, but the recovery is expected to be slow. It will depend greatly on the speed of recovery in world economic activity, especially on growth in middle-income developing countries, because that

Figure 1.5 World import volume growth is likely to rise in 1999



Source: World Bank staff estimates.

is where income elasticities of demand for commodities are highest. Large current supplies of both agricultural commodities and metals suggest that it may take several years of rapid economic growth such as that seen during the mid-1990s to draw down existing stock levels and provide conditions that could lead to rising prices. The same phenomenon occurred following the last global downturn, when world GDP growth began to pick up in 1991 but commodity prices continued to decline until 1993. By 2000, world economic growth is projected to average 2.4 percent, while growth in the developing countries is projected to average 3.7 percent, rising to 4.6 percent in 2001. This is likely to set the stage for a recovery in commodity prices in 2001–05.

The sharp oil price decline could be partially reversed if recently proposed cuts in production materialize. Oil prices continued to slide in late 1998, resulting in a 32 percent decline compared with 1997. The drop was larger than the 28.5 percent decline estimated in *Global Economic Prospects 1998/99* because of weaker-than-expected demand, rising oil production (including Iraq), and the failure of Organization of Petroleum Exporting Countries (OPEC) to cut output further.

In 1998, global oil supply exceeded demand by 1.6 million barrels per day (mb/d), resulting in very high levels of inventories. Demand growth slowed to 0.3 mb/d from 1.7 mb/d in 1997, as total Asian demand fell 0.4 mb/d, compared with growth of 0.9 mb/d the previous year. Iraq's output rose 1.0 mb/d, which more than offset cuts by other OPEC members. Non-OPEC supplies grew only modestly because of delayed developments and lower prices, but this did not prevent a large surplus from emerging.

Given current high levels of stocks and weak demand, the assumptions on which the economic projections in this report are based call for $12 per-barrel oil in 1999 and, assuming some supply management by OPEC, a price rising to $15 per barrel in 2000. However, on March 5, 1999, oil ministers from five oil exporting countries—Algeria, Iran, Mexico, Venezuela, and Saudi Arabia—proposed a removal of more than 2 mb/d from the market beginning April 1, 1999. OPEC was to meet March 23 to ratify its reductions, totaling some 1.7 mb/d, with non-OPEC producers accounting for additional cuts in supply.

If the reductions are fully implemented, it could substantially reduce the supply overhang and allow prices to rise sharply. Less than full compliance is expected, however, as producers were only 80 percent compliant with agreed cuts of 2.6 mb/d in 1998. In addition, the outlook for demands remains weak in developing countries and there is risk of slowdown in the United States and Europe. Assuming a significant amount of oil is removed from the market, the oil price forecast would likely be raised to $14 per barrel in 1999 and to $16 per barrel in 2000. This would provide fairly large balance-of-payments relief for oil-exporting developing countries in the near term, but at the expense of some reduction in activity in oil and related sectors of their economies.

The crisis has led to a large fall of aggregate demand in developing countries. The massive deterioration in the international environment in the wake of the Asian crisis contributed to the sharp decline of developing countries' GDP growth from 4.8 percent in 1997 to just 1.9 percent in 1998 (table 1.11). Sluggish world aggregate demand, including the fall in GDP growth of major industrial countries from 2.6 percent in 1997 to 1.8 percent in 1998, contributed to reducing the growth rate of developing country exports from 10.2 percent to 3.9 percent, a reduction in realized demand equivalent to 1.6 percent of developing country GDP.

Developing countries' terms of trade deteriorated, as oil prices plummeted by 32 percent and non–oil commodity prices dropped 16 percent. Although some developing countries (for example, oil importers such as India) gained as consumers

Table 1.11 Developing countries' GDP growth
(percentage change)

		Forecasts		
	1998[a]	1999	2000	2001
Developing countries	1.9	1.5	3.7	4.6
Sub-Saharan Africa	2.1	2.5	4.0	4.0
East Asia and Pacific	1.8	4.0	5.5	6.3
South Asia	5.2	4.4	4.8	5.2
Europe and Central Asia	–0.3	–1.5	2.3	3.6
Middle East and North Africa	1.5	0.7	2.5	3.3
Latin America and the Caribbean	2.0	–0.8	2.5	3.9
Memo item				
East Asia Crisis-5[b]	–7.7	0.3	3.5	4.5

a. Preliminary
b. Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand
Source: World Bank Development Prospects Group.

of lower-priced commodities, in the aggregate the decline in the terms of trade of developing countries represented about 1 percent of their GDP. Furthermore, the availability of external finance declined, as net private long-term flows dropped from $299 billion in 1997 to $227 billion in 1998, equivalent to 1.4 percent of developing country GDP (see chapter 2 for a full discussion of capital flows). These three shocks, world import demand growth slowdown, terms of trade deterioration, and decline of capital inflow operate through very different channels, and their effects cannot be simply aggregated. Nevertheless, one can estimate that their net initial effect might have been to reduce aggregate demand in developing countries as a group by 3–4 percent in 1998, compared with the previous year. Although the slowdown in world import demand also adversely affected activity in the industrial countries, the effects of the crisis on them was much less severe, since the terms of trade moved in their favor, and capital tended to flow toward "safe havens."

The impact on developing countries varied greatly. Despite some recovery in financial indicators in the last quarter, output in the five East Asian crisis countries fell by an estimated 7.7 percent, but on a regional level this was partly offset by strong growth in China. Growth rates in Latin America declined in part because of the restrictive monetary and fiscal policies required to adjust to reduced capital flows. The oil price collapse contributed to reduced growth in the Middle East and North Africa. Growth in South Asia, which has been relatively insulated from the financial crisis, slowed only moderately. The Russian crisis led to a severe reduction in output in Russia and the other Commonwealth of Independent States (CIS) countries. Per capita incomes in Sub-Saharan Africa declined for the first time in three years as oil exporters and some metals and minerals exporters (particularly Nigeria and South Africa) suffered large terms of trade losses. However, Sub-Saharan countries that (a) export commodities whose prices remained relatively firm (for example, Robusta coffee), (b) are oil importers, and (c) are not integrated in international financial markets, were relatively unaffected.

The crisis is likely to be protracted. Reflecting the large deterioration in their external environment, developing countries as a group are expected to experience a second year of very low growth in 1999, and are unlikely to return to long-term trend growth rates before 2001. Domestic factors will, as is normally the case, play the critical role in determining the aggregate growth picture in individual countries. These factors range widely, from weather conditions in countries dependent on rain-fed agriculture to the effects of long-standing programs of structural reform. In broad perspective, three sets of domestic factors appear most important in determining growth of developing countries over the forecast period.

First, the rate at which fiscal consolidation progresses in countries such as Russia, Brazil, India, and Turkey will determine investor confidence and the speed of recovery or the sustainability of their current growth path, as the case may be.

Second, the extent and speed of financial and corporate restructuring will be critical in maintaining or recovering the confidence of markets in countries as diverse as China, Indonesia, Thailand, and Malaysia.

Third, the resolution of civil and international conflicts will determine growth and investor confidence in several countries in Sub-Saharan Africa (for example, Angola, Ethiopia, Eritrea, Democratic Republic of the Congo, Sierra Leone, and Sudan), parts of the Middle East and North Africa region, the former Yugoslavia, Indonesia, and parts of Central and South America.

Reflecting this consideration of both external and internal factors, most developing regions are likely to experience even slower growth in 1999, with the Mercosur countries, those of the former Soviet Union, and oil exporters throughout the world the most adversely affected. The recovery in the East Asian crisis countries, although difficult and protracted, is likely to show steady progress, and be reflected in rising regional growth aggregates. The regional and country features of the projections are discussed more fully in the regional annexes.

Risks to the Forecast

There remain substantial risks to the baseline forecast, though the likelihood of markedly worse outcomes appears to have receded since autumn of last year.

The probability that the *Japanese economy* will undergo another very sharp contraction in

1999 has diminished somewhat in light of the important policy measures undertaken in recent months. However, the restructuring of the financial sector, although unavoidable, will mean weak economic activity in the near term even as it sets the stage for a sustained recovery. Output is still likely to fall in 1999, and growth in 2000 is expected to be moderate at best in the baseline scenario, and may relapse into recession if fiscal stimulus is withdrawn rapidly. At the same time, if the large rise in government debt implied by widening fiscal deficits is not accompanied by progress on structural reforms and renewed confidence, a further rise in long-term interest rates would be inevitable, choking off the fragile recovery, and sending output falling once again.

The risk of a protracted withdrawal of *capital market financing to Latin America* sufficiently large as to cause current account balances to go to zero or positive remains significant. Given the uncertainty in the Brazilian outlook, a further withdrawal of international investors from Latin America cannot be ruled out. This could cause private capital flows (excluding FDI) to Latin America to fall below the level assumed in the baseline for the region, which is similar in growth expectations to the *Global Economic Prospects 1998/99* low case. Under one scenario, Latin America's current account would swing from a deficit of more than $80 billion in 1998 to a surplus in 1999, paralleling the $100 billion swing in the East Asian crisis after that crisis erupted. If this were to occur, it would shave 1.6 percent off world trade directly.[5] Linkages to the region through trade and capital flows could be large enough to cause another major shock to the world economy.

The possibility of a large stock market correction in the United States and Europe remains. Price-to-earnings ratios (P/Es) of companies constituting the S&P 500 are near 30 at present, almost double the historical average. A recent IMF analysis suggests that these multiples imply earnings growth of 7.5 percent a year, about 2–3 percent faster than potential GDP (assuming inflation at 2.5 percent). The average earnings of S&P companies declined in 1998, and investment strategists project that earnings will rise at rates below 5 percent. A sustained 25 percent stock market correction could slow consumption spending in the United States by 1 percent,[6] enough to significantly slow the economy but not (in isolation) to cause an outright recession. A correction of similar magnitude in Europe is both less likely (because P/Es have not deviated as much from historical norms), and would have much smaller effects on the economy, since stock market capitalization is smaller as a share of GDP.

A deterioration in the trade climate is possible, should economic activity in the United States and European economies decelerate more than projected in the baseline. Sources of strain would include the widening current account deficit in the United States—which could reach $300 billion or 3.4 percent of GDP in 1999—and double-digit unemployment rates in Europe. Further declines in the prices of manufactured goods exported by developing countries caused by the spread of crisis to Brazil could exacerbate the effects of a demand slowdown.

Notes

1. In contrast with East Asia, where countries were largely consumers of commodities and demand effects were dominant on prices (exceptions of natural rubber exported from the region, Thai rice, and Malaysian logs), the importance of devaluation and economic contraction in a dominant supplier to world markets could be substantially greater than that of an importing country in crisis. When a country (like Brazil) is a consumer as well as a supplier, falling income and rising domestic prices following devaluation induce a contraction in domestic demand, as well as a positive supply response. The effects are additive to increase exports.

2. Debt service for major countries: Mexico ($26 billion), Argentina ($24 billion), Venezuela and Chile ($4 billion each), Colombia ($2 billion); short-term debt for this group stands at $78 billion.

3. The definition of net long-term flows used in *Global Development Finance* excludes other important elements of developing countries' external finance, including short-term capital flows, capital outflows, and use of IMF funds (see chapter 2).

4. A detailed discussion of the evolution of long-term flows in 1998 and further comments on prospects can be found in chapter 2 (flows from international capital market), chapter 3 (foreign direct investment), and chapter 4 (official flows).

5. The seven largest countries in Latin America (Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela) have an estimated debt service of $119 billion due in 1999 and short-term debt at end-1998 of about $116 billion. Under the assumption that only 50 percent of short-term debt is rolled over, FDI inflows totaling $40 billion, and usage of $40 billion in reserves (to maintain reserves at between 3 and 3.5 months of imports), the resulting gap of about $98 billion is 1.6 percent of 1998 world trade levels.

6. Data Resources, Inc.