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RECENT GLOBAL ECONOMIC DEVELOPMENTS

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Executive Summary

GLOBAL ECONOMIC DEVELOPMENTS

1. INTRODUCTION

Small economies, like those of the Caribbean, are heavily dependent not only on the international economy but also, most importantly, on many factors that are outside their control and influence. Production of Caribbean countries continues to be limited to a narrow range of primary commodities with exogenously determined terms of trade.[1] The markets for these products remain, by and large, in the developed countries. Similarly, their imports are heavily sourced from the developed countries. This heavy dependence on international trade places a high premium on macroeconomic policy management.[2]

Recognizing the inherent disadvantages of the developing countries, in general, and smaller economies, in particular, a number of countries, notably the European Union and the United States, have sought to give preferences to products from these countries by giving them easy access to their markets. This protection has undoubtedly served the Caribbean, particularly the Windward Islands, well but not without a cost. Now as the world steams steadily towards freer trade, the various systems of preferences which the smaller Caribbean countries have been enjoying are increasingly coming under threat.

Any analysis of the current global economic developments cannot help but include the recurrent bouts of instability that have marked global financial markets in 1998. The financial crisis that started in Thailand in mid-1997 spread to other countries and by 1998 a dozen countries in the developing regions were embroiled in one form of financial instability or another. Financial contagion spread to Russia in mid-1998, largely fuelled by persistent budgetary imbalances and underlying weaknesses in the country's financial institutions and enterprises. The crisis was also felt in Brazil in 1998 and forced the Government to abandon the pegged exchange rate system.

[1] The exogeneity of terms of trade for the Caribbean countries is suggested by their small share in the world economy even for products in which their exports are heavily specialized as well as by the composition of their exports.

[2] The index of openness as proxied by the trade to GDP ratio for many Caribbean countries is over 100 per cent, indicating that the value of trade in goods and services exceeds the value of Gross Domestic Product.

The waves of financial crisis in the 1990s, from Mexico (1994-95) and, more recently, Asia (1997) have demonstrated how globalization and, especially, financial integration can expose countries to external shocks that have negative effects on growth. They have also generated more calls for a reexamination of the institutions, structures, and policies aimed not only at crisis resolution but also, more importantly, crisis prevention. While there is a clear consensus on the need to reform the global financial architecture, the question as to how best it should be redesigned has been vigorously debated. Some architectural blueprints have called for the abolition of the twin Bretton Woods institutions, especially the International Monetary Fund (IMF), while others have questioned the wisdom of capital account convertibility. As Ocampo[3] succinctly explains:

> " *There are actually no strong arguments in favour of moving towards capital account convertibility. There is no evidence that capital mobility leads to an efficient smoothing of expenditure in developing countries through the business cycle and, on the contrary, strong evidence that in these countries the volatility of capital flows is an additional source of instability. There is also no evidence of an association between capital account liberalization and economic growth, and there are some indications that point in the opposite direction."*

This paper highlights salient global economic developments during the course of 1998. The objective of the paper is to provide information, as accurate as possible to policy makers in the Caribbean, on the global economic context in which the smaller open island economies must operate as the forces of globalization and regionalization intensify.

The structure of the paper is as follows: Section One is an introduction. Section Two examines global and regional developments in output and inflation. Section Three looks at the international trade developments as well as institutional developments in the area of trade. Section Four looks at international financial developments with a special reference to the Asian crisis. Section Five of the paper looks at trends in savings and investment as well as current account developments. Section Six examines developments in capital flows while Section Seven discusses recent developments relating to the (HIPC) Initiatives. Finally, Section Eight presents the main conclusions of the paper.

2. GLOBAL OUTPUT, INFLATION AND REGIONAL PERFORMANCE

The pace of **global output** slowed down considerably as evidenced by a decline in the annual growth rate of G.D.P from 4.1 per cent in 1997 to 2.5 per cent in the current year (See Table I*)*. Virtually all the regions experienced decline, albeit in varying degrees, in output growth during the year under review. In the advanced economies output recorded a growth rate of 2.2 per cent in 1998 compared to 3.0 per cent in 1997. Most of these countries, with the exception of the United States, experienced a decline in GDP growth in 1998. At 4.0 percent, the growth rate in output for the United States economy changed only marginally when compared to 1997. The contraction in output was more pronounced in Japan which recorded a negative growth rate of

[3] See Jose Antonio Ocampo, " International Financial Reform: The Broad Agenda", 1999.

2.8 per cent in 1998, compared to a positive growth rate of 1.4 per cent in the previous year. Output growth in the European Union was 0.2 percentage points below the growth rate of 2.6 per cent for 1997. For the developing countries, as a whole, output growth slowed down to 3.2 per cent in 1998 from 5.9 per cent in 1997. This slowdown was reflected in all the subregions, with the exception of Sub-Saharan Africa where output growth remained unchanged from that of the previous year. Output decline was heavily felt in Asia and Latin America. The year-on-year growth in output in countries in transition turned negative in 1998, after rising to almost 2.0 per cent in the preceding year.

Table I: Growth in GDP

	1994	1995	1996	1997	1998
Global Output	**3.9**	**3.6**	**4.0**	**4.1**	**2.5**
Advanced economies	**3.2**	**2.5**	**2.7**	**3.0**	**2.2**
Japan	0.5	0.9	3.6	1.4	-2.8
United States of America	3.5	2	2.4	3.9	4.0
European Union	2.9	2.5	1.7	2.6	2.4
Developing Countries	**6.8**	**5.9**	**6.4**	**5.9**	**3.2**
Africa	2.6	2.9	5.3	3.4	3.4
Asia	9.6	8.9	8.1	6.8	3.7
Middle East and Europe	0.7	3.5	4.6	4.1	3.2
Latin America	5.4	0.2	3.5	5.3	2.3
Countries in Transition	**-7.6**	**-1.3**	**0.1**	**1.9**	**-0.2**
Russia,Transcaucaus, & Central Asia	-14.8	-4.1	-0.9	2.4	2
Central & Eastern Europe	-2.6	1.3	1.5	2.4	2.2

Source: I.M.F. World Economic Outlook; May 1999, ECLAC, 1999

Although virtually all the countries experienced decline in the growth rate of output, performance varied widely among regions and countries. In **the United States of America**, the expansion that began in 1991 continued into 1998 with output growing by 4.0 per cent, underpinned by strong growth in private consumption expenditure and double-digit growth in investment, due to falling real interest rates. The strong performance of investment, particularly in the high technology sectors, has generated a rapid increase in productivity particularly in the manufacturing sector, thereby restraining inflation.[4] Higher employment had also contributed to the high growth in output, through increases in both labour force and participation rates. The booming United States economy provided a stimulus for intra-North American Free Trade Agreement (NAFTA) and sustained output and growth in other regions.

[4] According to UNCTAD's Trade and Development Report (1999), roughly two percentage points increase of the 4.0 per cent increase in United States output in 1998 was accounted for by productivity gains in the manufacturing sector.

Table II: Inflation and interest rates

	1994	1995	1996	1997	1998
Inflation <1>					
Advanced economies	**2.6**	**2.5**	**2.4**	**2.2**	**1.5**
European Union	3	2.9	2.5	1.9	1.4
Japan	0.7	-0.1	0.1	1.7	0.6
U.S.A.	2.6	2.8	2.9	2.4	1.6
Developing Countries	**51**	**22.7**	**13.3**	**9**	**10.3**
Africa	39.3	32.9	25.2	14.1	8.7
Asia	14.8	11.9	6.8	4.1	8
Middle East and Europe	31.9	35.7	24.7	22.3	23.6
Latin America	335.1	25.9	18.4	10.5	10.6
Countries in Transition					
Central and Eastern Europe	**153.3**	**75.3**	**32.4**	**38.9**	**18**
Russia	302	190.1	47.8	15.8	28
Transcaucasus and Central Asia	1667.7	250.4	65.3	36.1	15
Interest Rates <2>					
Major Industrial Countries	**7.1**	**6.8**	**6.1**	**5.8**	**4.2**
U.S.A.	6.7	6.3	5.8	5.5	5.3
Japan	4.2	3.3	3	2.1	1.3

Source: I.M.F World Economic Outlook, September 1999.
Notes: <1> percentage change in consumer prices
<2> Long-term interest rates, in per cent.

Table III: Unemployment rates (%)

	1994	1995	1996	1997	1998
Advanced economies	**7.6**	**7.3**	**7.3**	**6.8**	**6.7**
European Union	11.6	11.2	11.4	10.4	9.6
France	12.3	11.6	12.4	12.6	11.6
Germany	9.6	9.4	10.3	9.9	9.4
Japan	2.9	3.1	3.3	3.4	4.1
United Kingdom	9.3	8.2	7.5	5.7	4.7
United States	6.1	5.6	5.4	4.9	4.5

Source: I.M.F. World Economic Outlook (Interim Assessment September 1999)

Another factor boosting domestic demand has been the buoyancy of the stock market as rising equity and real estate prices led to an increase in household wealth. Encouraged by increased wealth, households increased their net indebtedness to the financial sector, resulting in a significant increase in consumer credit. The credit crunch that came in the wake of the Russian default and the near failure of the hedge fund Long Term Capital Management appeared to be bringing economic growth to a halt, but the easing of monetary policy by the Federal Reserve gave the economy the impetus it needed for sustained output growth.

Prudent management of public finances was reflected in a surplus on the fiscal balance for two consecutive years. The surplus for this year was estimated at 1.4 per cent of GDP. The stronger fiscal performance could be explained by the virtuous cycle created by a robust economy with more people working, more firms and individuals paying more taxes and fewer people seeking welfare benefits.

While the United States economy remained robust, the **Japanese economy** has been sluggish since the beginning of 1997. In 1998 alone, output contracted by an unprecedented 2.8 per cent, the strongest of all the industrialized countries (Table I*)*. In recent years the government has introduced a series of fiscal packages aimed at boosting the ailing economy. Monetary policy has been eased resulting in lower interest rates. Despite all of these measures, the economy showed no sign of recovery. The contraction in merchandise exports and imports by 1.5 per cent and 5.5 per cent, respectively, also contributed to the decline in output. Since the bulk of Japanese exports are destined to other Asian countries, the decline in these countries' imports was one of the major factors contributing to the contraction in the Japanese economy.

The failure of the European economies to generate any meaningful job growth has been the most worrying aspect of recent economic performance across the European continent. Output growth slowed slightly in the **European Union (EU)** from 2.6 per cent in 1997 to 2.4 per cent in 1998 which was 0.1 percentage point below the global average but slightly above the average for the advanced economies (See Table I). After an extraordinarily strong performance in the first half of 1998, output growth slowed down towards the end of the year. Despite the slight decline in the unemployment rate from 10.4 per cent in 1997 to 9.6 per cent in 1998, structural unemployment remains one of most serious economic problems confronting the EU (See Table III).

Private consumption expenditure that was expected to lead economic recovery, remained sluggish in 1998, largely due to an uncertain employment situation and slow growth in real income. Exports, therefore, became the major determinant of demand expansion. Even though Asia does not account for a large proportion of EU exports, the reduced demand in Asia had a larger than expected impact on output growth in the European Union, particularly in the second half of 1998.

Despite the high unemployment rates, significant progress has been made in the area of macroeconomic stability (low inflation, low budget deficits and stable exchange rates) thanks partly to the countries' adherence to the convergence criteria for joining the European Monetary Union (EMU), as well as the mechanism for closer coordination of economic policies.

Output for the **developing countries,** as a whole, slowed down considerably to 3.2 per cent compared to 5.9 per cent in the previous year. All the developing regions, with the exception of Sub-Saharan Africa, recorded reduced output growth. The developing countries were severely hit by the Asian crisis through decline in commodity prices which resulted in slower growth or contraction in output. Overall, the terms of trade declined by 3.9 percentage points for the developing countries while it rose by 1.4 per cent for the developed countries. The oil exporters suffered the most, losing as much as 18 per cent in their terms of trade and 6.3 per cent in income. The non-fuel primary commodity exporters experienced modest losses, with a decline of 3.2 per cent and 0.5 per cent in terms of trade and income, respectively.[5] The reversal in capital flows affected Asia and Latin America severely, while Sub-Saharan Africa remained relatively unscathed, precisely because the latter never lured the "hot money" or the highly volatile short-term capital flows.

Among the developing countries, performance varied considerably across the regions. In **Sub-Saharan Africa**, output registered a growth rate of 3.4 per cent in 1998, which for the first time in a decade outpaced the average growth for the developing countries as a whole. Economic performance varied markedly among subregions and individual countries. The limited access of the region to international financial markets, deprived it of the benefits of financial integration but also shielded it from financial turbulence. Of the countries of Sub-Saharan Africa, South Africa suffered the brunt of the Asian financial crisis, due to its relatively well-developed financial markets that benefited from the surge in capital flows to developing countries during the 1990s. GDP grew by a meagre 0.1 per cent in 1998 compared to 1.7 per cent in 1997.[6] This slowdown in output spilled over and affected other economies of the Southern African countries, notably Namibia and Botswana, due to their trade and investment linkages with South Africa. Output growth accelerated in North Africa. Economic performance also improved markedly in some Communauté Francaise Africaine (CFA) countries with the restoration of competitiveness that followed the devaluation of the CFA franc in 1994. Political and armed conflicts in several countries, notably Angola, the Democratic Republic of the Congo, Ethiopia, Eritrea and the Sudan set back the prospects for economic growth in these countries.

Latin America's strong output growth performance of 5.3 per cent in 1997 slowed down considerably to 2.3 per cent in 1998, owing to the contagion effects of the Asian financial crisis coupled with a series of natural disasters. The value of merchandise exports fell in 1998, for the first time in 10 years. Growth performance of merchandise imports became less dynamic, although at 5 per cent the region recorded one of the highest import growth rates in the world. The relatively faster growth in imports with slowing exports growth led to a deterioration in the region's current account deficits from 3.4 per cent of GDP in 1997 to 4.5 per cent in 1998.[7] Falling commodity prices, both oil and non-oil, and a slowdown in capital inflows all contributed to the decline in output growth in Latin America.

[5] See UNCTAD Secretariat, 1999, p.11.

[6] Ibid., p. 11.

[7] See Economic Survey of Latin America and the Caribbean, ECLAC, 1998-99, P. 9.

The El Niño phenomenon, which started in 1997, caused extensive flooding along the coast of Peru and Ecuador as well as in various parts of Argentina, Brazil, Chile and Paraguay. The damage from El Niño-related disasters was estimated at US$15 billion.[8] Towards the end of 1998, countries in Central America and the Caribbean also suffered from substantial damage caused by hurricanes, of which hurricane Mitch was the most destructive of this century. The damage was more pronounced in Honduras and, to a lesser extent, in Nicaragua.

Across regions and countries within Latin America there were marked differences in economic performance. The slowdown in output growth was more pronounced in Argentina, Brazil, and Chile. In Venezuela, GDP growth turned to negative 1.0 per cent in 1998 (See Figure 2). Marked differences were also discernible in the economic performance of the two largest economies in Latin America, Brazil and Mexico. In Brazil, the decline in output growth was stronger, while output growth in Mexico, although it declined, was well above the regional average. What might explain the relative superiority of the Mexican economic performance to that of Brazil is its access to the buoyant and expanding United States market, as well as the high share of manufactured exports in its total merchandise exports.

The economic slowdown was reflected in worsening labour market conditions throughout the region with unemployment rising from 7.3 per cent in 1997 to 8.0 per cent in 1998, the highest it has been in 15 years.[9] Among the countries, sharp differences were observed. Roughly 13 per cent, 11.2 per cent and 15.3 per cent of the labour force was unemployed in Argentina, Venezuela and Colombia, respectively (See Figure 3).

Falling export receipts, coupled with the pressing need to rehabilitate infrastructure in flood afflicted-countries, led to a worsening in the fiscal balance from –1.4 per cent in 1997 to -2.4 per cent of GDP with very high deficits, over 6 per cent in Brazil, Ecuador and Venezuela (See Figure 4).

[8] UNCTAD Secretariat, 1999, p.9.

[9] See Economic Survey of Latin America and the Caribbean, ECLAC, 1998-99, p. 25.

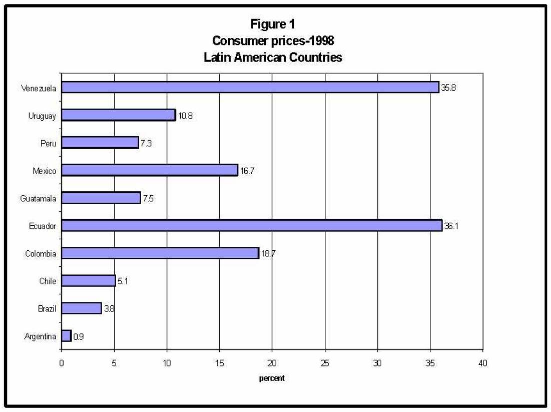

Figure 1
Consumer prices-1998
Latin American Countries

Source:IMF World Economic Outlook(1999)

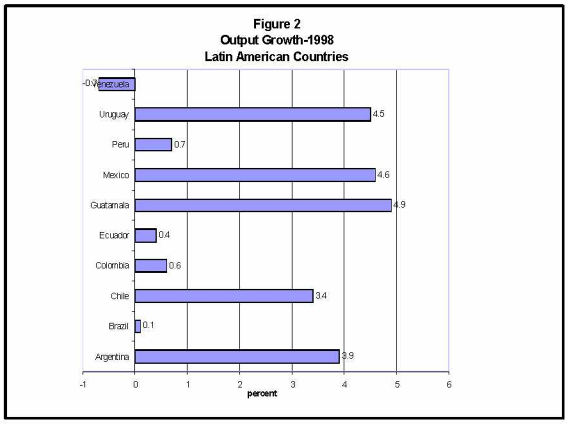

Figure 2
Output Growth-1998
Latin American Countries

Source:IMF World EconomicOutlook (1999)

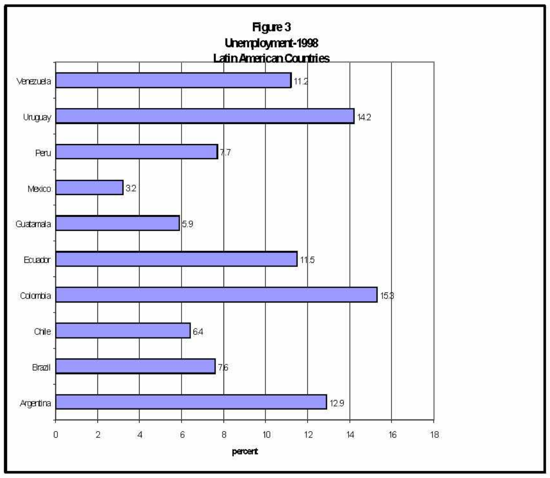

Figure 3
Unemployment-1998
Latin American Countries

Source: ECLAC, 1999.

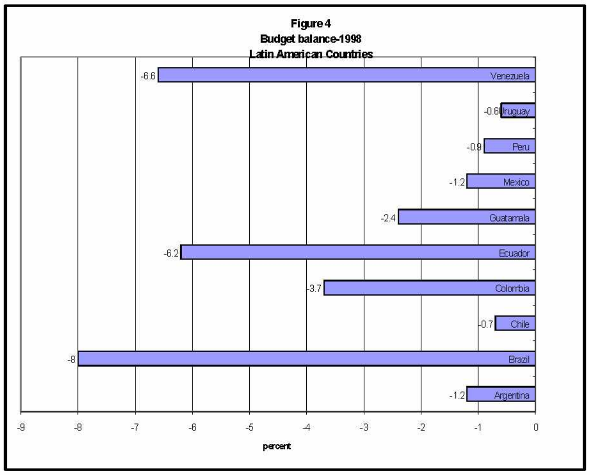

Figure 4
Budget balance-1998
Latin American Countries

Source: I.M.F World Economic Outlook (1999)

An examination of output performance in the **Caribbean subregion**, shows no significant change as GDP growth remained unchanged at 2.0 per cent in 1998. The decline in primary commodity prices affected the Caribbean countries in 1998. In the subregion, performance varied among countries. The most affected economies were Jamaica and Guyana where GDP recorded negative growth rates of 0.7 per cent and 1.3 per cent, respectively. The combined effect of the decline in the prices of aluminum by –15.1 per cent and sugar by –21.2 per cent in 1998 seemed to have had a negative impact on these countries, and especially on the Jamaican economy.

Despite the fall in the prices of banana, which is an important source of foreign exchange earnings for the Organization of Eastern Caribbean States (OECS) economies, these countries seemed to have weathered the effect of the crisis fairly well. Output growth in Saint Lucia rose from 0.9 per cent in 1997 to 2.9 per cent in 1998. Saint Vincent and the Grenadines recorded the highest output growth among the OECS economies. According to preliminary estimates by ECLAC, Saint Vincent and the Grenadines' output rose from 3.2 per cent in 1997 to 5.5 per cent in 1998. Output in Trinidad and Tobago slowed down to 3.6 per cent in 1998, from 4.2 per cent in 1997. In Barbados, economic growth rose to 4.4 per cent from 3.0 per cent in 1997.

The impact of the **Asian** financial crisis, which started in mid-1997, was mostly felt in 1998 as the contagion effect spread further afield to other Asian economies. Output growth for Asia slowed down considerably from 6.8 per cent in 1997 to 3.7 per cent in 1998. Only few countries, including China, were able to duplicate their extraordinary economic performance of recent years. Taiwan Province of China was very much insulated from the Asian financial crisis largely owing to its pre-emptive devaluation and large foreign exchange reserves. GDP growth in 1998 was 4.8 per cent slightly lower than 6.8 per cent growth rate recorded in 1997.[10] Hong Kong (SAR) experienced its first contraction in 13 years with output growth contracting by an unprecedented 5.0 per cent in contrast to a growth rate of 5.3 per cent in 1997. In Singapore output growth fell to 1.5 per cent, from 7.8 per cent in 1997.

In South Korea, the recession turned out to be worse than anticipated. The decline in both domestic and external demand led to a 5.5 per cent contraction in output, considerably down from a positive growth rate of 5.5 per cent in the previous year. The underlying problems in the corporate and financial sector and subsequent "liquidity constraint" served to compound the contraction in economic activity. Consequently, unemployment jumped to 6.8 per cent in 1998 up from 2.6 per cent in 1997. The tight conditions in the labour market led to a 7.9 percentage drop in real hourly wages.[11]

The decline in GDP growth was more pronounced in the **ASEAN-4**[12] countries, which contracted by an unprecedented 9 per cent in 1998, in contrast to an increase of 3.7 per cent in 1997. Although all the countries in this group witnessed contraction in economic growth, marked differences were observed among the countries. Output contraction was modest in the Philippines, falling by less than 1.0 percentage point compared to an unprecedented 14 per cent for Indonesia, 8.0 per cent and 6.2 per cent in Thailand and Malaysia, respectively. By and large, output contraction in the four countries reflected the precipitous currency depreciation, coupled with difficulties in corporate and financial sectors, which invariably led to widespread insolvencies in the aftermath of the massive reversal in capital inflows. In Indonesia, the adverse effect of the El Niño phenomenon on agricultural output compounded the problem.

Surprisingly, despite the negative supply shocks stemming from severe floods in the summer of 1998, the Chinese economy grew by an unprecedented 7.8 per cent in 1998, one percentage point below its growth rate for 1997. The crisis that affected many Asian countries left China relatively unscathed. The resilience of the Chinese economy could be explained largely by weak linkages with the global financial market. China's exports declined by 1 per cent

[10] See UNCTAD Secretariat, 1999, p.11.

[11] Ibid., p.11.

[12] ASEAN-4 group comprises of the following countries: Indonesia, Malaysia, Philippines and Thailand.

in 1998 because of the economic contraction in other Asian countries, which are major destinations of Chinese exports.

The **transition economies** of central and Eastern Europe experienced a contraction in output growth of 0.2 per cent in 1998 compared to an expansion of 1.9 per cent the previous year (Table I). The expansionary conditions in the Transcaucasus and Central Asian economies were more than offset by the contractionary conditions in the Russian economy. Hungary and Poland managed to maintain relatively high levels of economic growth in 1998. In both countries, considerable progress has been achieved particularly in the fight against inflation, which is now in single digits. The superior economic performance of these two economies could be explained by the sound macroeconomic management (both fiscal and monetary policy), as well as the commitment to the implementation of structural reforms.

The Czech economy slipped into recession as mounting domestic and external problems offset the impact of devaluation, which preceded the Asian crisis. In Lithuania, the current account deteriorated to 12 per cent of GDP.

2.1 Inflation

Global inflation, as measured by changes in consumer prices, declined further to 1.5 per cent in 1998 from 2.2 per cent in 1997. In the industrialized countries, consumer prices remained contained leading to gradual reduction in interest rates, thereby boosting aggregate demand in these economies. In developing countries, inflation edged slightly upward to 10.3 per cent in 1998 from 9.0 per cent the previous year. In Latin America which has had a long history of run away inflation rates, progress, albeit slow, continues to be made in the fight against inflation. In the transition economies, although substantial progress has been made in taming inflation, inflation rates of 18 per cent are still high compared to other regions.

3. GLOBAL TRADE AND INSTITUTIONAL DEVELOPMENTS

The annual growth rate in the volume of global merchandise exports slowed down considerably to 3.5 per cent in 1998, from a high growth rate of 10.5 per cent in the previous year. Although all the regions experienced a sharp decline in export volumes, performance varied widely among regions. In the industrial countries, the growth rate in the volume of merchandise exports declined from 10.2 per cent in 1997 to 3.4 per cent in 1998 (See Table IV). The decline was more pronounced in Japan with the growth rate in export volume declining from 12.0 per cent in 1997 to –1.5 per cent in 1998. In the developing countries the growth in the volume of merchandise exports slowed down considerably to 3.4 per cent in 1998, from 12.3 per cent in the previous year. Although the growth in the volume of merchandise exports slowed down in the countries in transition, they recorded the highest growth rate of 10 per cent.

Similarly, world merchandise imports contracted to 4.0 per cent in 1998, down from 9.5 per cent in 1997 (See Table IV). The growth in the volume of merchandise imports was 7.4 per cent for the industrial countries, -4.5 per cent for the developing countries and 10 per cent for the countries in transition (See Table IV).

In nominal dollar terms, world trade not only slowed down, but also recorded its strongest decline since 1982. The share of primary commodities in world trade fell below 20 per cent for the first time in the post-war period, while that of manufactured products continued to increase.

The contraction in world trade could be largely attributed to the slowdown in the crisis-afflicted economies of South East Asia. Although the contraction in world trade was more pronounced in Asia, all the other regions of the world also experienced declines in the rate of growth of volume merchandise trade. Despite the huge contraction, world trade still outpaced world output in 1998, though by a smaller margin (one percentage point) than in 1997 (See Tables I and IV).

Table IV: Global trade indicators

	1994	1995	1996	1997	1998
		Export Volume			
Global	**8.9**	**9**	**5.5**	**10.5**	**3.5**
Industrial Countries	**9**	**7.6**	**5.2**	**10.2**	**3.4**
Japan	1.7	4	1	12	-1.5
U.S.A	9	8.7	6.3	11.8	2.4
European Union		8.5	5.5	9.5	5
Economies in Transition		**17.5**	**6.5**	**12.5**	**10**
Developing Countries	**8.3**	**11.5**	**6.9**	**12.3**	**3.4**
Sub Sahara Africa	2	5	6.4	4.9	-1.3
Asia	11.5	13	6.2	12.4	1.4
Latin America	8.3	12	11	11	6.5
		Import Volume			
Global	**8.8**	**9**	**6**	**9.5**	**4**
Industrial Countries	**8.9**	**8.2**	**5.4**	**8.5**	**7.4**
Japan	12.2	12.5	5.5	1.5	-5.5
U.S.A	13.2	7	5.6	12.1	10.9
European Union		7.5	5	7	7.5
Economies in Transition		**17**	**16**	**17**	**10**
Developing Countries	**8.7**	**11**	**6.6**	**10.8**	**-4.5**
Sub Sahara Africa	4.9	6.5	0.8	9	0.6
Asia	12	15.5	5.8	7	-10.1
Latin America	11.7	3	8.5	22	9.5

Source: UNCTAD, 1999

The cyclical fall in commodity prices that started in early 1997 was aggravated by the financial crisis in Asia and continued throughout 1998. The decline in primary commodity prices tended to affect those countries whose exports were mainly concentrated in these products, including some Latin American and Caribbean countries. The prices of oil and non-oil commodities fell sharply in 1998.[13] The non-oil commodity prices registered a decline of more than 12.0 per cent, which was the largest in 20 years. The prices of sugar, banana and aluminum, which are all important sources of foreign exchange earnings for many Caribbean countries, declined by 21.2 per cent, 3.1 per cent and 15.1 per cent, respectively (See Table V). This had different implications for different countries and regions. Similar to the trends in primary commodity prices, prices of internationally traded manufactured goods and services also declined, though significantly less than those of primary commodities.

Table V: Commodity prices

	1994	**1995**	**1996**	**1997**	**1998**
All Commodities	**17.1**	**9.9**	**-4.2**	**0**	**-12.3**
Tropical Beverages	75	4.5	6.8	-3.5	-12.6
Sugar	19.7	10.8	-9.9	-4.9	-21.2
Aluminum	29.6	22.3	-16.6	6.2	-15.1
Bananas	-0.5	0.1	7.5	4.3	-3.1
Crude Petroleum	**-4.1**	**11.1**	**-3.6**	**-5.7**	

Source: UNCTAD, 1999.

In Latin America, trade growth slowed down considerably from the exceptionally high levels recorded in 1997, largely on account of sliding commodity prices and weak external demand. The growth rate in the volume of merchandise exports declined from 11 per cent in 1997 to 6.5 per cent in 1998, while that of merchandise imports declined from 22 per cent in 1997 to 9.5 per cent in 1998 (Table IV). There was a sharp contrast in economic performance of the two largest economies in the region, with trade declining in Brazil, while that of Mexico remained well above the regional average. Better access to the rapidly expanding and robust United States market and the high share of manufactures in merchandise exports are among the factors that explain why Mexico's trade performance remained superior to that of other Latin American economies.

The Asian financial crisis hit the economies of Latin America more severely than originally anticipated. Given the continent's strong ties with both Europe, where growth was slow, and with Asia, where economic activity contracted, Latin America was hit by negative trade shocks that compounded the financial crisis. The growth in the volume of merchandise

[13] Sub-Saharan Africa had suffered mostly the brunt of declines in primary commodity prices as merchandise export recorded a yearly growth rate of negative 1.5 per cent for the first time in five years.

imports continued to outstrip that of exports by a substantial margin, and the region’s trade growth - both exports and imports - remained well above the global average.

3.1 Institutional developments in the area of trade

As the pace of globalization quickened, institutional arrangements at regional and bilateral levels were increasingly being put in place to facilitate the integration of countries, small and large, into the global trading and financial system. The **World Trade Organization** (WTO) with the mandate to safeguard the world trading system, continued to make progress in resolving some of the outstanding issues from the Uruguay Round as well as new issues, such as the environment and electronic commerce.

The agreement on the liberalization of international trade in basic telecommunication services, which was signed by 72 countries including eight CARICOM countries, came into effect on 5 February 1998.[14] The services covered by the agreement included voice and data transmission, telex, telegraph, facsimile, private leased circuit services, fixed and mobile satellite services, cellular telephony, mobile data services, paging and personal telecommunication services.

Recognizing the increasing importance of electronic commerce and the enormous opportunities that are being created for trade world wide, the members of the WTO agreed at the May ministerial meeting in Geneva to study trade issues arising from this area. Products which are bought and paid for over the internet, but delivered physically, would be subject to existing WTO rules on trade in goods. But the situation is more complicated for products that are delivered as digitalized information over the internet.

The major issue overshadowing the **European Union** in 1998 was the launch of the process for enlarging its membership. This process was launched in March 1998 and accession negotiations with Cyprus, Hungary, Poland, Estonia, the Czech Republic and Slovenia have started. The European Union also welcomed the reactivation of Malta’s application for membership. The launch of the enlargement process gave the European integration a new dimension, progressively extending it across the whole continent.

In addition to the enlargement process, the EU concluded a number of negotiations and agreements aimed at extending integration to other areas of the world. In 1998, it concluded negotiations with Switzerland on a comprehensive, balanced set of sectoral agreements. It also consolidated its partnership with the Mediterranean countries and strengthened its links with independent States of the former Soviet Union. Apart from these, the EU launched a transatlantic economic partnership with the United States, with the aim of removing trade barriers and pursuing multilateral liberalization. It also strengthened its links with countries of Latin America and Asia. The European Union continued negotiations with the Republic of South Africa for the establishment of the EU-South Africa free trade agreement.

The efforts to unite the countries of the Western Hemisphere into a single **Free Trade Area of the Americas (FTAA)**, which was initiated in 1994, was given a further boost in 1998

[14] See WTO webside (www.wto.org)

by the adoption of the San José Declaration on 19 March 1998. This Declaration, agreed to by the 34 participating countries, paved the way for the launching of the negotiations for the FTAA. A month later, at the second Summit of the Americas, held in Santiago, de Chile, from 18-19 April 1998, the 34 countries agreed to commence the negotiations for the FTAA. The final agreement is scheduled to come into effect in January 2005. This undertaking signals a commitment to one of the most ambitious trade liberalization schemes of the time. The agreement is ambitious in the sense that it seeks to cover issues that are presently not under the WTO rules.

The structure of the negotiation was also decided. The FTAA negotiations will be carried forward under a structure that has been agreed through 2004. The structure is flexible and designed to ensure wide geographical representation by the participating countries through a rotation of the chairmanship of the process, the site of the negotiations themselves, and the responsibility for various negotiating groups. The Trade Negotiating Committee (TNC) was entrusted with the task of coordinating and overseeing the overall process of negotiations.

MERCOSUR continued to work towards deepening its economic integration by further reducing barriers to trade within the trade bloc. In December 1998 the countries agreed to replace the existing tariffs levied on auto imports from non-members with a common 35 per cent tariff from 1 January 2000. Concerning the rules of origin, they decided that in order for a product to qualify as a duty-free import, at least 60 per cent of production will have to take place within MERCOSUR. Intraregional trade has increased fivefold since the establishment of the group and by 1998 it was estimated to have reached an unprecedented US$20 billion. In percentage terms, intraregional exports hovered around 24.8 per cent of MERCOSUR total exports.[15]

The most significant activities for the **CARICOM** subregion in 1998 continued to be efforts aimed at the widening and deepening of the economic integration process. These included activities to complete the deepening of the integration process in CARICOM itself, as well as initiatives to integrate the region further with Latin American and other Caribbean countries.

Within CARICOM, ongoing efforts aimed at the implementation of the programme for the establishment of a Single Market and Economy (CSME) was given a significant push with the signing of all the protocols in 1998, with the exception of Protocol VIII on dispute settlement procedures and Protocol IX on competition policy. All these protocols are expected to increase the region's openness to trade and investment. Another significant development worth mentioning is the fact that despite the delays in implementing Phase IV of the Common External Tariff (CET), all the countries with the exception of Belize, Suriname and St. Kitts and Nevis have implemented the phase. Belize has been given a two-year grace period for implementing the CET with the last phase to be completed in the year 2000. Suriname was not in the position to implement the phase because of its fiscal implications, while St. Kitts and Nevis was awaiting results of a study on impacts of reduced CET on the OECS economies.

Another salient feature of the CARICOM policies in 1998, was the continuing preparation for and negotiations together with other African, Caribbean, Pacific (ACP) countries

[15] See I.M.F World Economic Outlook, 22 September 1999, p.4.

for a successor agreement to the LOME IV. The negotiating position so far seems to be leaning towards seeking the continuation of preferences beyond 2005.

4. INTERNATIONAL FINANCIAL DEVELOPMENTS

4.1 The Asian financial crisis and the crisis in emerging markets

Financial markets were again in turmoil in 1998 challenging the viability of the international financial system and threatening world economic growth. The Asian crisis that had erupted in 1997 continued to present downside risks for financial markets, and was aggravated by the Russian and Brazilian crises in 1998. The adverse contagion effects of these crises triggered the collapse of financial institutions and led to recessionary pressures in a number of countries. The Brazilian and Russian crises had probably superseded the Asian crisis as a risk factor, since the downturn in the Asian economies, that were affected by the crisis, seemed to have bottomed out in late 1998.

Economic recovery, though not robust, was evident in Korea and Singapore. It was stimulated by financial reform and stabilization, stronger exchange rates, which permitted an easing of monetary policy and strengthened business confidence on the domestic and international markets. Even in Indonesia, which initially suffered from slippages in the reform programme, the International Monetary Fund (IMF) stabilization programme was broadly on track. Indonesia has undertaken measures to restructure its flagging banking system while keeping its real interest rates high to prevent the further depreciation of its currency. Notably, growth remained fairly firm in China, stimulated mainly by public sector investment. China was shielded from the buffetings of the emerging markets financial crisis by its substantial foreign exchange reserves, its relatively low foreign debt and capital account controls which limited ‘hot’ speculative inflows.

The financial crisis in Russia was fuelled by persistent budgetary imbalances and incipient weaknesses in banks and other financial institutions and enterprises. The fiscal outturn was undermined by the decline in commodity prices, especially oil prices. Tax arrears accumulated, even as the federal government continued to overspend. By August, with international reserves running out and interest rates rising sharply, the authorities were unable to defend the ruble which depreciated by about 70 per cent to the United States dollar. With a loss of faith in the sustainability of the Russian reforms, investor confidence plummeted and a rapid flight to quality investments took place.

For some time fiscal imbalances, especially off-balance sheet budget items, had been a worry for Brazil. By 1998, the fiscal deficit had attained a substantial 8 per cent of GDP, leading to a widening current account deficit of 4.5 per cent of product. After the Russian crisis, investors lumped Brazil in a similar risk category with Russia, resulting in capital outflows of US$12 billion and US$19 billion in August and September 1998, respectively.

4.2 Reform of the global financial architecture

The frequency of financial conflagrations in recent times, especially the recent episodes in emerging markets has raised concerns about the very design and functioning of the global financial architecture. Discussions have focused on financial sector reforms to reduce systemic risk and moral hazard.[16] According to the World Economic Outlook and International Capital Markets: Interim Assessment, the three lines of defense against systemic risks-market discipline, prudential supervision and regulation, and macro-prudential surveillance had failed to prevent the buildup in vulnerabilities in emerging markets. The rescue of Long-term Capital Management (LTCM) hedge fund from near collapse in the United States further demonstrated that developed capital markets shared similar vulnerabilities to emerging ones.

The reality is that with the information age, agents have a wide range of information and are prepared to make many permutations in making their investment decisions. This has pushed back the boundary of financial excesses and speculative deals. A rather unfortunate outcome of financial crises is that innocent small investors and savers suffer the most when markets crash. The new financial architecture must devise strategies for protecting such agents from rabid speculators.

A number of proposals advanced for reform of the Bretton Woods System are outlined below. To strengthen market discipline, it was proposed that internal incentives were to be put in place, with an enforcement machinery from the top. This was designed to act as an early warning system to detect financial imprudence and imbalances and to eliminate these through internal management controls, such as arbitrage opportunities and bankruptcies and threats of takeovers.

Another vital area of reform was improved financial disclosure and transparency with regard to risk profiles. The overall aim here is to strengthen the level of transparency and disclosure so as to create a balance between providing information that allows supervisory bodies to accurately assess risk profiles and, at the same time, to encourage rather than stifle legitimate, efficient financial activity. Specifically financial institutions would be required to provide information that indicate their degree of exposure and concentration in specific markets and their linkages across markets. For example, the United States President's Working Group on Financial Markets proposed that hedge funds should be required to report their quarterly financial statements to the public. The Committee on the Global Financial System outlined a strategy for providing templates for disclosure of market exposures and trading positions of large multinational banks.

From the point of view of developing countries, some architectural blueprints have proposed that greater weight be given by domestic regulators to the accumulation of short-term liabilities in foreign currencies, to risk associated with the rapid growth in credit, to currency mismatches of assets and liabilities, and to the valuation of fixed assets as collateral during

[16] Moral hazard a term borrowed from insurance in simple terms means that agents, such as banks, governments and insurance companies that are protected from bearing the consequences of their actions, especially with respect to their bottom line, are likely to take imprudent risks, and hope to be bailed out if their decisions are wrong. (see Alan S. Blinder, Eight steps to a New Financial Order, Foreign Affairs, September/October 1999).

episodes of asset inflation. Most importantly, due consideration should also be given to the links between domestic financial risks and changes in key macroeconomic policy instruments.[17]

In addition, the range and quality of information on off-balance sheet operations of international financial institutions, particularly Over-The-Counter (OTC) derivatives, is being improved. This would provide central banks and other regulators with a better picture of the true balance sheet flows and outstanding commitments and enable better assessment of risk exposure.

5. TRENDS IN SAVINGS AND INVESTMENT AND CURRENT ACCOUNT DEVELOPMENTS

5.1 Trends in savings and investment

In concert with the 1.7 per cent decline in world output, world savings contracted by 3.0 per cent in 1998. World savings (see Table VI) slipped to 22.8 per cent of GDP, from 23.5 per cent of GDP in the previous year. This slowdown came after savings had averaged 23.2 per cent of GDP between 1994 and 1997, and registered average yearly growth of 0.9 per cent for the same period. Savings slowed in all the major economies, except the Newly Industrialised Asian Economies and the European Union, where they grew by 5.5 per cent and 0.5 per cent, respectively, to represent 34.5 per cent and 20.7 per cent of product. In the other major economies, the reduction in savings varied depending on output growth, consumer confidence and spending and the macroeconomic calculus. Similar to savings, world investment was down by 3.4 per cent in 1998 to 23.0 per cent of product. Dampened output also had a negative impact on investment.

Developing countries, as a group, recorded a 3.4 per cent reduction in aggregate savings to 25.8 per cent of product in 1998. Buffeted by commodity terms of trade shocks, these countries were forced to reduce their saving levels. Saving of fuel exporting countries contracted by 22.5 per cent to 16.2 per cent of product, while for non-fuel exporters, the decline was more modest at 1.8 per cent to 26.8 per cent of product. Similar to savings, **investment** in the developing countries slipped by 4.0 per cent to 26.5 per cent of product. This compared with a decline of 1.8 per cent in 1997 and an average yearly rate of decline of 0.7 per cent between 1994 and 1997.

[17] See Ocampo (1999)

Table VI: Summary of sources and uses of world savings (in per cent of GDP)

	1994	1995	1996	1997	1998
World					
Saving	22.9	23.2	23.2	23.5	22.8
Investment	23.6	23.8	23.8	23.8	23
Advanced economies					
Saving	20.4	21	21.1	21.6	21.2
Private	19.9	20.2	19.7	19.2	18.3
Public	0.5	0.8	1.4	2.4	2.9
Investment	20.6	20.8	20.9	21	20.8
Private	16.6	16.9	17	17.4	17.1
Public					
United States					
Saving	15.5	16.3	16.6	17.3	16.8
Private	14.8	15.2	14.5	14.1	12.4
Public	0.7	1.1	2.1	3.3	4.3
Investment	17.5	17.4	17.8	18.4	18.9
Private	14.5	14.4	14.8	15.5	16.1
Public	3	3	3	2.9	2.8
European Union					
Saving	19.4	20.2	19.7	20.6	20.7
Private	22	22.4	21.4	20.8	20
Public	-2.6	-2.3	-1.6	-0.2	0.7
Investment	18.9	19.4	18.7	19	19.7
Private	16	16.7	16.2	16.7	17.1
Public	2.9	2.7	2.5	2.4	2.6
Japan					
Saving	31.4	30.7	31.4	31	29.7
Private	25.9	25.9	27	26.9	27.4
Public	5.5	4.9	4.4	4.1	2.3
Investment	28.7	28.6	30	28.7	26.5
Private	20	20	21.2	20.9	18.6
Public	8.6	8.6	8.7	7.8	7.9
Newly industrialised Asian economies					
Saving	33.1	33.4	32.7	32.7	34.5
Private	25.4	25.8	25.6	25.5	27.4
Public	7.7	7.6	7.2	7.2	7.1
Investment	31.4	32.4	32.2	31.1	25.3
Private	24.6	25.7	25.4	24.8	18.4
Public	6.8	6.7	6.7	6.3	6.9
Developing Countries					
Saving	26.5	26.6	26.7	26.7	25.8
Investment	28.2	28.4	28.1	27.6	26.5
Change in reserves	2	1.8	2.3	1.5	-0.3
Regional Groups					
Africa					
Saving	15.8	15.3	17.7	17.3	14.6
Investment	21	20.6	19	19	19.9
Change in reserves	1.6	0.5	2.6	3	-0.5
Asia					
Saving	33.1	32.7	32.4	32.7	32.4
Investment	33.9	34.5	33.8	32.6	30.4
Change in reserves	3.3	2	2.5	1.5	-0.1
Middle East and Europe					
Saving	21.5	20.6	20.4	19.4	17.7
Investment	21.3	20.8	20.7	20.6	21.3
Change in reserves	1.2	2.1	2	1.1	0.4
Western Hemisphere					
Saving	18.4	18.9	19.2	18.4	17.1
Investment	21.4	20.5	21.1	21.6	21.5

Source: I.M.F World Economic Outlook, May 1999.

Savings were hardest hit in Africa, where aggregate savings contracted by 15.6 per cent to a sub-optimal 14.6 per cent of GDP. This followed average yearly growth in savings of 3.4 per cent (an average of 16.5 per cent of product) from 1994 to 1997. Commodity price shocks and adverse terms of trade effects led to dampened growth in many African countries, notably, Botswana, Zambia, Angola, Nigeria[18] (especially for oil) and the Republic of Congo. With the fall in output, many countries had to reduce savings in order to maintain reasonable levels of consumption. In contrast, investment demand was up by 4.7 per cent.

Like Africa, negative commodity price developments fed through to impact on savings in the **Middle East and Europe**, especially the Middle East. Savings in the Middle East and Europe declined by 8.8 per cent to 17.7 per cent of GDP in 1998, following a fall of 4.9 per cent in 1997. This compared with an average savings rate of 20.5 per cent from 1994 to 1997.

Meanwhile, in **Latin America and the Caribbean** savings contracted by 7.1 per cent to 17.1 per cent of GDP, after a slower 4.2 per cent decline in 1996. Public saving was at its lowest level for the decade as worsening terms of trade adversely affected income and the buoyancy of tax revenue. The downside fiscal effects were especially strong in Chile, Venezuela and Ecuador. In Brazil, national savings slipped from 18.5 per cent of product in 1997 to 16.9 per cent in 1998[19]. The public sector deficit increased from 6.1 per cent of GDP in 1997 to 8.0 per cent in 1998. In Argentina, national savings fell by 40 basis points to 17.2 per cent of product. The reduction in national savings seem to have come largely from reduced private savings, as the public sector deficit declined to 1.2 per cent of product from 1.4 per cent in1997.

In the **United States** saving fell by 2.9 per cent to 16.8 per cent of GDP. Private sector saving was down by 12.1 per cent in 1998, relative to a decline of only 2.8 per cent in the previous year. United States household saving was adversely affected by a fairly robust economy, increasing employment and incomes and strong consumer confidence. The bullish equity markets resulted in a redistribution of household wealth in favour of equities, compared with real estate and other assets and helped to fuel consumer spending. The buoyant spending climate was also facilitated by low interest rates, declining commodity prices and cheaper imports, especially from the Asian crisis countries with depreciated currencies. In contrast, public saving, an area of consolation for the United States, was up by a strong 30.3 per cent (1 per cent of GDP). The recent turnaround in the United States budget was so welcomed that there was wide ranging debate in Congress about what to do with the budget surplus. Some representatives favoured offering tax breaks to the middle and lower income groups, while others preferred increased social spending and the reform of the social security system.

Aggregate investment in the United States rose by 2.7 per cent to 18.9 per cent of product in 1998. Private investment declined by 3.9 per cent following growth of 4.7 per cent in 1997. Meanwhile, between 1994 and 1997, private investment increased on average by 2.3 per cent per year (to account for an average 14.8 per cent of product). Private investment was stimulated by the positive crowding in effect of the shrinking federal budget deficit, lower interest rates, the bullish stock market and vibrant growth in output. Public investment on the other hand,

[18] The average world price of oil declined from $19.3 a barrel in 1997 to $13.1 a barrel in 1998.

[19] See Economic Survey of Latin America and the Caribbean, ECLAC, 1998-1999.

contracted by 3.4 per cent almost the same rate as in 1997, and accounted for only 2.6 per cent of product.

An issue that has prompted animated discussion and concern recently is the continued deterioration in the United States private sector saving-investment gap. This gap has remained at around 5 per cent of GDP, (the highest in post war United States history) and is forecasted to continue in this range in the medium term. Some analysts believe that this gap is unsustainable and that a correction will occur sooner or later through a contraction in aggregate demand. A fairly rapid adjustment through a sharp contraction in demand, it is feared could spell disaster for the United States economy and the buoyancy of world growth. This was underscored by the role the robust United States growth played in absorbing the recessionary impulses in the Asian crisis economies.

Savings contracted by 4.2 per cent in **Japan** to 29.7 per cent of product. This was due to a 43.9 per cent reduction in public saving, as private savings were up by about 2 per cent. Public sector savings fell with the easing of fiscal and monetary restraint in 1998. In spite of these policies to stimulate the economy, rock bottom business confidence has thwarted the expected fuelling of economic growth. Although Japan was seemingly in a "liquidity trap" (the cost of capital approached historic lows), consumers simply saved any injection of purchasing power that was induced by the authorities. These infusions were sizeable, for instance, in November 1998 the government proposed a fiscal package worth 24 trillion yen or 5 per cent of GDP, including corporate and income tax cuts and public works. This followed a 16 trillion yen growth stimulus package earlier, which failed to work.

5.2 Current account developments

The **current account** positions of individual countries and regions reflected differences in global demand and movements in commodity and services flows and prices. The fallout from the Asian crisis meant that growth in the surplus in Japan and other Asian economies was largely accommodated by an increase in the deficit in the United States.

Among the **Organization for Economic Cooperation and Development (OECD) economies**, current account performance was varied. The Euro area countries recorded an 18.0 per cent reduction in their current account surplus to US$89.5 billion. This contrasted sharply with average growth in the surplus of 79.4 per cent a year between 1994 and 1997. Japan, reflecting its net lending position to the rest of the world, registered a 29.2 per cent increase in its current account surplus in 1998. This outturn took place in spite of the slowdown of the economy caused by the Asian crisis and was accounted for in part by the devaluation of the Yen which led to strengthened export competitiveness in the United States and EU markets. Meanwhile, the current account surplus of the other advanced economies grouped together almost quadrupled to amount to US$48.4 billion in 1998. This growth rate was similar to that recorded between 1994 and 1998.

Table VII: Current account balances for various regions and countries
(billions of US$)

	1994	1995	1996	1997	1998
Advanced economies	31.3	50.1	32.6	69.9	14.3
United States	-123.8	-115.3	-134.9	-155.2	-233.4
Euro Area	21.4	53.9	85.1	109.2	89.5
Japan	130.6	114.4	65.8	94.1	121.6
Other advanced economies	3.0	1.2	13.1	10.0	48.4
Industrial Countries	17.7	49.0	36.7	64.1	-45.6
Newly Industrialised Asian economies	16.1	5.9	1.0	9.0	62.6
Developing Countries	-87.5	-95.1	-73.0	-69.1	-92.5
Regional Groups					
Africa	-11.8	-16.4	-5.7	-6.1	-18.1
Asia	-20.2	-42.5	-38.9	-4.0	35.5
Middle East and Europe	-4.7	-0.4	10.5	6.1	-20.0
Western Hemisphere (LAC)	-50.9	-35.9	-38.9	-65.1	-89.9
By source of export earnings					
Fuel	-4.9	2.7	31.3	23.4	22.3
Nonfuel	-82.6	-97.8	-104.3	-92.6	-70.3
By external financing source					
Net creditor countries	-6.8	3.1	13.0	11.9	-11.5
Net debtor countries	-80.7	-98.2	-86.1	-81.0	-81.0
Official Financing	-14.6	-17.2	-14.9	-13.8	-17.9
Private Financing	-48.9	-57.2	-47.5	-42.0	-43.1
Diversified Financing	-17.2	-23.8	-23.7	-25.2	-19.9
Net debtor countries by debt servicing experience					
Countries with arrears and/or rescheduling during 1993-97	-15.7	-38.5	-26.2	41.6	-66.2
Other net debtor countries	-65.1	-59.6	-59.9	-39.5	-14.8
Countries in Transition	**3.9**	**-2.4**	**-16.2**	**-29.3**	**-25.8**
Central and eastern Europe	-4.0	-6.1	-16.6	-19.7	-21.8
Excluding Belarus and Ukraine	-2.1	-4.1	-14.9	-17.5	-20.1
Russia	8.7	5.2	4.3	-5.7	0.8
Transcaucasus and Central Asia	-0.8	-1.6	-3.9	-4.0	-4.8
Total	**-52.2**	**-47.5**	**-56.7**	**-28.5**	**-103.9**
In per cent of total world current account transactions	-0.5	-0.4	-0.4	-0.2	-0.8
In per cent of world GDP	-0.2	-0.2	-0.2	-0.1	-0.4
Emerging market countries, excl. Asian countries in surplus	-74.1	-73.9	-73.3	-115.9	-167.8

Source: I.M.F World Economic Outlook, May 1999

The current account deficit of the **United States** (see Table VII) expanded by 50.4 per cent to US$233.4 billion, three times the rate of growth for 1997. Notably, the United States current account deficit shot up in 1998 after fairly modest growth of 8.4 per cent per year between 1994 and 1997. There is widespread concern about the ability of the United States to continue being a net debtor to the rest of the world. Although the problem of the twin deficits is no longer a major concern since the budget has returned a surplus of an average of 5 per cent of GDP during the period 1993-98, the escalation in the current account deficit has raised major alarms about the sustainability of United States growth and prosperity. The United States deficit was deemed necessary during the Asian crisis and its fallout to offset flagging demand in those economies that were experiencing recessionary conditions.

The current account deficit of the **developing countries** saw an unwelcome expansion by 33.9 per cent in 1998, compared with a reduction of 5.3 per cent in 1996. The deficit contracted by an average 6.6 per cent per annum between 1994 and 1997. Within the regional groups, **Sub Sahara Africa's** current account deficit almost tripled from US$ 6.1 billion in 1997 to US$18.1 billion in 1998. This was a significant reversal of the trend for the mid-1990s, when the deficit contracted on average by 6.4 per cent between 1994 and 1997. African countries, being largely producers of crude primary products, were hard hit by plummeting prices for these goods that resulted from the slowdown in world growth and demand on account of the Asian financial crisis. Indeed, the terms of trade of African countries as a group were estimated to have declined by 9.9 per cent in 1998, compared with a marginal decrease of 0.2 per cent in 1997.[20] This contraction in the terms of trade was estimated to have resulted in a 2.6 per cent fall in real incomes, which was accommodated primarily by a drop in real consumption and reduced savings. Within Africa, the oil producers were hardest hit. Their terms of trade plummeting by 28.8 per cent, with a significant negative 13.3 per cent contraction in real GDP. Sub-Saharan Africa, which has suffered substantial output constraints due to supply shocks precipitated by war, droughts and poor investor expectations, registered a 9.9 per cent reduction in its terms of trade and a 2.4 per cent decline in real incomes. Meanwhile, the CFA franc zone countries recorded a more moderate 4.3 per cent fall in their terms of trade and a 1.6 per cent reduction in real incomes.

The current account position of the **Asian countries** improved dramatically in 1998, shifting upwards to a surplus of US$35.5 billion from a deficit of US$4.0 billion in 1997. The current account deficit of Asian countries had increased at an average rate of 4.1 per cent between 1994 and 1997. Competitive devaluation in Asia and depreciating real effective exchange rates resulted in sharp growth in Asian exports to the United States and other developing countries, thereby strengthening its current account position. In the Middle East and Europe, the US$6.0 billion surplus of 1997 swung into a deficit of US$20.0 billion in 1998, largely as a result of a loss in competitive advantage in export markets to Asian countries and the drastic fall in commodity prices, notably oil prices.

In **Latin America and the Caribbean**, the current account of the balance of payments deteriorated by 38.1 per cent, slipping from a deficit of US$65.1 billion in 1997 to US$89.9 billion in 1998. This was more than double the rate of growth (15.4 per cent) of the deficit between 1994 and 1997. The region was ravaged by commodity price shocks, impelled by soft

[20] See IMF: World Economic Outlook, May 1999.

demand in major markets. These deficits were financed by a decumulation of reserves and increased foreign borrowing.

Among the economies in transition, the current account deficit contracted by 11.9 per cent to US$25.8 billion in 1998. This was a welcomed turnaround after growth in the deficit of 80.9 per cent in 1997, and average annual growth of over 160 per cent between 1994 and 1997. Dampened output in Russia fuelled by the Russian financial crisis and contracting demand for commodities, especially fuel and crude manufactures and worsening terms of trade, impacted negatively on the merchandise account of these countries. The deficit was up in all the transition countries, except Russia, which recorded a small surplus of US$0.8 billion. The current account deficit of the Transcaucasus and Central Asian countries increased by 20.0 per cent, to US$4.8 billion while for Central and Eastern Europe it was up by 10.7 to US$21.8 billion.

6. CAPITAL FLOWS

Net private capital flows to emerging markets in **developing countries** contracted sharply in 1998 (see Table VIII). Estimates point to a reduction in these flows by about 57 per cent to US$64 billion, compared with a decline of about 30 per cent in 1997. As a ratio of GDP, private capital flows to developing countries were at their lowest levels since 1989. While in 1997, the drought of capital flows had impacted mainly the **Asian crisis countries**, in 1998, the financial contagion from the Asian, Russian and Brazilian crises affected a number of other countries. Net private outflows from the five Asian crisis countries[21] were estimated at US$45.3 billion, a significant 7 per cent of GDP. In the Asian crisis economies, net portfolio investment, a significant portion of which was comprised of short-term, 'hot' speculative flows contracted by a staggering 151.6 per cent. Also, net direct investment, which had proven to have a much more long term developmental impact, declined, by 59.5 per cent, after expanding by 27.4 per cent in 1997. Net official external finance to the Asian crisis countries was down by 9.2 per cent to US$22.7 billion.

Reduced profit expectations and a heightened sense of risk also impacted negatively on external finance in the **rest of Asia**. In the other Asian emerging markets, capital outflows were estimated at US$9.6 billion in 1998, following inflows of US$22.8 billion in 1997. Net direct investment contracted by 10.7 per cent to US$45.1 billion, relative to the same rate of increase in 1997. By contrast, net official capital flows were up by over 78 per cent to US$5.9 billion. China's financial exposure was not much affected by the crisis in emerging market. China's access to international capital markets was buoyed by its low external indebtedness, large reserves and current account surplus.

[21] These countries are Indonesia, Korea, Malaysia, the Phillipines and Thailand.

Table VIII: Net capital flows (in billions of US$)

	1994	1995	1996	1997	1998
Total					
Net private capital flows	152.6	193.3	212.1	149.1	64.3
Net direct investment	82.7	97.0	115.9	142.7	131.0
Net portfolio investment	105.6	41.2	80.8	66.8	36.7
other net investment	-35.8	55.0	15.4	-60.4	-103.4
Net official flows	1.8	26.1	-0.8	24.4	41.7
Change in reserves	-66.7	-120.2	-109.1	-61.2	-34.7
AFRICA					
Net private capital flows	4.8	6.8	7.6	16.3	10.3
Net direct investment	3.4	4.2	5.5	7.6	6.8
Net portfolio investment	0.8	1.5	-0.2	2.9	3.5
other net investment	0.7	1.2	2.3	5.8	..
Net official flows	14.0	10.8	3.7	-4.5	1.5
Change in reserves	-4.7	-1.7	-7.4	-12.3	2.9
ASIA CRISIS COUNTRIES					
Net private capital flows	33.2	62.5	62.4	-19.7	-45.3
Net direct investment	6.5	8.7	9.5	12.1	4.9
Net portfolio investment	8.3	17.0	20.0	12.6	-6.5
other net investment	18.4	36.9	32.9	-44.5	-43.6
Net official flows	0.3	0.7	4.8	25.0	22.7
Change in reserves	-6.1	-18.3	-13.6	37.7	-39.1
OTHER ASIAN EMERGING MARKETS					
Net private capital flows	33.2	32.6	38.1	22.8	-9.6
Net direct investment	38.7	41.1	45.6	50.5	45.1
Net portfolio investment	1.1	-6.1	-7.5	-11.8	-8.8
other net investment	-6.6	-2.4	0.1	-15.8	-45.9
Net official flows	5.1	3.8	5.3	3.3	5.9
Change in reserves	-47.7	-26.2	-42.5	-46.3	-9.7
MIDDLE EAST AND EUROPE					
Net private capital flows	15.4	10.1	6.8	16.7	26.5
Net direct investment	3.8	3.7	2.4	3.3	2.9
Net portfolio investment	13.6	9.4	4.1	4.3	8.8
other net investment	-2.0	-3.0	0.4	9.1	14.7
Net official flows	-1.3	-1.4	-0.7	-1.0	-2.2
Change in reserves	-3.6	-12.7	-16.2	-20.4	-5.3
LATIN AMERICA &THE CARIBBEAN					
Net private capital flows	47.5	38.3	82.0	87.3	69.0
Net direct investment	24.9	26.1	39.3	50.7	54.0
Net portfolio investment	60.8	1.7	40.0	39.7	33.0
other net investment	-38.2	10.6	2.7	-3.1	-18.1
Net official flows	-4.1	20.6	-13.7	-7.8	1.6
Change in reserves	4.2	-25.5	-28.3	-14.6	17.7
COUNTRIES IN TRANSITION					
Net private capital flows	18.5	42.9	15.1	25.7	13.6
Net direct investment	5.4	13.4	13.5	18.5	17.4
Net portfolio investment	21.0	17.8	24.4	19.0	6.7
other net investment	-8.0	11.7	-22.8	-11.9	-10.6
Net official flows	-12.2	-8.5	-0.2	9.3	12.2
Change in reserves	-8.7	-35.8	-1.0	-5.3	-1.2

Source: I.M.F World Economic Outlook, May 1999

The evolution of external finance to Asia in 1998, underscored the role of expectations and investor confidence, and the speed with which these sentiments can change. The modest recovery in Korea and Thailand[22] in early 1998, seemed to have portended well for emerging markets as a whole. Prospects for Korea had improved with investors welcoming its external debt restructuring and the IMF-funded programme of reforms. Indonesia remained an outlier, however, as poor economic policies and civil unrest damaged investor sentiments. In response to the financial crisis, the government took an unorthodox approach and imposed capital controls in September 1998 despite heavy criticism from the international community.

Net private capital inflows contracted in **Latin America and the Caribbean** by some 21.0 per cent, amounting to roughly US$69.0 billion. This outturn followed growth in inflow of about 6 per cent in 1997. Moreover, the decline in 1998 contrasted with an average rate of increase of roughly 33 per cent between 1994 and 1997. These countries were somewhat fortunate, unlike their Asian counterparts in that the reduction in external finance was borne by portfolio and official flows only and not by the more developmental direct investment. Net portfolio investment in these countries slipped by roughly 17 per cent to US$ 39.7 billion. Meanwhile, net official capital outflows were almost halved to US$7.8 billion. Brazil's exposure to external funding swung sharply in 1998 from an accumulation of roughly 10 per cent in the first half of the year, to a cutback of 15 per cent in the second half, that resulted from fiscal excesses; the default on debt payments by some states and the devaluation of the real.

Although not as exposed as some other emerging markets, net private capital flows to **Africa** contracted by over 36 per cent in 1998, on the heels of a doubling of these flows in 1997. There was an unfortunate 10.5 per cent reduction in net foreign direct investment in Africa. This contraction came at a time when the region could hardly afford it, affected as it was by sluggish output performance and high unemployment. Meanwhile, official flows rebounded to amount to US$1.5 billion, after having declined to US$4.5 billion in 1997. Reflecting generally poor investor sentiments, most African countries had little exposure in the international financial market. South Africa, however, was hard hit by reduced investor confidence. Bonds and equity issues, the second major source of private market finance in emerging markets, was down by 85 per cent in South Africa in 1998. Investor confidence in the South African economy was dampened by high real interest rates that impacted negatively on growth prospects. Equity issues also contracted to almost zero in Sub-Saharan Africa.

In contrast to most other regions, net capital flows to the **Middle East and Europe** expanded substantially by 58.7 per cent to US$26.5 billion. Net capital flows to the Middle East shifted upwards from 1.1 per cent of GDP in 1997 to 3.5 per cent of GDP in 1998, as domestic investors drew down their foreign asset positions in the wake of the softness in oil prices. Bond issuance fell by 23 per cent for the Middle East, but was up by 50 per cent for Europe, largely reflecting growth for Hungary and the Slovak Republic.

Net private capital flows to **countries in transition** declined sharply by 47.1 per cent to US$25.7 billion in 1998. Portfolio investment plummeted by 64.7 per cent, as a result of the flight to quality investments occasioned by the Russian crisis. Net foreign direct investment

[22] Equity prices that had sagged in these countries in 1997, rebounded by over 60 per cent in U.S. dollar terms.

being more stable contracted by 5.9 per cent. Meanwhile, net official flows were up by 31.2 per cent, reflecting the Russian bailout and financing for other troubled economies.

Reflecting sluggish growth, the new paradigm of reciprocity and a loss of faith in government management aid maintained a declining trend in 1998. Net concessional flows were below the 1990 level in real terms. Incidentally, the reduction in aid flows took place at a time when needy low income countries were undertaking policy reforms which should enable them to make more optimal use of such funds. Net concessional finance to developing countries amounted to US$32.7 billion in 1998, marginally below the total for 1997. Unfortunately, net disbursements were only one sixth of the amounts pledged by donors. A favourable development though, was the replenishment of IDA-12 for the period July 1999 to June 2002, with more than US$11 billion in new contributions.

7. EXTERNAL DEBT AND HIPC INITIATIVES

The external debt of developing countries as a whole expanded by 6.0 per cent in 1998 *(see Table IX)* to US$1922.0 billion. Between 1994 and 1997, external debt of these countries shifted upwards by 5.1 per cent on average. Among the regional groupings, the debt of the Middle East and Europe increased by 11.2 per cent to US$243.0 billion. In Latin America and the Caribbean, one of the most highly indebted regions, outstanding external debt moved up by 10.3 per cent (almost twice the average growth from 1994 to 1997) in 1998 to US$737.7 billion. External debt in this region averaged US$621.9 from 1994 to 1997 and grew on average by 5.8 for this period. Among the Countries in Transition, the external debt expanded by 10.2 per cent to US$315.7 billion. The debt of Russia, which represented about 43 per cent of the total, grew by 11.5 per cent, while that of Central and Eastern Europe and the Transcaucasus and Central Asia increased by 9.7 per cent and 9.0 per cent, respectively. The debt of Asian countries was up marginally by 2.4 per cent to US$655.0 billion, while Africa's debt rose slightly by 0.1 per cent to US$286.2 billion.

Debt service payments accounted for 24 per cent of the exports of goods and non-factor services for all the developing countries, up from 21.4 per cent in 1997. Underscoring the protracted impact of the debt crisis, debt service represented 45.7 per cent of exports of goods and non-factor services in Latin America and the Caribbean. In Africa, debt service payments stood at 16.3 per cent of exports of goods and services, up from 13.6 per cent in 1997. In the Countries in Transition and the Middle East and Europe, respectively, debt service payments accounted for 15.9 per cent and 14.5 per cent of exports of goods and services.

Table IX: External debt and debt service payments (in billions of US$)

	1994	1995	1996	1997	1998
Developing Countries	1563.5	1688.6	1749.4	1812.9	1922.0
Regional Groups					
Africa	277.0	298.0	299.0	285.9	286.2
Asia	510.1	561.0	595.7	639.6	655.0
Middle East and Europe	211.1	216.0	214.8	218.6	243.0
Latin America and the Caribbean	565.3	613.4	639.8	668.9	737.7
Countries in transition	248.9	266.9	277.6	286.5	315.7
Central Europe and Eastern Europe	121.7	136.9	140.8	148.6	163.0
Excluding Belarus and Ukraine	112.0	125.8	129.8	133.1	148.4
Russia	119.8	120.4	125.0	123.5	137.0
Transcaucasus and Central Asia	7.4	9.7	11.8	14.4	15.7
Debt-service payments					
Developing Countries	203.0	226.6	250.4	267.8	286.8
Regional Groups					
Africa	27.1	31.7	30.0	28.8	28.9
Asia	62.0	73.3	80.8	75.8	89.5
Middle East and Europe	23.5	23.3	25.3	22.9	33.6
Latin America and the Caribbean	90.4	98.3	114.3	140.3	134.8
Countries in transition	29.1	31.0	31.1	30.1	46.3
Central Europe and Eastern Europe	24.2	23.3	22.6	22.7	28.1
Excluding Belarus and Ukraine	22.3	21.5	21.3	20.9	25.1
Russia	4.3	6.4	6.9	5.9	15.1
Transcaucasus and Central Asia	0.6	1.4	1.5	1.5	3.2

Source: I.M.F. World Economic Outlook, May 1999

An issue that has overshadowed debt developments, was the need for adequate means of debt restructuring following the crises in emerging markets. Although the East Asian countries, with the exception of Indonesia, were able to service their debt, Russia faced chronic payments problems. An important aspect of the developing country exposure during the recent crisis has been the large share of their debt outstanding to private creditors as opposed to official sources. This underscores the need for an internationally accepted bankruptcy framework. By providing mutually agreeable debt restructuring terms, creditors could reduce the downside effects on growth of the debt drag and expedite the repayment of arrears outstanding to them.

Further progress was made under the Heavily Indebted Poor Countries (HIPC) Initiative that was approved by the Interim and Development Committees in September 1996. The HIPC Initiative's goal is to achieve a comprehensive solution to unsustainable levels of debt owed by the poorest developing countries[23]. A number of countries qualified for debt relief in 1998. These included Bolivia, Burkina Faso, Cote d'Ivoire, Guyana, Mali, Mozambique and Uganda. Debt relief packages to these countries amounted to US$3 billion in net present value terms. Further, Ethiopia, Guinea-Bissau and Mauritania were set to qualify for possible debt relief. Bolivia and Uganda, having benefited from the scheme, reached their completion points in 1998, after receiving debt relief amounting to US$800 million. Guyana, which started the HIPC Initiative in 1997, was set to complete it in 1999. By this time Guyana was scheduled to attain a debt sustainability target of 107 per cent of exports of goods and non-factor services, debt relief of US$253 million in net present value terms and estimated nominal debt service relief of US$500 million.

8. CONCLUSION

The most striking developments for 1998 have been the recurrent bouts of instability that have marked global financial markets. The financial crisis that started in Asia in mid-1997 spread to other emerging markets. In 1998 Russia and Brazil were feeling the effect of financial contagion. Virtually all the regions and countries experienced slowdown in output growth. The crisis set back the progress achieved in Latin America, and in the most seriously affected countries, the Asian countries themselves, it wiped out the fruits of decades of economic growth and poverty reduction.[24]

The developing countries and especially those that are dependent on primary commodities, such as the Latin American and Caribbean countries, suffered the brunt of the cyclical fall in commodity prices. In Latin America, GDP growth fell on account of the financial crisis coupled with a series of natural disasters. The oil producing countries suffered the most from the decline in oil prices. Developing countries, particularly those that had reaped the benefits of financial integration, suffered from the reversal in capital flows which followed the Russian crisis.

Advanced economies, by contrast, gained from the decline in commodity prices and cheaper manufactured imports from countries that had suffered from currency devaluation. The improvement in terms of trade helped to maintain output levels and reduce inflation. Similarly, these economies also gained from the reversal in capital flows away from the developing countries. These inflows helped to boost stock markets in the developed economies, particularly the United States, and stimulate consumption.

[23] See Global Development Finance 1999, World Bank 1999.

[24] UNCTAD Secretariat, 1999