

ECONOMIC AND SOCIAL SURVEY OF ASIA AND THE PACIFIC 2000

**Economic and Financial
Monitoring and Surveillance**



UNITED NATIONS

ECONOMIC AND SOCIAL COMMISSION FOR ASIA AND THE PACIFIC

**ECONOMIC AND SOCIAL SURVEY OF
ASIA AND THE PACIFIC 2000**

UNITED



NATIONS

**New York
2000**

UNITED NATIONS
ECONOMIC AND SOCIAL SURVEY OF ASIA AND THE PACIFIC
2000

ST/ESCAP/2043

UNITED NATIONS PUBLICATION

Sales No. E.00.II.F.19

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ISBN: 92-1-119955-7 ISSN: 0252-5704

FOREWORD

Asia has made a remarkable recovery from the financial crisis of 1997-1998. Growth has resumed. The economies of the region have shown impressive staying power, and a new sense of optimism is clearly visible. Nevertheless, there is no room for complacency. Sustained efforts will be required to resolve a host of lingering problems. Financial institutions have to be revamped. Corporate governance has to be improved. Social safety nets have to be strengthened and expanded. Asia's poor have not yet regained lost ground, and the global community must do all it can to respond to their immediate suffering and long-term plight.

This edition of the *Economic and Social Survey of Asia and the Pacific* reviews the progress made in the ESCAP region over the past year, assesses the policy initiatives that have been taken and identifies a number of areas for further action by policy-makers. The *Survey* also examines the international financial system, with a particular focus on ideas for reform such as improved surveillance and the establishment of early warning systems. It is my hope that this publication will assist our ongoing efforts to derive the right lessons from the Asian crisis – and to apply those lessons in a spirit of partnership among all members of our United Nations.



Kofi A. Annan
Secretary-General

April 2000

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EXPLANATORY NOTES

The term "ESCAP region" is used in the present issue of the *Survey* to include Afghanistan; American Samoa; Armenia; Australia; Azerbaijan; Bangladesh; Bhutan; Brunei Darussalam; Cambodia; China; Cook Islands; Democratic People's Republic of Korea; Fiji; French Polynesia; Guam; Hong Kong, China; India; Indonesia; Iran (Islamic Republic of); Japan; Kazakhstan; Kiribati; Kyrgyzstan; Lao People's Democratic Republic; Macao, China; Malaysia; Maldives; Marshall Islands; Micronesia (Federated States of); Mongolia; Myanmar; Nauru; Nepal; New Caledonia; New Zealand; Niue; Northern Mariana Islands; Pakistan; Palau; Papua New Guinea; Philippines; Republic of Korea; Russian Federation; Samoa; Singapore; Solomon Islands; Sri Lanka; Tajikistan; Thailand; Tonga; Turkey; Turkmenistan; Tuvalu; Uzbekistan; Vanuatu and Viet Nam. The term "developing ESCAP region" excludes Australia, Japan and New Zealand.

The term "Central Asian republics" in this issue of the *Survey* refers to Armenia, Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.

The designations employed and the presentation of the material in this publication do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers.

Mention of firm names and commercial products does not imply the endorsement of the United Nations.

The abbreviated title *Survey* in footnotes refers to *Economic and Social Survey of Asia and the Pacific* for the year indicated.

Many figures used in the *Survey* are on a fiscal year basis and are assigned to the calendar year which covers the major part or second half of the fiscal year.

Reference to "tons" indicates metric tons.

Values are in United States dollars unless specified otherwise.

The term "billion" signifies a thousand million. The term "trillion" signifies a million million.

In the tables, two dots (..) indicate that data are not available or are not separately reported, a dash (-) indicates that the amount is nil or negligible, and a blank indicates that the item is not applicable.

In dates, a hyphen (-) is used to signify the full period involved, including the beginning and end years, and a stroke (/) indicates a crop year, a fiscal year or plan year. The fiscal years, currencies and 1999 exchange rates of the economies in the ESCAP region are listed in the following table:

<i>Country or area</i>	<i>Fiscal year</i>	<i>Currency and abbreviation</i>	<i>Rate of exchange for \$1 as of June 1999</i>
Afghanistan	21 March to 20 March	afghani (Af)	3 000.00
American Samoa .....	..	United States dollar (\$)	1.00
Armenia	1 January to 31 December	dram	543.84
Australia	1 July to 30 June	Australian dollar (\$A)	1.52
Azerbaijan	1 January to 31 December	Azeri manat (AZM)	3 975.00
Bangladesh	1 July to 30 June	taka (Tk)	48.50
Bhutan	1 July to 30 June	ngultrum (Nu)	43.36
Brunei Darussalam	1 January to 31 December	Brunei dollar (B\$)	1.70
Cambodia	1 January to 31 December	riel (CR)	3 800.00
China	1 January to 31 December	yuan renminbi (Y)	8.28
Cook Islands	1 April to 31 March	New Zealand dollar (\$NZ)	1.89
Democratic People's Republic of Korea .....	..	won (W)	2.20 ^a
Fiji	1 January to 31 December	Fiji dollar (F\$)	1.98
French Polynesia .....	..	French Pacific Community franc (FCFP)	115.67 ^a

<i>Country or area</i>	<i>Fiscal year</i>	<i>Currency and abbreviation</i>	<i>Rate of exchange for \$1 as of June 1999</i>
Guam.....	1 October to 30 September	United States dollar (\$)	1.00
Hong Kong, China	1 April to 31 March	Hong Kong dollar (HK\$)	7.76
India	1 April to 31 March	Indian rupee (Rs)	43.36
Indonesia	1 April to 31 March	Indonesian rupiah (Rp)	6 726.00
Iran (Islamic Republic of).....	21 March to 20 March	Iranian rial (RIs)	1 754.45
Japan.....	1 April to 31 March	yen (¥)	121.10
Kazakhstan	1 January to 31 December	tenge (T)	131.00
Kiribati	1 January to 31 December	Australian dollar (\$A)	1.52
Kyrgyzstan	1 January to 31 December	som (som)	42.15
Lao People's Democratic Republic	1 October to 30 September	new kip (NK)	9 430.00
Macao, China	1 July to 30 June	pataca (P)	8.02
Malaysia	1 January to 31 December	ringgit (M\$)	3.80
Maldives	1 January to 31 December	rufiyaa (Rf)	11.77
Marshall Islands	1 October to 30 September	United States dollar (\$)	1.00
Micronesia (Federated States of)	1 October to 30 September	United States dollar (\$)	1.00
Mongolia	1 January to 31 December	tugrik (Tug)	1 014.73
Myanmar.....	1 April to 31 March	kyat (K)	6.43
Nauru.....	1 July to 30 June	Australian dollar (\$A)	1.52
Nepal	16 July to 15 July	Nepalese rupee (NRs)	68.48
New Caledonia .....	..	French Pacific Community franc (FCFP)	115.67 ^a
New Zealand	1 April to 31 March	New Zealand dollar (\$NZ)	1.89
Niue	1 April to 31 March	New Zealand dollar (\$NZ)	1.89
Northern Mariana Islands	1 October to 30 September	United States dollar (\$)	1.00
Pakistan	1 July to 30 June	Pakistan rupee (PRs)	51.39
Palau	1 October to 30 September	United States dollar(\$)	1.00
Papua New Guinea	1 January to 31 December	kina (K)	2.56
Philippines	1 January to 31 December	Philippine peso (P)	38.02
Republic of Korea	1 January to 31 December	won (W)	1 157.60
Russian Federation	1 January to 31 December	rouble (R)	24.22
Samoa	1 July to 30 June	tala (W\$)	3.02
Singapore	1 April to 31 March	Singapore dollar (S\$)	1.70
Solomon Islands	1 January to 31 December	Solomon Islands dollar (SI\$)	4.84
Sri Lanka	1 January to 31 December	Sri Lanka rupee (SL Rs)	70.95
Tajikistan.....	1 January to 31 December	Tajik rouble (TR)	1 287.00
Thailand.....	1 October to 30 September	baht (B)	36.90
Tonga.....	1 July to 30 June	pa'anga (T\$)	1.59
Turkey	1 January to 31 December	Turkish lira (LT)	420 350.00
Turkmenistan	1 January to 31 December	Turkmen manat (M)	5 200.00
Tuvalu	1 January to 31 December	Australian dollar (\$A)	1.52
Uzbekistan.....	1 January to 31 December	som (som)	117.42
Vanuatu	1 January to 31 December	vatu (VT)	129.91
Viet Nam	1 January to 31 December	dong (D)	13 931.00

Sources: United Nations, *Monthly Bulletin of Statistics*, December 1998; International Monetary Fund, *International Financial Statistics*, January 1998; and national sources.

^a 16 July 1999.

ABBREVIATIONS

ADB	Asian Development Bank
AFTA	ASEAN Free Trade Area
AIER	American Institute for Economic Research
APEC	Asia-Pacific Economic Cooperation
ARIC	Asian Recovery Information Center
ASEAN	Association of Southeast Asian Nations
BIS	Bank for International Settlements
CIS	Commonwealth of Independent States
CPI	consumer price index
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ECE	Economic Commission for Europe
ECO	Economic Cooperation Organization
EU	European Union
FDI	foreign direct investment
FSAP	Financial Sector Assessment Programme
GDDS	General Data Dissemination System
GDP	gross domestic product
GNP	gross national product
GSP	generalized system of preferences
HIV/AIDS	human immunodeficiency virus/acquired immune deficiency syndrome
IAIS	International Association of Insurance Supervisors
IAPC	International Auditing Practices Committee
IASC	International Accounting Standards Committee
IFAC	International Federation of Accountants
IIF	Institute of International Finance
ILO	International Labour Organization
IMF	International Monetary Fund

ABBREVIATIONS *(continued)*

IOSCO	International Organization of Securities Commissions
IT	information technology
NGO	non-governmental organization
NPL	non-performing loan
ODA	official development assistance
OECD	Organisation for Economic Cooperation and Development
OPEC	Organization of the Petroleum Exporting Countries
PECC	Pacific Economic Cooperation Council
PIN	Public Information Notice
SAARC	South Asian Association for Regional Cooperation
SAPTA	SAARC Preferential Trading Arrangement
SDDS	Special Data Dissemination Standard
SDRs	special drawing rights
SME	small and medium-sized enterprise
SPECA	Special Programme for the Economies of Central Asia
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
VAT	value added tax
WTO	World Trade Organization

PART ONE

**RECENT ECONOMIC AND SOCIAL
DEVELOPMENTS**

GLOBAL ECONOMIC DEVELOPMENTS AND IMPLICATIONS FOR THE ESCAP REGION

OVERVIEW

The world economy exhibited several welcome developments in 1999. The United States of America managed to sustain a remarkable growth momentum, robust consumer demand and a tight labour market did not undermine domestic price stability, and the stock market avoided any major correction despite recent volatility. These positive developments in the United States coincided with the budding economic recovery in Japan, the maintenance of reasonably healthy growth in a large part of Asia, and positive trends in production and employment in several of the Asian economies hit by the crisis underpinned by falling interest rates, fiscal stimulus, higher export earnings and reserves, and improved investor and market confidence. All these developments combined to raise global growth estimates by almost one percentage point in real terms during the second half of 1999, compared to forecasts made at the beginning of 1999. The improvement in global economic performance and outlook expected for the year 2000 provides a sharp contrast to the relatively bleak prospects of the world economy as perceived by many at the beginning of 1999.

However, the relatively brighter picture envisaged for the year 2000 will have to be tempered by a number of possible downside risks. Most notable among them is the sustainability of the exceptionally strong growth in the United States economy and of the economic recovery in Japan. The upturn in oil and, to a lesser extent, commodity prices should give a boost to a large number of developing countries, but it may also induce some monetary tightening to contain the risk of inflation, constraining global and regional economic expansion in the process. Cross-border capital flows remain highly risk-averse with considerable interest spreads and

volatility, notwithstanding the easier financial conditions worldwide. Among other concerns are the large and rising private dissavings, the potential of a drastic correction in the stock markets in the United States and the slow pace of restructuring in labour and product markets in several European Union (EU) members. At the same time, developing countries will have to make substantial progress in implementing a variety of structural reforms, including in the financial and corporate sectors. There is also the need for human and institutional capacity-building, as well as for better social security and social protection for all.

The year 1999 marked another year of robust economic performance by the United States, with unemployment at a record low and remarkable price stability. EU displayed signs of a gradual improvement in output from the latter part of the year. Inflation continued to remain at very low levels and unemployment also began to decline gradually in EU last year. On the back of a succession of large fiscal stimuli, the Japanese economy exhibited encouraging indications of revival in the latter part of 1999, after five quarters of negative growth. The global stock markets continued to suffer from periodic bouts of volatility in investor sentiment, but did not suffer any major upset in 1999 as a whole. Indeed, many markets showed respectable gains during the year, with the Japanese stock market being especially buoyant.¹

The Asian crisis and its reverberations continued to be the primary focus of attention in both official and academic circles during much of 1999. Nevertheless, there was growing evidence that

¹ The Nikkei 225 stood 39.6 per cent higher in United States dollar terms on 3 November 1999 than its level on 31 December 1998.

economic recovery among the crisis-hit countries had entered a more positive phase from the first or second quarter of 1999; several of them had experienced a deep contraction in output and employment during 1998. The extent and pace of restructuring in the financial and corporate sectors would exert an important influence over the patterns of economic growth and diversification in East and South-East Asia in the near to medium term. Gross domestic product continued to expand at or near its recent trends in most other Asian developing countries.

Reflecting in part these positive developments, world trade showed a small increase in value terms in the first half of 1999, compared to the same period of the previous year. Rising oil prices and greater firmness in a number of commodity prices provided a further impetus to the nominal gains in world trade during the second half of 1999. Remarkable stability in producer and consumer prices, by and large, prevailed in the world economy during 1999, except notably in Central Asia and the Russian Federation. Inflationary pressures had been subdued since the early 1990s. Given the strong policy stance to preserve price stability, particularly among developed countries, the outlook for a continuation of this global trend remained favourable for the coming year.

The return of financial stability and improved growth prospects were accompanied by signs of a modest recovery in capital flows to the developing countries, including those in the Asian and Pacific region during 1999. The earlier fears of a generalized credit crunch in the wake of the financial crisis in the Russian Federation proved unfounded. Nevertheless, the gross volume of such inflows (totalling \$103.6 billion up to August 1999) would only be marginally higher than the previous year's level of \$148.5 billion, which represented a precipitate decline from the pre-crisis inflow to all emerging markets, averaging \$252.2 billion a year in 1996-1997.

Against these favourable developments, however, the major economies of Latin America weakened perceptibly and slipped into recession, in part the result of financial market turmoil that had hit them in late 1998 and early 1999. The Central Asian economies showed only fitful progress in dealing with longstanding structural and financial

sector problems; they continued to suffer from constrained access to foreign capital markets. The economy of the Russian Federation rebounded with surprising vigour after the turmoil of 1998 but with few signs of a breakthrough on the domestic fiscal front or in the renewal of foreign investor confidence. In Africa and West Asia, economic performance and prospects remained mixed. As in previous years, political problems and military conflicts had posed a major impediment to sustained restructuring and durable economic progress in a number of developing countries in Africa.

This chapter reviews the broad macroeconomic trends in the developed and developing economies in 1999. An assessment will also be made of the implications of the trends in global trade and financial flows for the ESCAP region.

RECENT GLOBAL MACROECONOMIC TRENDS

Developed countries

Table I.1 summarizes the salient features of the global economy in recent years. Perhaps the most noteworthy aspect has been the tremendous resilience of the United States economy. Its undiluted strength added to the growth rate for the global economy in 1999; it also played a significant role in the rapid turnaround of the crisis economies in Asia. Indeed, contrary to widespread predictions of an imminent slowdown in the American economy, growth in output was sustained at just under 4 per cent per annum in 1999, and for the two preceding years as well. Such expansion, which was noticeably above the recent long-term trend, took place in an environment of remarkable price stability. In addition, from the various indicators now available, actual performance is likely to remain strong so that by April 2000 the current period of economic growth in the United States will have been the longest on record. Furthermore, unemployment at 4.1 per cent in October 1999 had declined to its lowest level since the 1960s.

Some analysts suggest that the United States economy has been reaping the huge benefits from significant investments in information technology and

Table I.1. Selected indicators of global economic conditions, 1996-2000

	1996	1997	1998	1999 ^a	2000 ^b
Economic growth (percentage change of GDP)					
World	3.0	3.2	1.6	2.6	2.8
Developed economies	2.9	2.6	1.8	2.5	2.2
Japan	3.9	0.9	-2.9	0.9	1.0
United States of America	3.4	3.9	3.9	3.9	2.4
European Union	1.7	2.5	2.7	2.1	2.6
Developing economies	5.7	5.5	1.2	3.3	5.1
Economies in transition	-0.1	1.7	-0.4	1.6	2.2
Growth in volume of trade (percentage)^c					
World	6.8	9.9	3.6	3.7	6.2
Developed economies					
Export	6.3	10.3	3.2	3.0	6.2
Import	6.5	9.2	4.8	5.9	5.9
Developing economies					
Export	8.8	11.4	4.9	2.4	5.6
Import	8.3	11.4	-1.3	1.1	7.2
Commodity prices (annual percentage change; US dollar terms)					
Non-fuel primary commodities	-1.2	-3.3	-14.8	-7.2	3.4
Oil	18.4	-5.4	-32.1	27.7	7.8
Inflation rate (percentage)^d					
CPI in the developed economies	2.4	2.1	1.5	1.4	1.8
CPI in the developing economies	14.6	9.2	10.3	6.7	5.8
Exchange rates (nominal units per US dollar; 1995 = 100)^e					
Yen per US dollar	115.6	128.6	139.1	125.9	126.7
Deutsche mark per US dollar	105.0	121.0	122.8	127.5	121.4
Euro per US dollar				0.86-0.94 ^f	

Sources: United Nations, "Project LINK World Outlook: summary", 1 November 1999; IMF, *World Economic Outlook* (Washington DC), October 1999; and *OECD Economic Outlook* (Paris), June 1999.

^a Preliminary estimate.

^b Forecast.

^c Exports and imports (goods and services).

^d Developed and developing economies ratios weighted at purchasing power parity.

^e Period average.

^f Exchange rate between January and August.

other new or productivity-enhancing technologies.² Such capacity-building has simultaneously raised the long-term rate of growth and kept inflationary pressures muted. Flexible labour and product markets have also played a part in sustaining growth with price stability. Higher productivity gains and subdued cost pressures have been reflected in the strong growth of corporate earnings over the last two to three years, notwithstanding a temporary hiccup in late 1998. This served to underwrite increased

levels of business investment and the upward movement of stock market price indices. Such had been the rise in stock market prices in the United States that the price-earnings ratio in early 1999 was close to 30, approximately double its average between 1970 and 1990.³

The substantial capital gains, in turn, supported high levels of household consumption. But as mentioned in *Survey 1999*,⁴ the wealth effects of

² For a discussion of recent productivity trends in the United States economy, see Richard Herd, "United States: riding out the boom", *OECD Observer*, No. 217/218, Summer 1999.

³ *OECD Economic Outlook*, June 1999, p. 20.

⁴ *Economic and Social Survey of Asia and the Pacific 1999* (United Nations publication, Sales No. E.99.II.F.10).

rising stock market prices had also contributed to a relatively sharp reduction in the household saving rate. In the middle of 1999, for example, the average household in the United States was spending more than its disposable income.⁵ The fall in private savings was offset only partially by the government's budget surplus, thus contributing to a large deficit in the external current accounts. Moreover, high levels of capital expenditure by the corporate sector and rising consumption outlays by households had together generated a strong demand for credit, leading to a rapid growth in total bank lending and the money stock. Partly as a result, yields on both corporate and government bond rose by around 1.5 percentage points between the third quarter of 1998 and the third quarter of 1999. The financial markets therefore expected inflation to pick up modestly at some point in the near future, given the low level of unemployment.

While the sustained, overall strength of the United States economy bears eloquent testimony to sound policies, a number of other factors also played a supportive part over the last two to three years. The cumulative gains in equity values clearly enabled individuals to maintain consumption expenditure at high levels and corporations to invest in capital equipment beyond what might otherwise have been possible. Low commodity prices and the sustained strength of the dollar contributed to the prevention of inflationary pressures. The latter, in turn, contributed to, as well as benefited from, restrained real wage gains, despite a tight labour market.

A major issue of worldwide interest and concern has been the sustainability of American economic growth over the next few years. Typically, a slowdown occurs when low unemployment and tight labour markets cause wages to escalate faster than productivity; inflation picks up and interest rates have to be increased. Many analysts maintain the view that, despite recent productivity gains in the United States, skill shortages and wage pressures are likely to emerge, especially with the unemployment rate as low as 4.1 per cent. Apart from the possibilities of a wage hike and higher inflation, there are other concerns. These include the large and rising volumes of private dissavings and a high

current account deficit, which was estimated at over 3.5 per cent of GDP in 1999. The sustainability of stock market price indices would be another possible area of risk, as already noted.

The strength of the American stock market, however, is not an unmixed blessing. Most categories of stock price indices in the United States have kept on rising over the last few years. A wide range of stocks issued by established or new enterprises, especially those engaged in the development or application of new technologies, can remain buoyant, feed self-sustained optimism and rising stock values, and contribute to the strong growth of the economy. But when high stock values are associated with increasing levels of net dissavings and credit extension to (and indebtedness of) the private sector, then a restoration of household savings to the long-term trend average can trigger reduced consumption and lowering of corporate revenues and earnings, with an adverse impact on growth. Equally, a fall in household dissavings independent of any decline in the stock markets could precipitate a major decline in consumption and corporate sales and earnings, leading to a fall in stock market prices and further adverse effects.

The private sector financial balance in 1999 fell to about -4.7 per cent of GDP in the United States;⁶ such a deficit in the private sector financial balance had never exceeded 1 per cent in the United States over the previous five decades.⁷ Further increases in dissaving are regarded as unsustainable as they would lead to inordinately large private debt levels possibly triggering substantial increases in borrowing costs. At some stage, therefore, private savers could be expected to rebuild their savings and reduce their spending, not least to lower the debt-service burden. Whether consumption and thus GDP growth would decline gently or abruptly in consequence is very difficult to predict.

Thus far, the general mix of domestic policies, and monetary measures in particular, has been highly successful in smoothly steering the American economy through the financial turmoil of the past three years and in maintaining the momentum of growth in output and employment without the penalty

⁵ *OECD Economic Outlook*, June 1999, p. 40.

⁶ *OECD Economic Outlook*, June 1999.

⁷ *The Economist*, 25 September 1999, p. 15.

of overheated cost pressures and unsustainable debt accumulation. The policy challenge appears to be in ensuring a gentle descent and slowdown in economic growth to a more manageable and sustainable level (of between 2.5 and 3.5 per cent) without provoking a large sell-off in the stock markets. The risk is that monetary gradualism may not be entirely adequate to restrain optimism and consumer spending, and corporate enthusiasm about business investment and rationalization, including through mergers and takeovers.

Turning now to EU, some of the euphoria generated by the introduction of the euro on 1 January 1999 dissipated as the new currency weakened significantly against the dollar. In hindsight, the depreciation proved a blessing in disguise as it reversed, to some extent, the weaknesses in economic performance that had characterized many of the EU economies prior to the introduction of the euro. Growth indeed picked up in the 11 economies of the euro zone in the latter part of 1999, in part due to improved price competitiveness. Unemployment levels also began to decline slowly in the 11 economies of the euro zone. Elsewhere in Europe, too, growth in 1999 was higher than had been forecast at the beginning of the year, partly on account of the economic expansion in the euro zone itself and partly because of other favourable factors, including the supportive strength of the American economy.

Despite this recent improvement, growth performance within EU has been considerably weaker than that of the United States since the early 1990s. Its record was also poorer than that achieved by most EU members themselves in the 1980s. The 11 economies of the euro zone are faced with a range of difficult policy issues in sustaining higher growth trajectories in the short and medium term. On the fiscal side, the Maastricht treaty requires further fiscal consolidation; member countries have to eliminate their structural deficits progressively so as to ensure fiscal positions close to overall balance or to achieve a budget surplus by 2002. This leaves the task of managing the pace of growth almost exclusively to monetary policy, the mandate of the European Central Bank (ECB).

Monetary policy stance in the euro zone is now concerned with all the 11 member countries in monetary union; it cannot therefore be tailored

to deal with specific conditions and circumstances in individual countries. Moreover, inflation is to be kept within the target band of 0–2 per cent per annum; ECB has no mandate to pursue higher growth in output and hence employment. The relatively weak performance until recently of the larger economies in the euro zone, especially Germany, Italy and, to a lesser extent, France, contrasted with the rapid economic growth in some of the smaller member countries such as Finland, Ireland, Portugal and Spain. However, ECB raised its refinancing rate by 0.5 percentage points to 3.0 per cent in November 1999. Another supply-side factor that might serve to constrain or impede the achievement of higher growth in EU relates to the extent and pace of restructuring in labour and product markets within the 11 economies of the euro zone despite considerable progress made in these respects.

By and large, unemployment in EU persisted at historical highs with only minor reductions during the recovery in 1997–1998, and in 1999. Longer-term supply factors, such as labour and product market rigidities, remained at the heart of the problem. This was especially true in Germany, where part of the unification costs had been met by levies on wages, thereby raising the cost of labour. The lower productivity of workers in the former German Democratic Republic was another factor in keeping unemployment high. However, several major steps to address these issues, taken recently by the Government of Germany, have boosted business confidence in the country; the pertinent measures included a reduction in pension contributions by employers, early retirement options and an expansion of youth training facilities and programmes. In comparison, the French economy performed better, partly because it did not have to meet the high fiscal costs as in Germany on account of unification. As a result, the extent of fiscal consolidation that had to be made prior to the introduction of the euro in France was smaller as a percentage of GDP. The poorer performance of Italy could also be attributed largely to previous fiscal profligacy; the fiscal consolidation required over the span of two years amounted to some 9 per cent of Italy's GDP. Furthermore, both Germany and Italy had been more heavily exposed financially and otherwise, and were thus more vulnerable to the severe financial and economic crisis in Asia and in the Russian Federation.

Outside the 11 economies of the euro zone, growth picked up in the United Kingdom of Great Britain and Northern Ireland in the second half of 1999. The slowdown in late 1998 and early 1999 was occasioned by the weakening of external demand; in turn, this could be attributed to the strengthening of sterling and the consequent sharp decline in net exports. Interest rates were reduced in April and June 1999 to achieve some economic stimuli; core inflation stayed well below its target rate of 2.5 per cent. Thereafter, economic activities picked up fairly rapidly so that interest rates were raised marginally in September and then in November 1999 to choke off any incipient inflationary pressures. The brevity of the recent economic slowdown in the United Kingdom provided a sharp contrast to previous experiences. This achievement can be attributed primarily to a policy-induced environment of low inflation which, in turn, has allowed interest rates to be adjusted more quickly and often in response to marginal changes in economic activities. Extensive labour and product market reforms carried out in the 1980s have also facilitated speedier outcomes of policy changes.

As a whole, any significant improvement in growth performance in the 15 economies of the European Union in the year 2000 and beyond will depend greatly on the extent and pace of structural reform in the largest economies. First of all, further labour market reforms that would help to reduce structural unemployment could be expected to raise output fairly quickly. Reforms in the product markets, such as in telecommunications, retailing and utilities, and greater flexibility in zoning laws could also achieve similar results. Other than in the United Kingdom, progress in such areas of policy and structural reforms has not been speedy in the larger EU economies.

The slow pace of reform has possibly also impeded or constrained a faster and wider absorption of information technologies and other new technologies in many of these economies. Such technologies greatly improved the performance, as well as the resilience, of the United States economy in the 1990s, as discussed in some detail previously in this chapter. A possible stimulus to economic performance relates to the gradual convergence to higher income levels in the poorer EU economies; the process could promote increased competition and greater efficiency in EU as a whole. But such income convergence and the associated efficiency

gains are likely to eventuate in the long run. On balance, it is unlikely that EU as a whole will become an alternative to the United States as a source of significant demand for exports from developing countries over the next few years.

Turning now to the ESCAP region, there is increasing evidence that the Japanese economy has finally bottomed out, with much of the recovery so far gained being a direct result of a series of major fiscal stimuli provided by the government in 1998 and 1999. Output growth was estimated at just under 1 per cent in 1999, compared to a contraction of almost 3 per cent the year before. However, these fiscal packages did not promote higher consumer spending or even higher consumer confidence. Unemployment, at 4.6 per cent in September 1999, remained stubbornly high by Japanese standards, while low levels of capacity utilization and large inventories persisted in the manufacturing sector, especially in activities less exposed to international competition.⁸ In addition, the recent appreciation of the yen has compounded some of the current difficulties.

There was no let-up in the pace of decline in business investment as companies grappled with and sought to reduce overcapacity and large volumes of inventories. Overcapacity was responsible not only for the significant slack in the economy but also for making cost-cutting efforts an indispensable, ongoing feature of Japanese economic life. Such efforts, in turn, tended to add directly to deflationary pressures, aggravate indirectly the bad loan problems in the financial sector, and lower consumer confidence. There was a marked improvement in the performance of the banking sector in 1999 but it is commonly felt that a full resolution of the substantial amount (in absolute terms) of non-performing loans will take considerable time.

On a brighter note, business confidence showed credible signs of improvement and the rate of new bankruptcies slowed down noticeably. Nevertheless, policy makers continued to face a formidable array of challenges in initiating and sustaining the ongoing process of economic rationalization for stronger and more durable growth

⁸ Bank of Japan, *Monthly Report of Recent Economic and Financial Developments*, September 1999.

performance in the near to medium term. The multidimensional reforms will not only involve widespread re-engineering of business corporations and lay-offs of workers for enhanced cost efficiency but also require considerable restructuring and consolidation of the financial sector. In macroeconomic policies, a critical area of concern is the rising fiscal deficit emanating from several large public spending packages to stimulate the economy. On current assumptions, the deficit will be over 9 per cent of GDP in both 1999 and 2000.⁹

A noticeable reduction in such a high level of fiscal deficit will not be a viable proposition until the recovery has taken hold, given the need to support economic turnaround through fiscal means. Monetary policy has been supportive of the expansionary fiscal stance, but limited scope exists for further easing of monetary conditions, especially with overnight rates of interest being close to zero. However, financial market concerns over the expanding volume of public debt have already been reflected in upward pressures on long-term interest rates in Japan. It has been suggested in this connection that part of the fiscal deficit should perhaps be monetized. If the central bank were to purchase and hold more government bonds, yields would not need to rise to provide the needed premium for private investors to hold more public debt. In the process, the money supply and financial system liquidity would expand, and inflationary expectations would rise; these would then serve to counter or weaken some of the recent strength acquired by the yen, sharpening export competitiveness in the process.

These debates have underlined the difficult choices and trade-offs facing policy makers in Japan. Against this backdrop, it is clear that structural reforms would play a critical role in determining the depth and durability of Japan's economic recovery. The problems of the banking sector were discussed at some length in *Survey 1999*. The recognized need for faster progress with the banking sector's restructuring, recapitalization and consolidation is highlighted by the prospective replacement in March 2001 of the blanket deposit insurance scheme currently in operation with a more limited system. The banking sector plays a greater role in Japan than in any other developed economy. As such, it is of vital importance that the sector regains

profitability in its core activities so as to provide the fullest support for Japanese economic revival.

The prospects of successful financial sector consolidation and recapitalization are intimately linked to the resolution of the problems within the corporate sector; the latter depend, in turn, upon the effectiveness and timeliness of both public and private sector measures to reduce excess capacity, large inventories and overmanning in manufacturing. Progress in these areas has not been as speedy as is desirable. Taking all these factors into account, it is unlikely that the Japanese economy will grow appreciably faster than the 0.9 per cent expected for the 1999 fiscal year (ending 31 March 2000).¹⁰ A further major fiscal package equivalent to \$172 billion was introduced towards the end of 1999. This should prevent the economy from sliding backwards in 2000. However, it is the structural reforms and the reinvigoration of consumer confidence that would have a more lasting bearing on economic performance in Japan over the medium term.

Australia, one of the three developed countries of the ESCAP region, has performed strongly in recent years. Rising consumer expenditure contributed to another vigorous rate of economic growth of over 3.4 per cent in 1999. On the other hand, the after-effects of the Asian crisis served to widen the current account deficit to over 5 per cent of GDP. Sound macroeconomic fundamentals prevented a further weakening of the Australian dollar, despite relative stability in domestic interest rates. Some degree of economic slippage is possible now that investment expenditure has started to weaken in the face of poorer export prospects. In New Zealand, the economy moved out of the recession of 1998, and output growth was expected at around 2.2 per cent in 1999, with a possible acceleration in 2000 if world economic expansion continues at rates currently projected. The effects of the Asian crisis and the attendant volatility in domestic financial markets were substantially moderated during the latter part of 1999. In fact, the New Zealand economy has been enjoying renewed competitiveness and rising business and consumer confidence. The latter reflects the considerable progress made so far in restructuring corporate and household balance sheets, a process which is inevitable after a recession.

⁹ *OECD Economic Outlook*, June 1998.

¹⁰ Recent private sector forecasts suggest a GDP growth rate of 1 per cent for the fiscal year ending in March 2000.

Developing economies

The worst periods of output contraction ended during the first or second quarter of 1999 among the economies hit by the crisis in the ESCAP developing region. The economic consolidation and recovery phase appear to have begun firmly, with the Republic of Korea showing the most dramatic improvement in levels of production, exports and employment. The turnaround process had these common characteristics. First, there was the reversal of the extreme depreciation in the exchange rates which had persisted until the middle of 1998. Second, inflationary pressures were initially contained and then substantially moderated, and this allowed interest rates to fall significantly from the very high levels which had existed up to mid-1998. Third, a rapid turnaround was achieved in the balance of payments, initially based upon a sharp compression of imports but lately reinforced by buoyant export earnings despite the increased outflows resulting from a revival in import spending. Fourth, foreign exchange reserves were built up in the process, to higher levels than before the crisis in some cases. Fifth, domestic and international investor confidence and external perceptions of local credit risks improved significantly. However, the steady recovery in stock prices and a narrowing of international bond yield differentials were also accompanied by considerable instability in the financial markets of the crisis economies in the latter part of 1999. This was partially a reflection of the slow pace of progress with financial and corporate sector restructuring, the continuing overhang of substantial levels of non-performing loans, corporate indebtedness and excess capacity. Such volatility was also due to the ripple effects of other factors, notably the political turmoil in Indonesia, uncertainties as regards the value of the yen and fluctuations in the perceptions of foreign investors not necessarily related to objective conditions.

Economic performance remained encouraging outside the crisis economies of the ESCAP developing region, as has also been the case in the recent past. The rate of output growth in China is estimated at 7.2 per cent for 1999; this is marginally lower than the rate for the previous year but is clearly healthy by regional standards. India achieved a slightly lower GDP growth in 1999 than in 1998.

The country benefited considerably from a strong performance in agriculture and exports, particularly of computer software. Inflationary pressures also abated in India during the year. Growth in output and incomes among most other developing countries in the region was not dramatically different from recent trends.

The Asian crisis induced a steep drop in capital flows to many Latin American countries. Monetary policy in most of the larger economies of that region was tightened so as to stem the outflow of capital. The problems created by resultant higher interest rates were made much worse by the sharp decline in commodity prices that had occurred during 1998 and that persisted into 1999. The overall outcome was a fall in export earnings and larger current account deficits in most Latin American economies. Output growth consequently turned negative during 1999 in the five largest economies (namely Argentina, Brazil, Chile, Colombia and Venezuela). Only the Mexican economy had recorded some positive gain in GDP during the 12 months to mid-1999, albeit at a decelerating pace. Even with some recovery in production during the second half of 1999, aggregate GDP for the region is likely to have contracted by one percentage point for the year as a whole. This estimate presumes no further disruptions in Latin American financial markets and assumes that economic growth will continue at its recent pace in the United States. The recent rise in oil prices, the general pickup in commodity prices and some easing of monetary conditions in the region suggest the likelihood of positive growth in 2000.¹¹

African and West Asian economies are primarily commodity-dependent. For these economies, integration with the world economy, other than through trade flows, remains negligible or limited and developments in the external financial markets tend to have a diluted bearing on their economic performance. In 1998, export earnings had declined sharply and, as in Latin America, there was a concomitant widening of the current account deficits in many African and West Asian economies. In Africa, the consequent deficits were funded mainly by official development assistance

¹¹ *Financial Times*, 5 November 1999.

(ODA); external deficits in West Asia had been funded largely by drawing down foreign exchange reserves.

GDP growth in most of Africa was expected to be about 2–3 per cent in 1999; this was about the same pace as that realized a year earlier, notwithstanding somewhat firmer commodity prices in the latter part of 1999. There was, on the other hand, considerable intraregional variability attributable to economic and other factors; the latter included political and civil unrest. Regarding the former, some improvement in foreign exchange earnings, as well as marginally easier access to external finance, should be the experience of the larger countries of North Africa, and of South Africa, in 1999. These economies are at comparatively higher development stages; they are also more closely integrated with the global economy, including EU, in terms of both trading and financial linkages. Many of the less developed economies in Africa continue to suffer from acute structural problems, including large fiscal deficits, inefficiency in production, market rigidities, inadequate infrastructure and human resources, and debt-service burdens that have long been unsustainable. The recent initiative designed to address the latter problem among highly indebted poor countries should provide them with relief over the medium term, but its benefits and impact are expected to be incremental. In the short run, therefore, economic performance in the African developing region will continue to depend heavily upon commodity prices.

In West Asia, the economic outlook has recently become much better than it has been for some time because of the sharp increase in the price of oil exports. Oil production levels and unit values are the major determinants of economic performance of most West Asian economies. Such windfall gains by no means lessen the pressing need for policy adjustments and economic restructuring in at least three main areas: wide-ranging fiscal reforms; the diversification of output and the promotion of higher value-adding activities; and a sizeable redirection of public spending for human resources development and skill enhancement. These are essential to improve domestic efficiency and flexibility in both factor and product markets. Such reforms and restructuring are also indispensable for ensuring and sustaining higher trajectories of (equitable) output growth and greater diversification in the medium and long term.

On balance, the developing countries as a group could record an appreciable improvement in economic performance in 2000, compared to that of the preceding year. This assessment has to be tempered by the following considerations, some of which were discussed at length earlier in the chapter. On the external front, there are still appreciable uncertainties concerning the economic performance of the United States, EU and Japan in 2000 and the years immediately beyond. On the domestic front, the durability of the growth of the developing countries, and diversification in their output and employment in the near to medium term, will depend on their success in implementing multisectoral policy reforms and restructuring. At the same time, local human resources and institutions will need to be built up and strengthened to handle more satisfactorily the increasingly complex requirements of integration into the emerging knowledge-driven global economy.

TRADE AND CAPITAL FLOWS

Trade

The sustained and buoyant growth in world trade (both exports and imports of goods and services) has been one of the most striking features of the global economy in the 1990s; this has been discussed at some length in several previous issues of the *Survey*. Between 1990 and 1997, for example, world trade in goods and services increased by 52 per cent in dollar values, from \$4.3 trillion to \$6.5 trillion. In volume terms, the average growth rate of global trade, at 6.7 per cent annually, significantly outpaced the expansion in global production, at 3.0 per cent per annum, during the same period. By 1998, the ratio of world trade in goods and services to global GDP had increased from 19 per cent in 1990 to 23 per cent.

The growth trends in world trade, however, decelerated sharply in both value and volume terms in 1998; and so did the rate of global production. A sharp decline in trading volumes in the wake of the crisis in Asia, accompanied by lower commodity prices, contributed to the steepest decline in the nominal value of world trade since 1982, growth in volume terms being 3.6 per cent in 1998, and 9.9 per cent a year earlier (tables I.1 and I.2). The price of manufactured goods also fell but by less than that of raw materials, thus causing significant

Table I.2. External trade of selected economies, 1997-1999

(Billions of US dollars)

	Exports			Imports		
	1997	1998	1999 (Jan.-Sep.)	1997	1998	1999 (Jan.-Sep.)
World	5 377	5 324	4 072	5 462	5 389	4 190
Developed economies	3 610	3 622	2 790	3 609	3 687	2 910
Japan	421	388	302	389	281	221
Developing economies	1 558	1 499	1 140	1 611	1 463	1 121
ASEAN	330	303	249	336	254	209
China	183	184	83 ^a	142	140	75 ^a
Hong Kong, China	188	174	126	209	184	130
India	34	34	17 ^a	41	43	21 ^a
Republic of Korea	136	132	102	145	93	84

Source: United Nations, *Monthly Bulletin of Statistics*, January 2000.

^a January-June.

losses in the terms of trade for countries producing raw materials, and fuel exporters in particular (terms of trade declined by 20.2 per cent for these exporters relative to 6.9 per cent for developing countries as a group). Up to the third quarter of 1999, world trade had grown marginally in value terms compared to the same period in 1998; as a whole, the recovery from the contractionary level of the previous year's trade values and low growth in volume is expected to be modest in 1999. A faster pace of world trade will be more likely in 2000.

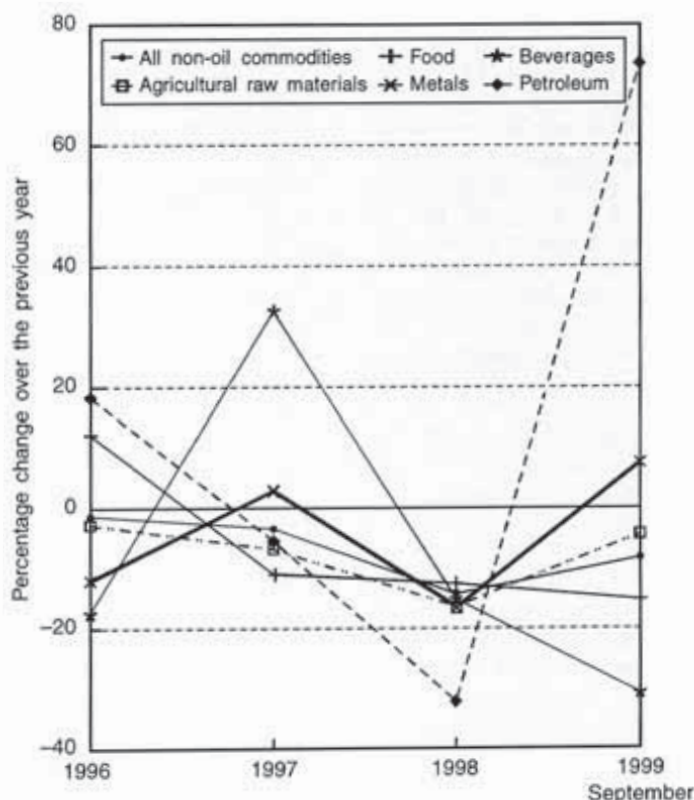
The above estimates embody a combination of diverse movements. Domestic production and exports were picking up in the crisis economies of Asia, and so the value of imports could be running significantly higher in the second half of 1999. On the other hand, however, a reduction in import demand in Latin America can be expected, given the contraction in output in the region in 1999, as discussed earlier. Among the developed countries, the United States economy has been the source of much of the buoyancy in import demand over the past several years. Economic growth remains robust in 1999, but it is unlikely that there will be any significant increase in United States import demand for the year compared to that of 1998. Asymmetrically, however, a slowdown in this economic powerhouse could have a sharp impact on import demand,

and on the import of consumer goods especially. This is perhaps the biggest and most uncertain element in global trade in the coming years. A stronger performance in EU and Japan could provide a boost to world trade growth in both volume and value terms, but is unlikely to compensate for any major decline in import demand in the United States.

The recent trends in global trade deserve a few comments. The significant depreciations in the exchange rates of the Asian crisis economies since late 1997 have improved their export competitiveness, but this was not reflected in higher levels of actual export earnings until well into 1999. The positive impact was delayed because of weakened external demand for all major commodity groups; such weaknesses had become evident in 1998 and persisted well into the middle of 1999. The export prices of manufactured goods, with only some minor exceptions, were also affected adversely by the regional and global economic slowdown and poorer demand and, perhaps, price competition among developing country exporters.

These unfavourable price trends were reversed, most dramatically in the case of oil, from March 1999 onwards (figure I.1). By November 1999, for

Figure I.1. Changes in world primary commodity prices, 1996-1999



Source: IMF, *International Financial Statistics*, November 1999.

example, oil prices were almost 100 per cent higher than the levels prevailing up to mid-1998. This upturn was largely the result of production cuts by the members of the Organization of the Petroleum Exporting Countries. Other commodity prices, especially those of food and non-food agricultural commodities, also experienced a renewed upswing, albeit of a much more modest magnitude; export prices of metals were beginning to firm up as well. Lower stocks and inventories of commodities and recovery-led increases in demand were the major causes of the reversal and upturn in commodity export price trends in the latter part of 1999.

At present, the gains in oil prices are tied in with production restraints. Their impact in terms of

higher export earnings can be large only with a sustained expansion in external demand to offset the lower volumes traded. Some exporting countries could opt, in the first instance, to replenish reserves; the windfall gains in export earnings may not translate into higher imports for some time. In the oil-importing countries, on the other hand, higher oil prices could lead to lower non-oil imports, especially of consumer goods, as oil demand is relatively more price-inelastic. The hikes in production costs and domestic prices resulting from higher prices of oil and other commodities could conceivably trigger a tighter policy stance to reduce fiscal and external account deficits, and choke off any incipient inflationary pressures. This could affect overall economic performance in both the developed and the developing regions.

Box I.1. Globalization after the Seattle debacle

The establishment of WTO represented a major success of the international community in creating a rules-based system pertaining to some important aspects of the globalization process. However, the Third WTO Ministerial Conference, held in Seattle in November and December 1999, which was to advance the process further, could not come up with an agreed agenda for a new round of multilateral negotiations because of sharp divergences between the developed and the developing countries, and within them, on a wide range of issues. Some of the major stumbling blocks are briefly discussed below.^a

A second round of negotiations on trade liberalization during 2000 had been mandated under the Agreement on Agriculture. Several developing countries and the United States wanted the negotiations to aim at a progressive elimination of export subsidies and a substantial reduction in domestic support. Other WTO members, including EU, Japan, Norway, the Republic of Korea and Switzerland, emphasized non-trade concerns and the multifunctionality of agriculture. A large number of developing countries, which have been heavily dependent on agriculture for employment and output, wanted a consolidation and extension of the special and differential provisions in various agreements, including the Agreement on Agriculture. On the other hand, the possible increases in world food prices emanating from lower agricultural subsidies from the developed countries was a matter of significant concern for the net food importers among developing countries. There were still other WTO members who wished to see substantial cuts in the persistent barriers to their agricultural trade, especially the high tariff peaks and tariff escalation on processed agro-products and manufactured goods.

A process of comprehensive negotiations was favoured by, among others, EU, Japan and a number of developing countries in Asia and Latin America which are exporters of agricultural products. This would serve

^a For further details, see "The Seattle crisis and post-Seattle strategy", paper prepared by the Group of Fifteen, Federation of Chambers of Commerce, Industry and Services, Cairo; and Anwarul Hoda, "Imperatives for South-South cooperation in the multilateral trading system", paper presented at the ESCAP Seminar on Interregional Cooperation in Trade and Investment: Asia - Latin America, Bangkok, 15 and 16 February 2000.

to diffuse attention away from the politically sensitive issue of agriculture and offer scope for the cross-sectoral give-and-take that is essential to achieve ambitious results. But many other countries had not expected or did not favour a comprehensive approach; they felt insufficiently prepared for this purpose. Moreover, fundamental differences persisted over the inclusion of the so-called four Singapore issues: investment, competition policy, transparency in government procurement, and trade facilitation.

Indeed, many developing countries preferred to adopt a minimalist agenda for negotiations, focusing largely on a range of issues involved in the implementation of the WTO agreements already reached. One of these issues, for instance, related to the scheduled liberalization in textiles and clothing. The process apparently had not led to a significant removal of quota barriers in the developed importing countries, and market access was considerably negated by such measures as transitional safeguards and restrictive rules of origin. In addition, many WTO members (including Japan, the Republic of Korea and some European countries) were strongly convinced that anti-dumping investigations were being utilized to impede trade flows and reduce competition. Also, developing countries often felt excluded from the creation of international standards with which they were expected to comply fully, even though these were beyond their own technical ability or financial capacity. Furthermore, they sought a review and, where necessary, amendments or tightening of WTO rules in the pertinent agreements, including those on subsidies and countervailing measures, and trade-related investment measures in order to give them more policy flexibility and greater security of market access.

Another deep fissure was in the area of international labour standards on which the United States and EU were keen to push for further action. Developing countries, on the other hand, suspected protectionist motives, especially if trade sanctions were to be imposed to enforce compliance with agreed labour standards. An informal proposal at Seattle envisaged the establishment of a joint ILO/WTO working forum on trade, globalization and labour issues. The forum would be outside the WTO structure, be open to the relevant international organizations, including the World Bank and UNCTAD, and would promote a better understanding of the substantive issues involved through the facilitation of interactive dialogue between governments.

Trade-related aspects of intellectual property rights were another important area of focus at Seattle. Many developing countries wanted the scope of protection to be extended to include such items as handicrafts and agricultural products. Other matters of concern included the lengthening of transitional periods, especially in the case of pharmaceuticals (from 2000 to 2003), the possible exemption of the World Health Organization list of essential drugs from patentability, and developing countries' own (technical and financial) capabilities to survey and record all available agricultural resources before 2005.

There were major procedural problems too. Initial negotiation in small groups of participants (usually major economies) was a common practice during the time of the General Agreement on Tariffs and Trade, but there were genuine fears in Seattle that the compromises reached through a similar process could undermine the interests of those who did not participate. A new modality was needed to ensure greater internal transparency and inclusion, given the much larger and diverse membership of WTO. The disruptions at Seattle also underlined the need for greater external transparency through, *inter alia*, more timely and extensive dissemination of information, as well as the greater involvement of all stakeholders, including civil society organizations.

It is against this backdrop of sharply divergent views that the tenth session of UNCTAD was held in Bangkok in February 2000. UNCTAD is not a negotiating forum and there was therefore no expectation that agreement would be reached on specific issues. Nevertheless, it is worth noting that the Bangkok Declaration which came out of this session agreed that globalization was an ongoing process that presented opportunities for countries to benefit, but also raised the risk of marginalization of countries, in particular the poorest countries, and of the most vulnerable groups everywhere. It was also agreed that globalization could be a powerful force for development, if it was properly managed. More specifically, the conference emphasized commitment to a multilateral trading system that was fair, equitable and rules-based, and that operated in a non-discriminatory and transparent manner and in a way that provided benefits for all countries, especially developing countries. That would involve, among other things, improving market access for goods and services of particular interest to developing countries, resolving issues relating to the implementation of WTO agreements, fully implementing provisions on special and differential treatment, facilitating accession to WTO and providing technical assistance. The future pattern of globalization and distribution of its benefits will be largely determined by the extent of the implementation of these commitments.

The buoyant expansion in world trade and the deepening interdependence among countries led to considerable efficiency gains. These have served to underpin the high rates of global and regional economic growth for most of the current decade. But it is also apparent that the benefits from the globalization of goods, services, finance and ideas have been highly uneven. The substantial anticipated gains have proved elusive or modest for many developing countries, particularly the least developed countries and other disadvantaged economies. Moreover, the downside risks of policy liberalization and globalization are real even for the strongest developing economies; they are also far greater than was presumed generally, as has been demonstrated by the experience in East and South-East Asia and Latin America (see box I.1).¹²

Capital flows

Among the ripple effects of the financial crisis in Asia was the ensuing turbulence in the Russian Federation and in Latin America and, temporarily, even in the financial markets of developed countries. Initially, alarms had been sounded by many observers about the breadth and the depth of the impact of the Asian crisis on the global economy. Indeed, fears were raised of a possible global recession through a generalized credit crunch and the reversal of capital flows to emerging markets in developing countries. The latter apprehension was not entirely unfounded. The net private capital flows to emerging markets were estimated at \$66.2 billion in 1998, compared to \$148.8 billion in 1997. Those channelled to the five Asian crisis economies, namely Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand, were \$29.6 billion and \$22.1 billion respectively during these two years.¹³

¹² UNCTAD, *Trade and Development Report, 1999* (United Nations publication, Sales No. E.99.II.D.1).

¹³ IMF, *World Economic Outlook* (Washington DC), October 1999, table 2.2.

In the event, however, the highly adverse repercussions as anticipated did not materialize. There was a fairly rapid return to stability in most financial markets, including those of the crisis economies. The impact of the crisis on global growth, with its ripple effects was short-lived (table I.1). A generalized credit crunch did not materialize and, by the third quarter of 1999, cross-border capital flows had recovered more or less to their level of 12 months earlier. Gross private financing to emerging markets in the developing region stood at \$103.6 billion as of August 1999, compared to \$148.5 billion for the whole of 1998 (table I.3).

Thus, the evidence suggests that the contagion of financial crises can indeed spread to virtually all corners of the globe. Their overall effect, however, can be contained partly by acquired depth and sophistication of global financial market centres, and partly by policy responses at both the international and the national level. For example, the highly developed state of the financial markets in the United States underpinned the attraction of dollar-denominated assets (such as government bonds and corporate equities). Besides, policy initiatives in the form of the three reductions in interest rates in October and November 1998 bolstered fragile investor confidence at an especially vulnerable stage.

Largely as a result, the stock and bond markets in the United States had recovered virtually all their losses by the end of 1998; the former also reached record levels in the first half of 1999. There

were some downward movements and renewed bouts of nervousness but, by and large, the overall market sentiment remained bullish. However, as the United States economy continued to grow strongly for much of 1999, the downward trend in interest rates was reversed so as to pre-empt overheating. Indeed, the strong pace of expansion of the United States economy and relative weakness of the EU economy led to expectations of still higher interest rates in the former and lower interest rates in the latter. Such expectations probably played their part in the depreciation of the euro, thus enhancing somewhat euro-zone export competitiveness in the course of 1999. But there were certain adverse developments within EU itself. The money supply expanded towards the third quarter of 1999 at a faster rate than originally expected and, in addition, signs of inflation in asset prices were emerging, especially in the stock markets. All this culminated in the imposition of a half-point increase in the refinance rate by ECB in November 1999.

Initially, Japan was worst affected by the crisis in Asia; the yen also weakened considerably in the aftermath. The successive packages of fiscal stimuli and large injections of liquidity served to reduce the nominal interest rates to almost zero and, at the same time, to raise bond yields significantly in Japan. The latter effect, coupled with a weaker yen, however, induced a substantial flow of external funds into Japanese financial assets; the process thus generated large gains in stock market prices as well as a considerable strengthening of the yen against

Table I.3. Gross private financing to emerging market economies, 1996-1999

(Billions of US dollars)

	1996	1997	1998	1999 ^a
Total	218.4	286.1	148.5	103.6
Asia	118.5	127.5	34.1	38.2
Percentage Asia	54.3	44.6	23.0	36.9
Equity ^b	127.7	162.9	88.1	72.1
Asia	62.3	68.5	16.4	27.8
Percentage Asia	48.8	42.1	18.6	38.6
Loan commitments	90.7	123.2	60.4	31.6
Asia	56.2	58.9	17.7	12.0
Percentage Asia	62.0	47.8	29.3	38.0

Source: IMF, *World Economic Outlook* (Washington DC), October 1999.

^a Up to August.

^b Comprising bond issues, other fixed income and equity issues.

the dollar. An appreciating yen at this particular juncture poses several adjustment problems. It could hamper the economic recovery in Japan via reduced export competitiveness. The consequent stagnation in corporate earnings and profitability could also limit consumption expenditure and ratchet up savings rates for precautionary purposes, adding to deflationary pressures. An appreciating yen could also necessitate adjustments in the exchange rates of major currencies across the globe, which might be an additional source of instability in the international financial markets.

The achievement of historically low rates of inflation in the developed economies is a striking feature of the 1990s; this stands in contrast to the relatively large volatility in the costs of money across space (exchange rates). The maintenance of low inflation is certainly a desirable objective of policy. However, it may have a bearing on the volume and pattern of capital flows from the developed to the developing countries. One particular concern in this regard is the induced fall in the prices of assets which serve as collateral for bank lending. A rise in real interest rates caused by a period of declining inflation can have a large negative impact on the value of such collateral. In turn, this could lead to a tightening of credit conditions, affecting both domestic and cross-border lending.

The experience of Japan since the early 1990s indicates that asset price deflation can exert a negative impact on the liquidity position of the banking system and induce highly risk-averse behaviour in lending operations. Such risk-averse intermediation, by and large, has characterized international financial markets in both the capital-exporting and the capital-importing economies in recent times. This is well illustrated by the trends in private financial flows to emerging markets (table I.3). The gross volume of such inflows in 1999 is unlikely to have exceeded the previous year's level by any substantial amount. The terms and conditions involved have also proved more onerous.

One bright feature in the above context of risk preoccupation is the improvement in the share of private capital flows to the emerging markets in Asia. The relative proportion reached almost 37 per cent as of August 1999, compared to 23 per cent for the whole of 1998. Such a relative gain translates into

only a marginal improvement in absolute terms and implies a corresponding tightening of the flows to other emerging markets outside Asia.

The patterns of foreign direct investment (FDI) flows have exhibited rather different characteristics. Contrary to most expectations, the global volume of gross FDI grew from \$464.3 trillion in 1997 to \$643.9 trillion in 1998 in spite of difficult economic and financial conditions; such flows are projected to have expanded further in 1999.¹⁴ This observed buoyancy in FDI was confined totally to transactions among developed countries. To a considerable extent, it was driven by cross-border merger and acquisition activities in many diverse fields; these have ranged from resource-based industries in oil and gas to corporate enterprises in banking, finance, and information and communications technologies. As long as merger and acquisition activities represent a consolidation of sunk investment, they are replacing possible new investments in the fields or industries under consideration, regardless of the modalities or sources of financing.

The upward trend in the share of developing countries in world FDI flows was reversed by a fall of some 4 per cent in the volume of FDI channelled to these countries, the gross amount being \$165.9 billion during 1998, compared to \$172.5 billion a year earlier. The largest cut was experienced in Asia, totalling some 12 per cent (or \$10.5 billion), with Hong Kong, China; Indonesia; Malaysia; and Taiwan Province of China bearing much of the fall.¹⁵ Nevertheless, under the circumstances, FDI flows have remained surprisingly resilient in several of the crisis economies as well as in the rest of Asia. In fact, the Philippines, the Republic of Korea and Thailand were among those countries which recorded a considerable increase in FDI inflows in 1998.

Merger and acquisition activities are relatively cost-effective for transnational corporations because of the ready availability of good productive assets at low or heavily discounted prices in the countries affected by the crisis. They also proved a convenient substitute for investments in new projects.

¹⁴ UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development* (United Nations publication, Sales No. E.99.II.D.3).

¹⁵ *Ibid.*

IMPLICATIONS FOR THE ESCAP REGION

Trade

The patterns of world trade were reviewed at some length earlier in this chapter. The decline in the value and volume of trade flows was evident in 1998 and persisted into the early part of the following year; the downward trend appears to have been halted towards the middle of 1999. The recent increase in world trade in value terms embodies a sharp rise in oil prices, aided by an upturn in the export unit values of several categories of commodities. It was also underpinned by a measurable trade expansion fuelled by the recovery of exports from the crisis countries of Asia. Within the ESCAP region as a whole, for example, exports rose in both volume and value terms during the first half of 1999, compared to the levels prevailing in the first half of 1998 with this trend persisting into the second half of 1999.

The United States economy continues to provide much of the demand for exports from the region. EU and Japan, while showing welcome strength, are unlikely to add appreciably to the overall earnings through exports from Asia, as discussed previously. Indeed, the pace of economic recovery within EU is expected to be modest and could easily falter as a result of the recent increase in interest rates; at the same time, the depreciation of the euro could dampen the demand for imports. The appreciation of the yen, on the other hand, has generated some buoyancy in imports into Japan independently of the strength of the economic recovery; but the continuing weakness of consumer demand could be an offsetting factor. Intraregional trade, the engine of growth in the early 1990s, has remained sluggish thus far, although it should expand considerably with a broader and deeper recovery in the crisis economies.

On the supply side, higher prices for oil, if they persist, may increase production costs in oil-importing countries, which constitute the overwhelming majority of ESCAP countries. Higher prices of non-oil commodities should translate into higher earnings of a sizeable number of ESCAP economies, even with unchanged export volumes, especially given the relatively price-inelastic nature of short-run demand for such commodities. The greatest buoyancy currently

visible on the supply side is in manufacturing, though. Several of the regional suppliers of electronic goods and other manufactured products within the crisis countries have been able to boost their production and exports significantly. This upswing is largely attributable to their enhanced competitiveness though crisis-induced currency depreciation and the persistence of strong United States demand for electronics goods in general, and for computers in particular. The strong cash flows so garnered have combined with lower domestic interest rates to attenuate somewhat the financing problems associated with the credit crunch in these countries.

Another element of the silver lining is manifested in concerted efforts made by many regional manufacturers, especially those in the crisis countries, to improve their efficiency and flexibility, including in capital mobilization and utilization and in ensuring leaner inventories and payrolls.¹⁶ All these have contributed to enhancing productivity and export competitiveness. The present buoyancy in manufacturing and trade should continue well into the year 2000 on the basis of current demand and supply-side parameters. Once the initial stages of economic recovery and the associated trade expansion have been successfully completed, however, any broader-based increases in output capacity and exports will require much greater support from the domestic financial system within the crisis economies. It is in this connection that various caveats apply. In particular, the persistent constraints on bank lending cannot be relaxed without a satisfactory resolution of the bad loan problems, widespread corporate insolvency and high levels of corporate indebtedness.

Another set of qualifications relates to widened market access for export from the developing economies of the region, the least developed countries especially. Despite the success of the Uruguay Round, market access has not been increased for developing countries' exports in line with initial expectations. Export penetration from those countries is still hampered by persisting restrictions on market access, especially those concerning tariff peaks and tariff escalation on products of major interest to them, as well as the reinforced non-tariff barriers. This is particularly true in the case of agricultural commodities, processed primary products and

¹⁶ *Financial Times*, 18 November 1999.

labour-intensive low-technology manufactured goods. The non-tariff barriers may involve linking market access to importing countries' environmental regulations unilaterally applied at the level of both products and processes as well to labour standards. Developing countries of the region, as elsewhere, will have to remain fully engaged in global trade negotiations in order to ensure that their access to export markets is not restrained by international agreements.

Capital inflows

A recovery is under way in aggregate flows of private finance to emerging market economies, as already noted earlier in this chapter. However, the flows in 1999 are unlikely to have surpassed the level of the previous year by any significant margin and will remain much lower than the corresponding volume in 1997 (table I.3). Remarkably, the volume of private financial flows to Asia in the first eight months of 1999 exceeded the amount channelled to the region for the whole of 1998 despite a reduction in loan commitments. Furthermore, the share of Asia in external private capital flows appears to be gradually increasing, albeit out of a drastically reduced total. However, only a relatively small number of Asian economies have been the destination of such flows; this characteristic geographical concentration seems to have become stronger in the post-crisis months.

When the extended period of relatively easy access to private capital came to an abrupt end among the crisis economies in 1997, the financing gap was largely bridged by official flows (from the IMF-led rescue packages). Within the subsequent 18 months, most of these economies were able to convert large deficits in their external current accounts into surpluses. Market sentiment concerning the crisis economies, and Asia more generally, showed a marked improvement following the build-up of external reserves, the containment of inflation, the resumption of export and GDP growth and, in the case of Indonesia, the improvement in the political situation. These were some of the factors leading to the revival of private capital flows into the region.

The spreads on international bond issues have begun to narrow for the crisis economies and

for Asia as a whole. The risk premium declined from an unserviceable peak of 800 basis points in the third quarter of 1998 to 400 basis points by the first quarter of 1999. By and large, this downward trend continued as the year unfolded, even though the premiums involved were still much higher than those of the pre-crisis years. This positive development notwithstanding, access to such cheaper capital is now even more concentrated than before; it is available only to the highest-rated borrowers. Such enhanced concentration reflects lenders' fears of being forced to roll over existing lines of credit, or to provide new ones, should external financing problems arise again in the near future.¹⁷

The reduction in risk premium provides access to much less expensive funds as a means of restructuring the existing portfolio of external liabilities and lowering the overall cost of future debt servicing. While initially this option may apply only to the best borrowing entities, there could be positive spillover for others. But the easier access on improved terms should not lull policy makers into any sense of complacency. Although the events of 1997 and the hardships suffered in the aftermath are too recent to be forgotten, it is useful to remind policy makers that they have to keep perpetual vigil on the volume, terms and use of external private capital.

In the above context, it is also necessary to take note of the volatility that has been observable in the financial markets of the ESCAP region, including those in the crisis economies. There was a steady appreciation in exchange rates and rise in stock market indices up to the middle of 1999. Thereafter, both of these rising trends experienced a period of weakness, although a degree of financial stability was returning to most regional markets towards the latter part of the year. These changes in market sentiments did not appear closely related to movements in the so-called macroeconomic fundamentals; they tended to reflect the heightened volatility that has become a hallmark of global financial markets of late. In particular, the closer integration of international capital markets means greater correlation between selling and buying orders over different markets; and these

¹⁷ Bank for International Settlements, *69th Annual Report*, June 1999, p. 38.

orders may have little or limited relevance to the state of developments in individual markets of emerging economies. Given the considerable impact that sudden or frequent changes in foreign investor sentiment can have on exchange rates and stock prices, on the cost and availability of financing, and on overall financial and economic stability of individual countries, the vital importance of continually monitoring the domestic and international financial markets and of fine-tuning policy instruments to deal with any destabilizing developments cannot be overemphasized.

The comparative resilience of FDI flows into the region has been already noted, but there are some issues lurking behind the aggregate numbers. The recent patterns of Japanese FDI may serve to highlight some of the issues. The overall level of investment outflows from Japan declined by 7 per cent to \$24 billion in 1998, or to approximately half of the corresponding volume during the early 1990s. Indeed, even the figure actually recorded as FDI from Japan during 1998 could contain a large element of intra-company loans (extended by the parent corporations in Japan to their foreign subsidiaries or affiliates). The principal rationale for such loan transactions was to stabilize the operations of the subsidiaries or affiliates in the aftermath of the crisis; the very low interest rates prevailing in Japan and the steep depreciation in the exchange rates of the crisis economies were other facilitating factors. At some stage, these subsidiaries or affiliates will require fresh equity support. It thus remains to be seen whether the loans from transnational corporations in Japan will be converted into additional equity investment. Given the (domestic) financial pressures on Japanese transnational corporations the prospects for any significantly enlarged FDI flows in the form of new equity from Japan to Asia are not very promising in the immediate future. Similar observations may hold true for FDI flows from other sources.

A significant part of FDI flows into the region has been through mergers and acquisitions. Such FDI may have a beneficial effect on the host economy in terms of increased efficiency in production, technology transfer, and so on, but does not create new capacity. To that extent, the developmental impact of FDI is likely to be less than in the past.

It is clear that the process of recovery has been under way among the crisis economies of the ESCAP developing region from the early part of 1999. The region should see further improvement in its performance during 2000, given respectable growth in the major global economies, the ongoing restoration of some economic strength in Japan and the absence of heightened financial turmoil and corrections. From the preliminary indications available, output growth from the developing countries as a whole should accelerate from 1.2 per cent in 1998 to about 3.3 per cent in 1999, and further to 5.1 per cent in 2000. The overall rate of growth of developing countries within the ESCAP region should exceed that exhibited by the developing countries as a group. However, major uncertainties lie ahead in the realm of domestic reforms and the international environment, as discussed earlier.

CONCLUDING OBSERVATIONS

The economic linkages among countries have become far more complex and less predictable with greater policy liberalization and financial integration. In the past, there used to exist, by and large, a symmetrical, follow-on relationship between the developed and developing countries. The economic performance in the latter mirrored closely the cyclical stages in the former. This appears to have changed radically from the early 1990s, when the recession in the developed countries left many developing economies largely untouched, and especially those in Asia. Growth in intraregional trade and investment provided a crucial impetus for such resilience in regional economic performance.

On the other hand, economic performance among developed countries seems to have become more sensitive to the unfolding difficulties in their major trade and financial partners and markets within the developing region. Among other indications of this enlarged degree of vulnerability were the contagious changes in world trade and the decline in world economic growth in the immediate aftermath of the Asian crisis. But the impact has been uneven.

The financial turmoil in Asia caused a large repatriation and relocation of financial resources from the developing and other countries to dollar-denominated assets as a safe financial haven. This movement partially fuelled the growth momentum of the American economy. The transmission mechanisms operated through the enhanced buoyancy in the stock and bond markets, substantial capital gains, strong consumer confidence and increased household spending. The inflow of financial resources was also instrumental in raising the exchange rate of the dollar and muting inflationary impulses despite a tight labour market, providing a boost to consumer spending.

It is unlikely that the flow would be reversed significantly if the rate of growth in output and employment in the American economy were to falter for whatever reason. This asymmetrical relationship possibly rests on the very nature of financial markets as they exist now. The integration of capital markets has tended to inflate the value of, and the premium on, less risky assets such as United States treasury bills and other government-guaranteed papers. At the same time, such integration has facilitated a shift of resources in real time and with relative ease into, and out of, individual markets within the global economy. The process is well illustrated by the Asian crisis starting from July 1997, and then financial problems in the Russian Federation and elsewhere in 1998 and 1999. In practice, all this means that funds move rapidly out of developing countries with the slightest signs of trouble, but the reverse process takes considerable time even after objective conditions improve. How to deal with this asymmetry poses a major policy challenge for the international community.¹⁸

A fallout of the integration of financial markets has been a concurrent and noticeable increase in variations in both foreign exchange rates and the volumes of capital market transactions. The magnitude of such instability rose during the 1990s generally, but more so following the crisis. Market-based, daily fluctuations in exchange rates hitherto were confined largely to developed economies. They have now virtually become the norm in the more

open developing economies as well, following the abandonment, by an increasing number of these countries, of fixed or quasi-fixed exchange rates in the aftermath of the Asian crisis. This phenomenon poses new policy issues and a dilemma for several reasons. First, many developing economies had become accustomed to exchange rate stability stretching back several years. Such stability remains a critically important anchor for investment, trade, financing and other business decisions. Second, market sentiment has tended to overshoot, exaggerating the degree of economic uncertainty at any particular point in time. Third, market perceptions do not often reflect closely, or are not primarily a consequence of, changes in the so-called macro-economic fundamentals: inflation, the budgetary position, the balance on external current accounts, rates of interest and the level of foreign exchange reserves. The understanding of how market sentiment is formed in the private sector, and how it can be influenced by public policy responses, particularly in developing economies and emerging markets, remains rather nebulous.

Increased volatility in stock market prices, largely a result of reactions of private sector market participants, presents a broadly similar dilemma for governments. A prolonged upward movement in share prices raises several inevitable questions about its sustainability. A "market correction" is inevitable if an observed upswing does not represent a secular change in investors' portfolio preferences, or if it does not embody a lasting rise in rates of return. The magnitude of such an adjustment in market sentiment, however, could be more pronounced than necessary as a result of collective panic and widespread liquidation orders; a soft landing may not always prove feasible under the circumstances. The highly deleterious effects of such a financial bubble on financial and macro-economic stability, and on production and employment in the real economy, need no further reiteration in the light of the Asian crisis.

A connected issue pertains to government policy towards inflated prices of financial and real-estate assets within the private sector. Two questions, among others, are urgent: at what stage should such private sector bubbles be contained, and what measures are needed to ensure a soft landing to minimize their ripple effects. There are no painless answers, no easy short cuts. Financial

¹⁸ See *Survey 1999* for a discussion of some thoughts on the international financial architecture needed to deal with the adverse impact of financial market integration on developing countries.

sector management requires a better grasp of the quantum increases in its technical intricacies, fostered by closer interlinkages among financial markets in different parts of the world, but other equally important prerequisites include more detailed and up-to-date information for monitoring and decision-making purposes, a talent for forming fine judgements on the choice of policy instruments, and institutional capacity to implement policy decisions.

The Asian crisis brought in its wake terrible hardship for millions through aggravated poverty, loss of employment and earnings, and reduced access to social services, including health and educational

services. This has underscored the need for enhancing social security protection for all and, in particular, providing protection for the vulnerable through the provision of safety nets. However, enhanced social security protection will probably require additional public expenditure at a time when government budgets are already under severe pressure to provide the resources required to solve financial sector problems. The fiscal implications of increasingly vocal demand for improved social security protection, while integrating into the world economy with all its attendant vulnerabilities, will emerge as an increasingly significant challenge for developing countries.

REGIONAL OVERVIEW

Recent performance

The story of recent economic developments in the ESCAP region is one of resurgence of economic growth in an environment of substantially improved macroeconomic stability. Several factors contributed to stable consumer prices. Exchange rates appreciated considerably in the countries hit by the crisis by the early part of 1999 and then stabilized. Domestic supply conditions improved as a result of falling interest rates, the easing of the credit crunch and rising imports. In several countries, better weather conditions led to higher agricultural output. Private consumption demand tended to remain muted, and particularly so in the countries which had fallen victim to the 1997 crisis.

A noteworthy aspect was that the substantial reduction in inflation, averaging only 4 per cent for developing economies of the region in 1999, was shared by all subregions. In East and North-East Asia, inflation turned negative owing to deflationary forces in China and Hong Kong, China. Such was also the case for the developed economies of the region because of the influence of the Japanese economy, which continued to experience a mild deflation. Among the 25 developing economies of the region, as many as 19 recorded lower inflation rates. There were only five countries with double-digit inflation rates in 1999 as against eight in the previous year. Most of those which continued to have double-digit rates were able to bring down the rates very substantially.

The improved growth performance was also reasonably broad-based, cutting across all the subregions, with the exception of South and South-West Asia. The broad-based nature of improved growth pulled up the average growth rate of the developing economies of the ESCAP region to 5.6

per cent in 1999 in sharp contrast to the figure of 0.1 per cent in the preceding year. Fourteen out of 25 developing economies for which data are presented in table II.1 achieved a higher growth rate in 1999; only two registered negative growth as against eight in 1998.

The slight deceleration in South and South-West Asia has to be read against the fact that this subregion recorded the highest growth rate among all subregions in 1998. However, the majority of countries in this subregion, including the largest, India, experienced lower growth for a variety of country-specific factors. Particularly noteworthy was the debilitating impact of a devastating flood in Bangladesh, and of a colossal earthquake in Turkey, which caused a contraction of GDP in that country.

The major contribution to the dramatic upturn in GDP growth for developing economies of the region as a group came from the economies of East and South-East Asia which had been hit by the crisis in 1997. In 1998, as many as eight economies in the ESCAP region suffered a decline in output; six of them were in East and South-East Asia. All of them turned around and recorded large gains in output in 1999. The two exceptions were Hong Kong, China and Indonesia, where there was marginally positive growth. The Republic of Korea witnessed a stunning growth rate of 9.0 per cent, the highest in the region. The largest economy, China, maintained a high growth rate, although slightly lower than in the past few years.

The Pacific island economies averaged a much higher growth rate in 1999 because of significantly improved performance in the larger economies of the subregion. The highest rate within this group and the second highest in the entire ESCAP region was attained by Fiji. In contrast, there was negative growth in Tonga largely due to an exogenous shock in the form of a highly damaging cyclone.

Table II.1. Selected economies of the ESCAP region: rates of economic growth and inflation, 1998-2002

(Percentage)

	Real GDP					Inflation				
	1998	1999 ^a	2000 ^b	2001 ^b	2002 ^b	1998	1999 ^a	2000 ^b	2001 ^b	2002 ^b
Developing economies of the ESCAP region^c	0.1	5.6	6.2	6.4	6.5	11.3	4.0	3.7	4.2	3.8
South and South-West Asia^d	5.8	4.9	6.3	6.7	6.6	14.8	10.2	8.6	7.8	6.0
Bangladesh	5.7	5.2	6.4	8.3	8.3	7.0	8.9	5.0	5.0	5.0
Bhutan	5.8	5.1	5.2	..	..	9.0	9.2	9.0	..	..
India	6.8	5.9	6.9	7.1	7.2	13.1	7.0	6.0	5.0	5.0
Iran (Islamic Republic of)	1.6	2.5	4.5	5.5	6.5	20.0	23.3	19.6	17.6	15.2
Nepal	2.6	3.4	4.0	6.0	6.0	10.2	9.6	7.0	6.5	6.5
Pakistan	4.3	3.1	5.0	5.0	5.0	7.8	5.7	6.0	6.0	6.0
Sri Lanka	4.7	4.0	4.4	5.4	..	9.4	6.0	7.5	6.8	..
Turkey	2.8	-2.3	4.6	3.9	..	84.6	66.0	52.8	54.9	..
South-East Asia	-6.9	3.4	4.5	5.7	6.0	27.6	9.3	5.4	6.0	4.8
Indonesia	-13.7	0.1	3.0	6.0	6.5	77.6	20.4	4.0	6.6	8.0
Malaysia	-7.5	5.4	5.8	6.5	6.6	5.3	3.0	3.0	4.0	4.0
Myanmar	5.0	4.6	5.0	5.2	..	51.5	38.0	32.0	26.0	..
Philippines	-0.5	3.2	4.5	4.6	5.4	9.0	7.0	7.0	6.5	5.5
Singapore	0.4	5.4	6.0	6.8	6.5	-0.3	0.4	1.0	1.3	1.4
Thailand	-10.4	4.1	4.4	5.0	5.2	8.1	0.3	2.5	3.5	3.5
Viet Nam	5.8	4.8	5.8	6.0	6.0	9.2	2.5	6.5	7.6	8.9
East and North-East Asia	1.6	6.7	6.9	6.7	6.7	2.7	-0.4	1.5	2.3	2.8
China	7.8	7.2	7.5	7.8	7.6	-0.8	-1.4	0.0	1.1	2.3
Hong Kong, China	-5.1	0.5	4.0	6.0	6.5	2.8	-3.0	0.0	2.0	3.0
Republic of Korea	-5.8	9.0	7.8	6.0	6.0	7.5	0.9	3.2	4.0	4.0
Taiwan Province of China	4.8	5.2	6.0	6.2	6.1	1.7	0.5	2.2	2.0	1.8
Pacific island economies	2.0	5.8	2.0	2.0	2.0	10.9	8.4	5.7	4.1	4.1
Fiji	0.5	7.8	3.0	3.4	2.6	8.1	1.0	6.0	3.0	3.0
Papua New Guinea	3.1	5.3	0.9	0.9	1.4	13.6	13.0	6.0	5.0	5.0
Samoa	1.1	6.1	4.9	4.5	4.5	2.2	4.0	3.0	3.0	3.0
Solomon Islands	-3.9	4.8	5.8	3.5	2.6	12.0	5.0	5.0	4.0	4.0
Tonga	-0.3	-1.1	3.6	2.5	2.2	3.4	6.0	4.0	2.0	2.0
Vanuatu	3.4	1.1	3.3	3.2	3.2	4.1	0.5	3.0	2.0	2.0
Developed economies of the ESCAP region	-2.3	1.1	1.1	1.4	1.6	0.7	-0.1	1.0	1.4	1.5
Australia	4.8	3.4	3.0	3.1	2.0	0.8	1.5	3.5	5.0	4.2
Japan	-2.8	0.9	1.0	1.3	1.6	0.7	-0.2	0.8	1.2	1.3
New Zealand	-0.8	2.2	3.5	3.3	4.0	1.3	2.0	1.4	1.4	1.4

Sources: ESCAP secretariat calculations based on IMF, *International Financial Statistics*, February 2000; ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999) and *Asian Development Outlook 1999* (Oxford University Press, 1999); United Nations, "Project LINK World Outlook", 30 November 1999; The Economist Intelligence Unit, *Country Report: Myanmar (Burma)*, fourth quarter 1999; *OECD Economic Outlook*, December 1999; and national sources.

Note: Inflation refers to changes in the consumer price index.

^a Estimate.

^b Forecast/target.

^c Based on data for 25 developing economies representing about 95 per cent of the population of the region (excluding the Central Asian republics); GDP at market prices in United States dollars in 1995 has been used as a weight to calculate regional and subregional growth rates.

^d The estimates and forecasts for countries relate to fiscal years defined as follows: fiscal year 1999/00 = 1999 for Bhutan, India and the Islamic Republic of Iran; fiscal year 1998/99 = 1999 for Bangladesh, Nepal and Pakistan.

Of the eight economies in North and Central Asia for which data are presented in the present *Survey*, five registered the same or a higher growth rate in 1999 compared to the previous year. None had negative growth. The turnaround in the Russian Federation from the deep contraction of output in 1998 deserves special mention.

Towards an explanation

In the vast ESCAP region, the performance of individual countries is determined by the confluence of an array of country-specific as well as global forces. Nevertheless, it is possible to discern a number of common elements which contributed to the bright landscape depicted above. The following paragraphs briefly analyse some of these elements.

Fiscal stimulus provided a significant boost to growth in many economies, especially so in the economies of East and South-East Asia hit by the crisis. Several economies which had not been directly affected by the crisis also resorted to increased public expenditure as a means of stimulating growth or containing the damage inflicted by natural calamities. The budget deficit as a proportion of GDP increased in as many as 15 developing economies of the region out of a total of 25 for which full-year data are available for 1999. This was particularly pronounced in some economies of East and South-East Asia, including China. The only exception was the Republic of Korea, where there was a small decline in budget deficit as a proportion of GDP from an uncharacteristically high level of 4.2 per cent in 1998 to 3.9 per cent in 1999.

Export performance was another major source of boost to economic growth for the majority of countries. In this case, the distribution among subregions was relatively more uneven. All the economies in South-East Asia recorded a substantially higher growth rate of merchandise exports, with the exception of Indonesia where the growth rate remained negative, albeit of a much lower magnitude than in the previous year. In the other subregions, the picture was rather mixed. Overall, out of 25 economies in the various subregions (excluding North and Central Asia), 16 recorded a higher growth rate of merchandise exports. Among the factors which caused improvement in the export

performance were increased global demand against the backdrop of strong economic performance in the United States and the recovery in Japan, better world prices for many of the primary commodity exports from the region and enhanced domestic supply capacities resulting from a relaxation of the liquidity crunch and weather-induced improvements in agricultural production.

The combination of fiscal stimulus and better export performance created certain other conditions favourable for improved growth performance. These two elements together helped to increase capacity utilization and contained a rise in unemployment. In consequence, greater optimism was generated, leading to some recovery in domestic private consumption. In part, domestic consumption was fostered by the wealth effect of rising stock market indices as well as relatively greater stability in currency exchange rates.

Several economies in the region also benefited from external capital inflows. In addition to official flows to which many of the economies in East and South-East Asia gained access in the aftermath of the crisis, there has been a return of some private flows as well. As noted in chapter I, the volume of private financial flows to Asia in the first eight months of 1999 exceeded the amount channelled to the region during the whole of 1998.

Near-term prospects

Current indications suggest reasonably optimistic prospects for further strengthening of regional growth in the immediate future. It is projected that developing economies of the region will reach an average growth rate of slightly over 6 per cent in the year 2000, about half a percentage point above the rate achieved in 1999. There are a number of elements underlying this optimistic projection.

As detailed in the subsequent analysis, the restructuring of the financial sector is proceeding apace. Non-performing loans in the financial system have started declining. These developments should help a further easing of monetary policy stance and reduce interest rates. Private consumption and investment are thus expected to gain stronger momentum.

Many of the economies in East and South-East Asia still have considerable excess capacity in their manufacturing sectors. Falling interest rates, the easing credit crunch and the restoration of export finance facilities should help the utilization of the prevailing capacity for both domestic consumption and production for export. Another reason for expecting continued strong performance in exports is that demand conditions in the developed market economies are likely to remain favourable. Even though the United States economy may decelerate somewhat in 2000, the European Union is expected to register a higher growth performance. A slightly better performance in Japan cannot be ruled out. In addition, the current phase of recovery should boost intraregional trade and investment. Export growth, in turn, will help to finance the import of raw materials and intermediate inputs needed to utilize prevailing excess capacity, as well as of capital equipment for new investment.

Further progress in corporate debt restructuring is also anticipated. Exchange rate stability coupled with strong export performance will help to ease the debt-servicing burden and should encourage domestic investors to undertake more investment activities. In addition, it may be easier for corporate entities to raise investment finance from the domestic capital market with continuing improvement in stock market indices.

As already indicated, there are signs of the return of private capital inflows into the region. The current recovery and the accompanying policy changes, many of which are even more favourable to FDI than in the past, are likely to sustain this momentum. However, as in the past, private capital inflows will benefit only a small number of economies.

Downside risks and policy challenges

Despite the above optimistic scenario, the region is not free from some downside risks which pose a number of policy challenges. One of the risk factors lies in the short-term negative effects of the structural reforms. Many of the countries in the region are taking initiatives to restructure their corporate entities. The measures initiated in this

regard include efforts aimed at strengthening, and implementing more forcefully, bankruptcy legislation, privatizing state enterprises, opening up both private and state enterprises to acquisition by transnational corporations, and encouraging corporate entities to consolidate their operations, shed some lines of business and focus on core areas of business. These measures may generate a sense of uncertainty with respect to employment prospects and thus dampen the pickup in domestic demand. The policy challenge is to ensure that the momentum of efficiency-enhancing restructuring measures is retained or even intensified, while avoiding loss of consumer confidence and its adverse ripple effects.

The financial sectors of many countries remain plagued by serious problems. The overhang of non-performing debt remains huge in those countries of East and South-East Asia affected by the crisis despite the progress achieved so far. But even outside these subregions, the non-performing loan problem is significant in several countries. In many countries, commercial banks are under pressure to consolidate and restructure, capital adequacy requirements are yet to be fully met and loan loss provisions remain insufficient. Financial institutions may therefore continue to adopt a cautious lending stance which may restrain growth. Countries are thus confronted with the dilemma of encouraging financial institutions to lend in order to meet the credit needs for sustained growth or minimizing the risks of further accumulation of bad debt.

As has already been noted, a major source of recovery in the region has been the export momentum. It will be recalled that one of the crucial factors which caused the 1997 crisis was the dramatic deceleration in export growth suffered by the countries of East and South-East Asia in 1996. The reliance on external demand as a primary stimulus for growth is always fraught with some degree of risk.

In the above context, enhancing export competitiveness assumes critical significance. The recent recovery in export growth was facilitated by the presence of excess capacity and a major depreciation in exchange rates. Once the excess capacity reaches a point of exhaustion and exchange rates appreciate further, fundamental competitiveness will determine export performance.

Enhancing such competitiveness will require technological upgrading of existing lines of business, as well as progressive diversification and a shift into more knowledge-based and technology-based activities. Typically, there is stiffer competition in these activities from both developed countries and advanced developing countries outside the region. It is also worth mentioning here that a number of low-income developing countries in the region have succeeded in diversifying into low-end, labour-intensive manufactured exports, particularly textiles. To a great extent, this success has been underpinned by the global trade regime, including country-specific export quotas. With the envisaged abolition of quotas under WTO agreements, those countries will face stronger competition from other developing countries within and outside the region. They will have to improve their cost competitiveness significantly and develop new niche export products.

The agricultural sector continues to be a significant source of value added, employment, raw materials and exports for many economies in the region. For them, the agricultural sector is the major determinant of overall economic performance. The crisis in East and South-East Asia also highlighted the importance of this sector as a social safety net mechanism. Most countries of the region will therefore have to pay greater attention to improvements in agricultural productivity.

Fiscal stimulus played a significant role in improved economic performance in 1999, but there are obvious limits to the degree of reliance that can be placed on this source. Beyond a certain point, persistently large fiscal deficits are bound to affect macroeconomic stability. There is also a risk that the continuation of large fiscal deficits may crowd out private investment. In addition, they impose contractual debt-servicing obligations for governments which may pre-empt development expenditure in such areas as infrastructure, health, education and other essential public services. It is therefore imperative that alternative sources of stimulus are found to drive the future growth process. A stronger recovery of private consumption, as well as investment, is thus crucial.

Finally, it should be noted that there are some downside risks in the external environment. In this context, a particular concern relates to the performance of the United States economy. As explained in chapter I, this economy remains somewhat

vulnerable to a potentially abrupt decline, especially because of a record level of deficit in the private sector financial balance. There are also concerns about the strength of recovery in Japan. Another external risk arises from the recent hike in oil prices. Most of the countries in the ESCAP region are net importers of oil. So far, the increase in oil prices has not constrained the process of recovery in the region but, if the current level of prices continues for a substantial period of time, an adverse impact on balance of payments, production costs, competitiveness and eventually growth cannot be lightly dismissed.

DEVELOPING ECONOMIES OF THE ESCAP REGION

Asian least developed countries

Most least developed countries in Asia recorded growth rates in the range of 4-6 per cent in 1999, not substantially different from those of the recent past. Two countries fell outside this range. At one end, Maldives put up its characteristically strong performance with a growth rate of over 8 per cent. At the other end, Nepal, which has been experiencing deceleration consistently over the past three years, experienced a better performance in 1999, with a growth rate of 3.4 per cent. It should also be noted that of the three South-East Asian least developed countries whose growth performance in 1998 was directly affected by the Asian crisis, two (Cambodia and Lao People's Democratic Republic) showed significant recovery, whereas in one (Myanmar), the downslide continued.

Consumer prices increased substantially in most Asian least developed countries in 1998. In part, this was due to exogenous shocks in the form of natural calamities, which curtailed both subsistence and export-oriented output. There was also some imported inflation, transmitted through higher costs and prices in source countries and the depreciation of several of the local currencies. High rates of growth in domestic liquidity and inflation expectations were other causal factors. The rate of increase in inflation moderated considerably in 1999. Nevertheless, inflation remained quite high, with the exception of Cambodia and Maldives where it was below 5 per cent.

Growth performance

Extensive floods in Bangladesh, lasting for nearly three months from July 1998, affected some 30 million people and caused significant loss of property and productive capacity. Initially projected at 3.2 per cent owing to the dampening impact of the floods, GDP growth rebounded to an estimated

5.2 per cent in 1999 largely on account of the strong upswing in agricultural output (table II.2). The boro rice harvest, for example, rose by almost 30 per cent to around 10 million tons, thus offsetting the losses in aus and aman production. The wheat crop, at 2 million tons, was about 11 per cent larger in 1999. The value added in forestry, livestock and fisheries registered growth rates of 4, 7.6 and 8 per cent

Table II.2. Selected least developed countries of the ESCAP region: growth rates, 1996-1999

(Percentage)

		Rate of growth			
		GDP	Agriculture	Industry	Services
Bangladesh	1996	5.4	3.7	5.3	6.5
	1997	5.9	6.4	3.8	6.3
	1998	5.7	2.9	8.1	5.7
	1999	5.2	5.0	3.8	5.1
Bhutan ^a	1996	6.0	6.4	8.4	3.4
	1997	7.3	3.1	3.8	16.1
	1998	5.8	3.4	7.3	7.2
	1999	5.1	4.0	21.0 ^b	14.0
Cambodia	1996	5.5	2.2	11.7	4.8
	1997	2.6	-0.1	31.8	-5.1
	1998	1.3	-1.2	9.2	0.3
	1999	4.0	4.8	2.0	4.2
Lao People's Democratic Republic	1996	6.9	2.8	17.3	8.5
	1997	6.9	7.0	8.1	7.5
	1998	4.0	3.7	8.5	4.8
	1999	5.2	3.9	8.1	5.7
Maldives	1996	7.9	1.7	8.6	9.5
	1997	9.1	1.4	18.0	8.9
	1998	9.1	5.9	14.8	8.3
	1999	8.5	7.9	8.0	8.9
Myanmar ^c	1996	6.4	5.0	10.7	6.5
	1997	5.7	3.7	8.9	6.6
	1998	5.0	2.8	6.6	6.7
	1999	4.6	4.8	4.2	4.6
Nepal ^a	1996	5.6	4.4	8.3	5.4
	1997	4.9	4.1	6.4	4.9
	1998	2.6	1.0	0.2	5.6
	1999	3.4	2.4	4.1 ^d	..

Sources: ESCAP secretariat calculations based on ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999) and *Asian Development Outlook 1999* (Oxford University Press, 1999); and national sources.

Notes: Data for 1999 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

^a GDP at factor cost.

^b Excluding construction.

^c GDP at 1985/86 producer's prices.

^d Including services.

respectively, representing only marginal declines from the growth rates in previous years. Fish and shrimp cultivation was also adversely affected by the floods, but inland and marine catches were estimated to be higher than in 1998. Jute production, however, was sharply down, from 5.8 to 4.5 million bales between 1998 and 1999.

In contrast to the robust performance in agriculture, manufacturing activities slowed down significantly with total output going up by 3.8 per cent in 1999, compared to 8.1 per cent during the previous year. Industrial slippage was displayed in both small and large-scale manufactured goods. However, higher output was recorded in several subsectors such as ready-made garments, leather and skins, leather shoes, ceramic products and tea. Jute goods, sugar, edible oil, natural gas and pharmaceuticals did not perform as well. The growth rate of mining and quarrying, was down sharply to 21.5 per cent in 1999, from 32 per cent in the previous year. The marginal drop in value added of the services sector, to 5.1 per cent, was partly due to the lagged effects from natural disasters. Some of the subsectors displaying a slower rate of expansion were electricity, gas and water supplies; construction; and transport, storage and communications.

The volume of domestic savings was marginally up over the years 1998 and 1999 and, as a proportion of GDP, averaged some 8.5 per cent for the period. This was a notable achievement considering the highly adverse weather shock borne by Bangladesh which served to lower estimated fiscal receipts while boosting budgetary expenditure for the relief and rehabilitation drive in the aftermath of the floods and for additional imports of essential items. These contingencies were reflected in higher budgetary and trade deficits in 1999. Gross capital formation was maintained at around 17 per cent of GDP over the past four years.

There was a bumper harvest of the aman rice crop and a large upturn in industrial production during the first five months of the current fiscal year. In response to greater spinning activities and strong demand from local textile manufacturers, a target of 141,850 bales of cotton was set as input for local lint production. Government support for the import of fertilizers was to be raised sixfold in 2000 from the level in 1999 to raise agricultural productivity. However, tea output could fall by as much as 20

per cent year-on-year owing to adverse weather conditions. As regards services, higher output is expected from construction, power, transport, and wholesale and retail trade. The official projection of GDP growth rate of 6.4 per cent in the current fiscal year thus appears to be a reachable target, unless undermined by the mounting incidence of general strikes.

The annual expansion in Bhutan's GDP, which was in the range of 5-6 per cent in 1998 and 1999, was considerably below the country's potential as displayed in earlier years. Indeed, economic activities are projected to be on a higher growth path with the scheduled completion in 2002 of the two new hydropower projects: Basochu with 58 MW of generating capacity and Kurichu with another 60 MW. The agricultural sector in Bhutan accounted for 37 per cent of GDP and provided employment for nearly 85 per cent of the population in 1998, with only 8 per cent of the land area under cultivation. The principal subsistence crops were maize, rice and wheat; among the major cash crops were potatoes, oranges and apples. Bhutan's level of self-sufficiency in food grains, currently about 65 per cent, is projected to reach 70 per cent by 2002. Agricultural performance remained on an upward trend, expanding by 4 per cent in 1999; forestry output was expected to decline in the short term because of the ban on the export of logs and raw timber from January 1999. The forestry sector, with a relative share of about 29 per cent of agricultural output, had grown by 4 per cent in 1998. To maintain forest cover at not less than three fifths of the land area, the government has retained custodianship of forests and is the sole agency for extracting timber.

The industrial sector, with a relative GDP share of about 22 per cent in 1998, was forecast to rise by 21 per cent in value added in 1999. It has also generally expanded much faster than both the agricultural and the services sectors in the last few years, except in 1997. Export-oriented energy production was a dominant activity and the Chhukha hydroelectric plant of 336 MW provided more than 95 per cent of the installed generating capacity. Sales revenue increased through a doubling to one ngultrum per unit of the tariff rate on energy exports to India in April 1997, and subsequently to 1.5 ngultrum from July 1999. Tourism was most important

within the services sector and the number of tourist arrivals increased by 25 per cent in 1999. As a result, the contribution of tourism to the country's foreign exchange earnings rose to 28 per cent in 1999, from 24 per cent in 1998.

The restoration of political stability, the implementation of economic reforms and the dissipated impact of the East Asian crisis facilitated a sharp upturn in Cambodia's economic performance: GDP grew by an estimated 4 per cent in 1999, compared to 1.3 per cent in the previous year. Domestic economic activities are targeted to expand by some 6 per cent by 2002. The sharp recovery in 1999 was primarily derived from a robust agricultural sector whose output went up by just under 5 per cent; favourable weather conditions lifted the rice crop to more than 3 million tons, from 2.9 million tons in 1998. The volume of the fisheries harvest was almost 15 per cent higher, a considerable increase. However, floods in the southern provinces in early November 1999 may affect agricultural production in 2000. The government is calling for FDI in the local processing of paddy into rice to maximize value-adding activities and employment.

However, the industrial sector has been slowing down sharply since 1997, with output going up by 9.2 per cent in 1998 and 2 per cent in the following year. Quota restrictions on garment exports to the United States, slow recovery in private investment following the Asian economic crisis and poor economic performance in 1997 and 1998 were some of the factors constraining higher industrial growth in the country. Garment production thrived, taking advantage of the privileges under the generalized system of preferences. It remained a major source of domestic employment and foreign exchange but its spread effects were limited by a high import content and therefore little forward or backward integration with the rest of the economy. The services sector, led by tourism, was estimated to grow by 4.2 per cent in 1999 as a result of improved political stability and the regional economic recovery. On a year-on-year basis, the number of tourist arrivals by air rose by 35 per cent in the first nine months of 1999. Infrastructure was being improved to foster the development of this sector. At Siem Reap, for example, an additional runway and a new airport terminal were under construction and the total number of hotel rooms is to be doubled to 2,000 by the end of 2001.

Economic activities in the Lao People's Democratic Republic were back on an upward trend, with GDP growth estimated at 5.2 per cent in 1999 after a major slowdown in the previous year. The agricultural sector, which contributes over 50 per cent to aggregate output and employs about four fifths of the workforce, exerts a dominant influence on the economy. It is estimated to have grown by 3.9 per cent in 1999. Rice production in 1999 was expected to rise by 28 per cent because of a higher dry-season harvest, the result of expanded irrigation facilities; meanwhile, the wet-season rice crop survived the heavy rains in September relatively unscathed. A recovery during 1999 was estimated in the production of other crops which had been affected by the drought in 1998 (except notably sugar cane, coffee and peanuts). The forestry sector had contracted by 4.4 per cent in the same year on account of lower export demand and prices emanating from the East Asian crisis, an adverse experience also shared by several other exporters, including Papua New Guinea and Solomon Islands. Livestock had grown modestly in size, by 2.5 per cent in 1998, but there was some depletion of the herds through a large increase in exports.

The industrial sector, with a share of around a quarter of GDP, has been on a stable growth trend of over 8 per cent in the last two years; its output was expected to maintain similar growth in 1999. The sector was affected unfavourably by weak domestic and regional demand resulting from the economic slowdown in its Asian trading partners and the influx of cheap foreign goods as inflation soared in 1998 and 1999. Manufacturing activities, with a contribution of three quarters of industrial output, grew by 9.6 per cent in 1998 on account of higher garment production in the wake of the reinstatement of the generalized system of preferences by EU. Production of cement, furniture and plastic goods was lower. The construction sector declined significantly in 1998 with the completion of large-scale hydropower projects and the postponement of new investment projects after the crisis. The services sector, with a relative share of just over a quarter of GDP, was estimated to grow at a marginally higher rate of 5.7 per cent in 1999 than the rate of 4.8 per cent recorded for 1998. Transport and retail trade showed continued strength but financial services contracted sharply because of problems in the banking sector. Earnings on tourism went up to almost \$80 million in 1998, or nearly four times the level

realized in 1995, thus becoming larger than the combined receipts from the export of textiles and garments, and electricity. The promotional campaign of "Visit Laos Year 1999/2000" was launched in November 1999 and the rules for issuing tourist visas were considerably relaxed. On a year-on-year basis, the number of tourist arrivals increased by 40 per cent (to 220,000 persons) in the first half of 1999.

In Maldives, GDP growth was marginally lower at 8.5 per cent in 1999. The country's economic performance had been consistently strong by the standards of other least developed countries and, for that matter, of developing economies in Asia and elsewhere. The services sector accounted for almost 65 per cent of the value of aggregate production and expanded by almost 9 per cent during the year. It was dominated by tourism with a relative share of just under a fifth of GDP, two fifths of domestic revenue and 90 per cent of total service receipts. The tourism sector was projected to grow by 10 per cent in 1999 and tourist arrivals, at some 353,500 persons in the first 10 months of 1999, were mainly from Germany, Italy, Japan and the United Kingdom. There were 81 hotels and resorts with a capacity of 14,400 beds as of May 1999. The expansion of tourism provided a powerful stimulus to the rest of the economy.

Wholesale and retail trade, with a GDP share of one fifth, provided a significant proportion of fiscal revenue through import duties and other trading taxes. Primary products constituted 17.4 per cent of GDP and their strong expansion, by an estimate of almost 8 per cent in 1999, reflected a larger volume of fish landings in the first 10 months of the year. Fisheries activities alone accounted for up to a tenth of total domestic production and employed over 19 per cent of the labour force; poor soil and the scarcity of arable land greatly limited the importance of agriculture and the range of subsistence crops such as coconut, banana, breadfruit, papayas and mango. Tuna remained the country's top commodity export, but reef fishing gained importance through government efforts to diversify fisheries and encourage greater private sector participation. The industrial sector was rather modest, equivalent to some 18 per cent of GDP. Industrial growth, which had been extremely high in 1997 and 1998 moderated considerably to 8 per cent in 1999; fish processing and exports were adversely affected by

lower prices and excess supplies in the world market. The secondary sector, which included construction, manufacturing and electricity generation, grew by just under 8 per cent during the same year.

In Myanmar, growth decelerated steadily from 6.4 per cent in 1996 to about 4.6 per cent in 1999 owing to a succession of adverse circumstances. These included poor weather conditions which affected rural production, interruptions in the power supply, a sharp reduction in construction demand and the lingering ripple effects of the Asian crisis. Agriculture remained important in the country, with a relative GDP share of one half and an employment share of more than three fifths. Its declining growth in recent years can be attributed to a relatively poor rice crop whose cultivation was constrained by severe flooding in 1997, followed by a drought in 1998, and a general shortage of fertilizers. A ban on private sector exports of rice and a land tax implicit in the procurement system have tended to lower the rewards for rice farming. The value of rice exports dropped from \$200 million in 1994 to \$40 million in 1998.

Agricultural output was estimated to recover strongly by 4.8 per cent in 1999, partly because of incentives provided for the formation of large-scale farms and for bringing unused land into production. Nevertheless, the sustainability of a higher growth path for agriculture constituted a formidable challenge given the chronic shortage of adequate inputs (such as fertilizers and pesticides, and quality seeds), limited irrigation facilities and outdated farming techniques. Meanwhile, the industrial sector, which had developed at a rapid pace in the mid-1990s, has been on a downward trend since then. In previous years, the annual increases of industrial value added were higher than those in the agricultural and services sectors, except for 1999 when the figure was 4.2 per cent. Energy output was down by 4 per cent in 1998 because of bottlenecks in the extraction of crude oil and natural gas, while the projected sales from the offshore Yadana gas field were delayed by the recession in Thailand. There was also a contraction of 4.5 per cent in electricity generation during the same year because of the drought, a shortage of imported fuels and equipment failure. Load shedding, various measures to minimize distributional losses and an increase in household tariff rates apparently did not

relieve the electricity shortage significantly. On the other hand, value added in the mining sector increased by almost 17 per cent in 1999 as a result of substantial investment by private sector enterprises.

Manufacturing activities (employing about one tenth of the labour force) had expanded by nearly 7 per cent in 1998, reflecting in part a higher volume of processing in response to rising demand from the export-oriented garment sector. However, such growth remained constrained by an acute shortage of raw materials and spare parts due to import restrictions, power shortages and inadequate infrastructure. Lower government spending on investment projects following budget cuts and reduced foreign private investment impacted severely on construction activities and hotel and related services, among others. FDI approvals went down from \$2.8 billion in 1996 to less than \$30 million two years later. Cement production in the public sector fell by about 31 per cent in 1998.

The services sector, with a relative share of 20 per cent in total employment, had expanded strongly, by an annual average of more than 6.5 per cent from 1995 to 1998 on account of a higher level of domestic activities and encouragement of a larger economic role for private enterprises and initiatives. The recent downward trend in aggregate output growth also affected various commercial services so that their growth declined somewhat in 1999, despite higher tourism receipts associated with the easing of entry permit requirements and other measures aimed at the promotion of tourism, including package tours. Overall savings and investment in Myanmar continued to be stable as a proportion of GDP, albeit at a comparatively low level. Among the explanatory factors are negative real interest rates, business uncertainty, poor consumer confidence and high inflation.

In Nepal, economic performance turned around from a relatively sharp slowdown in GDP growth in 1998 to an expansion of 3.4 per cent the following year, primarily because of recovery in the agricultural sector. Indeed, aggregate output is expected to remain on an upward trend, rising by 4 per cent in 2000 as a result of further improvements in agricultural production, an upturn in exports and a strong economic performance in India which should lead to higher Indian investment in and demand for exports from Nepal.

The agricultural sector grew by 2.4 per cent and non-agricultural activities by about 4 per cent in 1999. The volume of principal food crops went up by just over 2 per cent; the output of maize and barley, however, declined somewhat, while that of wheat and paddy remained stagnant because of unfavourable rainfall in 1999. On the other hand, the volume of cash crops was estimated to increase by around 15 per cent in 1999. Of the non-agricultural activities, a higher level of value added was registered for manufactured goods, transport and communications, electricity generation, gas and water supplies, construction and mining. Domestic trade and restaurant and hotel services also increased but at a comparatively slower pace. As a proportion of GDP, gross domestic savings rose by one percentage point to 10.6 per cent in 1999 while investment fell noticeably for the fourth consecutive year to reach 17.3 per cent in 1999.

Inflation

The rise of inflation in Bangladesh from 7 to almost 9 per cent between 1998 and 1999 was largely due to declines in food and industrial production following the prolonged flooding in mid-1998 (table II.3). However, the year-on-year inflation rate fell from the flood-related peak of 12.7 per cent in December 1998 to 8.9 per cent in June 1999. Food prices, which had increased by as much as 17.6 per cent in December 1998, were on a downward trend in 1999 aided by the bumper boro rice crop and higher levels of food grain imports. There was a sharp fall in non-food prices, from 6.7 per cent in 1998 to 4.1 per cent in 1999. The outlook for greater price stability was reassuring: in particular, the inflation rate on a 12-month average basis went down further to 7.8 per cent at the end of October 1999 as a result of the bumper aman crop.

Movements in consumer prices in Bhutan followed those in India to a great extent since there was free trade between them, and the ngultrum was freely convertible at par with the Indian rupee. Inflation went up from 6.5 to 9 per cent between 1997 and 1998, but stabilized at just over 9 per cent the following year. Cereals constituted almost two fifths of the consumption basket, and their price surged by about 11 per cent in 1999, owing to higher food prices in India. On the other hand, vegetable prices

Table II.3. Selected least developed countries of the ESCAP region: summary of macroeconomic indicators, 1996-1999

(Percentage)

		1996	1997	1998	1999
Bangladesh	Savings/GDP	7.5	7.5	8.6	8.5
	Investment/GDP	17.0	17.3	17.8	17.5
	Budget balance/GDP ^a	-5.9	-5.6	-5.4	-7.7
	Trade balance/GDP	-9.8	-8.6	-7.1	-7.9
	Current account balance/GDP	-4.1	-1.7	-0.8	-1.2
	Money supply growth (M2)	10.7	9.8	11.4	14.7 ^b
	Inflation rate ^c	6.6	2.6	7.0	8.9
Bhutan	Savings/GDP	26.4	..	..	..
	Investment/GDP	44.4	47.0	48.0	49.0
	Budget balance/GDP	2.3	-2.4	3.3	-1.2
	Trade balance/GDP	-4.0	-8.0	-6.4	-16.1
	Current account balance/GDP	-11.2	-14.1	-12.1	-27.8
	Money supply growth (M2)	9.0	59.0	14.0	25.0 ^b
	Inflation rate ^c	8.8	6.5	9.0	9.2
Cambodia	Savings/GDP	5.3	4.8	3.6	..
	Investment/GDP	25.9	19.0	15.0	..
	Budget balance/GDP ^a	-7.2	-4.3	-3.9	-2.2
	Trade balance/GDP	-13.5	-10.7	-14.1	-9.3
	Current account balance/GDP	-5.8	-6.9	-8.0	-10.8
	Money supply growth (M2)	40.4	16.6	15.7	21.5 ^d
	Inflation rate ^c	7.2	7.9	14.8	5.0
Lao People's Democratic Republic	Budget balance/GDP	-5.6	-6.5	-10.0	-4.5
	Trade balance/GDP	-17.3	-16.2	-12.8	-17.0
	Current account balance/GDP	-18.7	-17.5	-11.6	..
	Money supply growth (M2)	26.7	65.8	109.7	80.0
	Inflation rate ^c	13.0	27.5	91.0	130.0
Maldives	Budget balance/GDP	-3.7	-2.0	-5.3	-4.2
	Trade balance/GDP	-61.2	-62.7	-58.1	-63.1
	Current account balance/GDP	-2.4	-10.7	-6.3	-9.5
	Money supply growth (M2)	26.0	23.1	22.8	16.6 ^b
	Inflation rate ^c	6.3	7.5	-1.4	3.2 ^e
Myanmar	Savings/GDP	11.5	10.4	12.1	..
	Investment/GDP	12.3	11.1	12.8	..
	Budget balance/GDP ^a	-2.2	-1.0	-4.0	..
	Trade balance/GDP	-0.7	-0.7	-0.7	..
	Current account balance/GDP	-0.2	-0.2	-0.3	..
	Money supply growth (M2)	38.9	28.9	36.4	26.5 ^f
	Inflation rate ^c	16.3	29.7	51.5	38.0
Nepal	Savings/GDP	13.8	14.0	9.5	10.6
	Investment/GDP	27.3	25.3	20.7	17.3
	Budget balance/GDP	-5.6	-5.1	-6.4	-6.8
	Trade balance/GDP	-22.0	-25.3	-20.9	-16.1
	Current account balance/GDP	-8.7	-5.9	-5.1	0.3
	Money supply growth (M2)	14.4	11.9	17.8	16.0
	Inflation rate ^{c,g}	9.2	4.0	10.2	9.6

Sources: ESCAP secretariat calculations based on ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999) and *Asian Development Outlook 1999* (Oxford University Press, 1999); IMF, *International Financial Statistics*, February 2000; and national sources.

Notes: Data for 1999 are estimates. Savings/GDP refers to gross domestic savings/GDP; investment/GDP refers to gross domestic investment/GDP.

^a Excluding grants.

^b January–September.

^c Referring to changes in the consumer price index.

^d January–November.

^e January–October.

^f January–June.

^g National urban consumer price index.

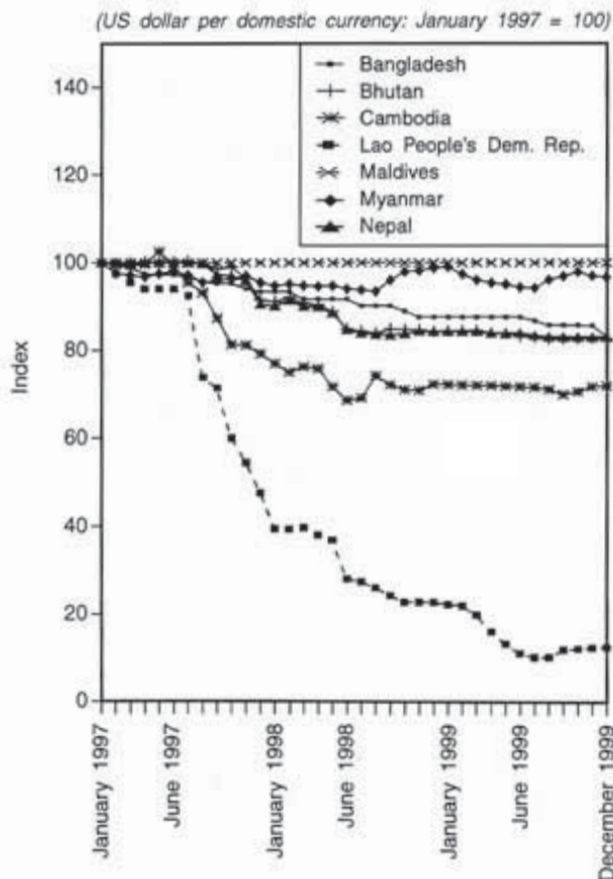
decreased significantly on account of greater local production and a stable supply from India during the winter season. The price of edible oils and fats, likewise, was down as a result of the return to normal supply and demand conditions following the price hike in 1998. Clothing and footwear were the main non-food component of the consumption basket, and their prices showed only a marginal increase, from 7.4 to 8.6 per cent in June 1998 and June 1999 respectively.

The rate of increase in consumer prices in Phnom Penh and other areas of Cambodia was expected to decline significantly to 5 per cent in 1999 from 14.8 per cent the previous year. The stabilizing factors included a fall in external demand, a good harvest which held down prices, and greater

stability in the riel exchange rate, which had taken the pressure off import prices.

Consumer prices in five provinces of the Lao People's Democratic Republic inflated sharply from 27.5 per cent in 1997 to reach about 130 per cent in 1999; large price increases were visible in both food and non-food components of the consumer price index. This inflationary trend can be traced to the extremely high rates of money supply growth (M2) between 1997 and 1999. In addition, the depreciation in the value of the local currency was particularly sharp in 1998 and continued intermittently in 1999 (figure II.1); this significantly pushed up the import price of a wide range of items in the typical consumption basket. To absorb excess liquidity, six-month certificates of deposit with an

Figure II.1. Index of exchange rates of selected least developed countries, 1997-1999



Sources: IMF, *International Financial Statistics*, various issues; and *Far Eastern Economic Review*, various issues.

annual interest rate of 60 per cent were offered in September 1999. Excessive central bank lending to government was also eliminated in the third quarter of 1999 and a relative stabilization of the local exchange rate was observed in the second half of the year. As a result, the monthly rate of inflation fell from 5 per cent in August 1999 to 0.4 per cent in October 1999 and, on current indications, the rate of price increases is likely to be much more modest in 2000.

Domestic consumption in Maldives depends heavily on imports, with the notable exception of fish and some services, and the stable exchange rate helped to contain imported inflation in 1999. Consumer prices went up moderately, by only 3.2 per cent during the first 10 months of 1999. Retail prices of clothing and medical care actually declined during the period.

In Myanmar, the very high rate of inflation of 51.5 per cent recorded in 1998 (measured by changes in consumer prices in Yangon) was forecast to moderate significantly to about 38 per cent in 1999. A high rate of money supply growth (M2) and a surge in food prices following poor agricultural production were two of the factors that had caused an increase of over 50 per cent in retail prices in 1998. By April 1999, however, the inflation rate had dropped to 29 per cent owing to improved agricul-

tural output, lower money supply growth and an easing of the pressure on administered prices.

The consumer price index in urban areas of Nepal went down marginally to 9.6 per cent in 1999 from over 10 per cent the previous year. The trend, however, was clearly downward as the year-on-year inflation rate fell further to 7 per cent in July-August 1999, and then to 6.4 per cent in August-September. The prices for food and beverages were rising much faster than for non-food items. In addition, the rates of increase in retail prices were much steeper in the hill regions, and more moderate in Kathmandu. These developments have adverse distributional implications. Consumer price inflation, which was originally forecast at around 5 per cent in 2000, is expected to be higher on account of increased world oil prices. Diesel and kerosene prices, for example, were hiked up 48 and 23 per cent respectively in October 1999. Public bus fares were consequently adjusted upwards by some 30-35 per cent.

Trade and exchange rates

After a large expansion in merchandise export receipts of nearly 17 per cent in 1998, Bangladesh experienced a modest improvement in export earnings of just under 3 per cent to \$5.3 billion in the following year (table II.4). EU and the United States

Table II.4. Selected least developed countries of the ESCAP region: merchandise exports and imports in United States dollar value and their rates of growth, 1996-1999

	Value (millions of US dollars)		Exports (f.o.b.) Annual rates of growth (percentage)			Value (millions of US dollars)		Imports (c.i.f.) Annual rates of growth (percentage)		
	1998	1996	1997	1998	1999	1998	1996	1997	1998	1999
	Bangladesh ^a	5 172	11.8	14.0	16.8	2.9	7 524	19.1	3.1	5.1	6.6
Bhutan ^a	111	39.4	1.7	12.1	-2.2 ^b	136	14.1	18.3	3.7	21.4 ^b
Cambodia ^c	999	-18.5	34.5	14.3	9.2 ^b	1 227	-9.3	3.0	7.4	0.7 ^b
Lao People's Democratic Republic	337	2.6	-1.2	6.3	..	553	17.1	-6.1	-14.7	..
Maldives ^c	98	-6.0	15.8	5.4	-4.9 ^b	312	12.6	15.6	1.5	7.2 ^b
Myanmar ^a	1 134	3.6	8.8	12.2	..	2 480	8.8	15.0	8.2	..
Nepal ^{a,c}	840	-8.8	84.9	-24.5	..	1 559	5.9	31.7	-12.3	..

Sources: IMF, *Staff Country Reports*; and national sources.

^a Fiscal year.

^b Projection.

^c Including re-exports.

were the country's most important markets. The value of ready-made garments shipped to these two markets, plus Canada, accounted for over three quarters of total receipts from merchandise exports; such exports rose modestly by 6.2 per cent in 1999. Moreover, the extensive flooding not only depressed production but also disrupted transport and communications. Largely as a result, there were lower export earnings of just under 7 per cent for fish and shrimps (to \$274 million), of almost 12 per cent for leather (to \$168 million), of about one third for raw jute (to \$72 million), and of 17 per cent for tea (to \$39 million). On a brighter note, however, jute exports from Bangladesh were expected to rise in response to a reduction in Indian tariffs on jute imports, from 40 to 16 per cent. In dollar terms, export earnings in the first quarter of fiscal year 2000 increased by 8 per cent year-on-year to \$1,390 million, an amount slightly below the government target of \$1,430 million. The export value of ready-made garments, knitwear, jute and jute goods, tea, handicrafts and chemical products was less than expected as a result of lower world prices.

Import payments, meanwhile, rose by 6.6 per cent to \$8 billion in 1999. Expenditure on food grain imports jumped by 170 per cent (to \$997 million) in 1999, from \$369 million in 1998, to compensate for flood-related shortfalls in domestic supplies. There were also large increases in other imported items during the same year; spending on oilseed and edible oil and on milk and milk products went up by almost a quarter; on fertilizers by about 11 per cent; and on chemicals by 0.8 per cent. However, imports of raw materials for the garment industries, such as cotton, yarn, dyes and textile materials, were reduced by 9.3 per cent in 1999 owing to the general slowdown in economic activities and higher levels of local production. Declines were also recorded for imports of other raw materials, intermediate goods and capital goods which were sourced mainly from China, India and Japan. Letters of credit for imports in July and August 1999 showed a year-on-year rise of 3.4 per cent, to a total of \$1.1 billion. The explanatory factors included efforts made to stabilize the total availability of food supplies, imports linked to flood rehabilitation and higher world prices for oil products.

Bangladesh has gradually embarked on an outward-looking trade regime, including through import liberalization, the removal of quantitative import restrictions and reductions in import duties. The

average unweighted rate of nominal protection, for example, stood at 89 per cent in 1991, at 22 per cent in 1996 and 20 per cent during 1999. Furthermore, import duties on commodities were lowered from 30 to 25 per cent, and on primary materials from 7.5 to 5 per cent in the 2000 budget. The long-term direction of the trade sector was also charted in the five-year trade policy (1997-2002). The immediate focus was on liberalizing imports further through the removal of or significant reduction in tariff and non-tariff barriers, strengthening customs administration for speedier import clearance, lowering duties on industrial inputs and capital machinery as incentives for both domestic production and exports, enabling foreign exchange convertibility on current accounts, and ensuring greater transparency in export promotion.

Adjustments to the exchange rate in Bangladesh were based on movements in the real effective exchange rate index, a measurement which reflected the changes in purchasing power parity among the country's major trade partners. Account was also taken of changes in the stock of foreign exchange reserves, the shortfalls on current accounts and the parallel market exchange rate. There was only a gentle depreciation in the local currency in 1998 and 1999. The exchange rate of the taka stood at 46.3 to the United States dollar at the end of June 1998; it was down to 49.5 on 18 July 1999, and to 51 on 1 December 1999.

Owing to geographical location and close economic ties, India absorbed about nine tenths of Bhutan's exports and provided three quarters of imports; Bangladesh was the next important trading partner in terms of exports, and Japan for imports. Electricity, mineral products (such as cement, ferro alloys, calcium carbide and coal), particle board and fruits (including oranges and apples) were the country's main exports, while capital goods, petroleum products and consumer goods constituted the primary imports. The dollar value of merchandise exports was projected to decline by 2.2 per cent in 1999 and that of merchandise imports to grow by 21.4 per cent (compared to just under 4 per cent in 1998). Spending on imports related to the construction of new power plants and related service payments went up considerably in the year. The trade deficit consequently widened from just over 6 per cent to about 16 per cent of GDP between 1998 and 1999, and the trade balance with India was in

deficit after registering a surplus in previous years. Shortfalls in the services accounts and transfer payments associated with aid-funded power projects pushed the current account deficit up significantly, from about 12 per cent to some 28 per cent of GDP during the same two years.

Bhutan implemented a trade liberalization programme in 1996 to foster trade diversification and increase convertible currency earnings. There were significant reductions in customs duties on imports from third countries complemented by a streamlining of rules and procedures on such imports. Revisions to the Foreign Exchange Regulations of 1997 were to be made to eliminate a number of foreign exchange restrictions on current account transactions. In addition, membership in WTO was under consideration.

Total merchandise exports, including re-exports, from Cambodia were forecast to expand by 9.2 per cent in 1999 while the value of total imports, was expected to be 0.7 per cent higher. Exports under GSP, mostly garments, were estimated to be the largest source (almost three fifths) of foreign exchange earnings in 1999; garment exports grew by almost 90 per cent in the first half of 1999 year-on-year. Largely because of the imposition of quota restrictions by the United States in early 1999, these exports were now directed increasingly towards EU. Rice exports were also expected to grow in view of a rice surplus of some 30,000 tons in 1998, and a forecast excess production of 50,000 to 60,000 tons in 1999. However, rice-processing facilities and transport infrastructure would need to be much improved for value-adding gains and for effective competition with alternative suppliers such as Thailand and Viet Nam. In 1999, over 1 million tons of goods were expected to pass through the port of Sihanoukville, up by almost one third from the 1997 volume. The main destinations for Cambodia's exports in 1997 were Singapore, Thailand, the United States and Viet Nam while imports originated mainly from Singapore, Switzerland, Thailand and Viet Nam.

In line with its commitment to the ASEAN Free Trade Area (AFTA), Cambodia has until 2010 to lower tariffs on most goods to a maximum of 5 per cent from the current range of 7-50 per cent. By 2002, however, the maximum tariff rate is expected to be reduced to 30 per cent and the effective tariff

rate to 14 per cent. The number of products in the temporary exclusion list and in the general exception list is also being reduced; these lists are intended to enable participating countries to extend protection on certain domestic goods for a longer period of time. As regards exchange value, the greater degree of stability in the rate of the riel reflected the improved political situation, lower domestic inflation and a more stable regional economic climate. The riel depreciated by 3.7 per cent between January and mid-November 1999, compared to a fall of over 11 per cent in 1998.

The trade deficit of the Lao People's Democratic Republic declined to \$216 million, as a result of a drop of 14.7 per cent in import outlays (to \$553 million) and a rise of 6.3 per cent in export receipts (to \$337 million) in 1998. There were higher earnings from the export of electricity (with the coming on-stream of the Theun Hinboun hydroelectric plant), wood and coffee, while garment exports declined in the same year. However, the latter subsequently strongly revived with the reinstatement of preferential market access to EU in July 1999. Imports were lower in dollar terms owing to the depreciation of the baht vis-à-vis the United States dollar. At the same time, however, unrecorded imports may have risen, constricting the domestic manufacturing sector which was facing additional constraints such as credit shortages and currency restrictions. These limited the availability of imported equipment and raw materials. The first quarter of 1999 witnessed a decline in both exports, by \$30 million to \$52 million, and imports, by \$34 million to \$105 million, on a year-on-year basis. The trade deficit was expected to decline, given an estimated export value of \$271 million against \$497 million spent on imports for 1999.

Thailand agreed to reduce import duties on 62 agricultural products and raw materials from the Lao People's Democratic Republic in September 1999 to help to reduce the impact of the current economic crisis. Meanwhile, a tripartite agreement between the Lao People's Democratic Republic, Thailand and Viet Nam was signed in late November 1999 to facilitate both transport and trans-shipment of traded goods; border trade on a barter basis with China and Viet Nam was reported to be increasing considerably. The country was planning to become a WTO member by 2001. Like neighbouring Cambodia, the Lao People's Democratic Republic will be

affected by the upcoming AFTA, which is expected to have a considerable effect on government revenue, of which fiscal receipts from the taxation of trade provide a significant share. On the other hand, the use of an outdated exchange rate of 4,000 kips to the United States dollar for import valuation and taxation purposes in 1999 might have helped in containing imported inflation; as a trade-off, however, it was estimated to have deprived the budget of revenue to the tune of 2.4 per cent of GDP. The exchange value had gone down from 4,200 kips to one United States dollar in the fourth quarter of 1998 to 9,350 kips in July 1999. It strengthened to 6,000 kips to the dollar within a week in September 1999 as commercial banks started limiting the circulation of the local currency.

In Maldives, the value of merchandise exports was projected to fall by about 5 per cent to \$92.7 million, and import payments to rise by 7.2 per cent to \$334 million, in 1999. A continuous trade deficit widened to \$59.6 million in the second quarter of 1999, from \$52.7 million during the corresponding quarter the previous year, on account of both lower export receipts and higher import payments. The value of merchandise exports was down by about 11 per cent to \$21.2 million in the second quarter of 1999 as a result of lower earnings on fish exports; these constituted 53 per cent of all domestic exports which, in turn, made up two thirds of total merchandise receipts with re-export, primarily jet fuel, supplying the remainder. On an annual basis, the export volume of live tropical fish declined by 13 per cent, and that of both canned and frozen non-reef fish by 40-60 per cent between June 1998 and June 1999; the latter was compounded by declining unit values as well. Meanwhile, on a year-on-year basis, garment exports doubled in terms of volume and earnings were 86 per cent higher during the second quarter of 1999; on an annual basis, however, the unit value of exported garments was about 8 per cent lower during the same period.

The largest trade partners of Maldives were Germany; Hong Kong, China; Japan; Sri Lanka; the United Kingdom; and the United States. Outlays on merchandise imports went up moderately, by 3 per cent, to almost \$92 million in the second quarter of 1999; the corresponding quarterly figure the previous year was \$87 million. The major import categories were consumer goods, petroleum products, and intermediate and capital goods; private sector imports

accounted for seven tenths of the total import bill. Public sector imports expanded by one fifth between June 1998 and June 1999, compared to a 6 per cent growth rate of private sector imports. Although the rufiyaa remained unchanged against the United States dollar at an exchange value of 11.77 in the year ending 30 June 1999, it appreciated against the Singaporean dollar (by 3 per cent), the Indian rupee (1 per cent), and the Sri Lankan rupee (9 per cent); but there was a depreciation of 13 per cent against the Japanese yen.

The merchandise trade receipts of Myanmar grew significantly in 1998, by over 12 per cent (to reach more than \$1.1 billion). There were higher earnings from agricultural exports to Bangladesh, China and India, offsetting the adverse price trends on primary commodities. Regarding the performance of individual items, significant increases in export value were recorded for rice (by three and a half times to \$39.5 million), teak and other hardwoods (by almost a quarter to \$169.4 million); in comparison, prawn and fish exports expanded moderately by one tenth to \$51.3 million. On the other hand, pulse exports fell by almost one fifth to earn \$181.6 million, while trade earnings on rubber also dropped sharply by about a quarter (to just over \$16 million) as a result of weak world prices. Trade promotion policies, which had previously focused on the energy sector, were increasingly directed at the large-scale development of export-oriented agriculture in Myanmar.

Spending on merchandise imports was estimated to have slowed down to just over 8 per cent (to \$2.5 billion) in 1998. As a result, the trade balance remained unchanged in 1998. However, the merchandise trade deficit narrowed, with the value of both capital and consumer goods imports apparently contracting by about 8.7 per cent in the first half of 1999 partly because of a shortage of foreign exchange and the implementation of stricter controls.

In 1998, the commercial tax, payable in foreign exchange, was raised from 5 to 8 per cent, while the open general import licence for state enterprises became available only on a case-by-case basis; the monthly limit on remittances against foreign exchange certificates for payments on invisible transactions and current transfers was also reduced from \$50,000 to \$30,000.

Myanmar maintained a dual exchange rate arrangement with public sector exports and imports, and government debt servicing, which comprised a third of all transactions, being conducted at the official exchange rate of 8.5 kyats per special drawing right. Private transactions, whether of a current or a capital nature, were governed by the parallel market rate which stood at some 345 kyats to the United States dollar in August 1999. The current arrangement accorded state-owned enterprises a high degree of effective protection which might not be conducive to efficiency. The main market-determined exchange rate is for foreign exchange certificates which are dollar-denominated local currency notes issued since 1993 against six major convertible currencies. This represented, in effect, a responsive de facto devaluation of the local currency.

The merchandise exports receipts of Nepal were down by almost a quarter, to \$840 million in 1998. Although the value of domestic exports increased steadily from just under \$400 million in 1997 to \$444 million the following year, that of re-exports (such as gold and oil products, mainly to India) declined substantially from \$716 to \$396 million. Import spending, meanwhile, shrank by over 12 per cent to \$1.6 billion in 1998. The trade deficit stood at \$700 million in 1998. Woollen carpets and ready-made garments provided about 54 per cent of trade receipts, with the latter surging by almost two fifths to reach 9.7 billion rupees in 1999, thus replacing carpets as the country's top export product in the early part of fiscal year 2000. The fast-paced growth of such exports will be constrained by the exhaustion of garment export quotas for the United States market; indeed, by June 1999, producers of ready-made cotton clothing had already used up four fifths of their quotas for 1999. Pulses recorded modest growth of just under 8 per cent in export value, while the growth of tanned skins and nigerseed dropped considerably (by 30 and 16 per cent respectively) during the first 11 months of 1999.

India was the market for 36 per cent of Nepal's exports following the trade pact of December 1996, which permitted most articles undergoing at least two manufacturing processes in Nepal to enter India duty-free. Consequently, India-bound shipments of products made largely or exclusively from imported materials increased dramatically. In particular, exports of vegetable ghee to India (at 2.9 billion rupees) went up by over four fifths year-on-

year in 1999; this item has become the largest export to India. Impressive growth was also registered in exports of toothpaste, soap and instant noodles. In 1998, the main destinations of exports were Germany, India and the United States while imports originated largely from China, India and Singapore. Imports from India included cotton fabrics, consumer goods, medicines and vehicles; their value rose by 12.3 per cent year-on-year in 1999 and was equivalent to about 37 per cent of all import spending. Expenditure on non-gold imports fell by some 6 per cent on account of a fall in the value of petroleum imports and a drop of 20 per cent in the value of machinery imports.

Capital inflows and outflows

Bangladesh's large trade deficit of almost \$2.7 billion contributed indirectly to shortfalls in the current account and the balance of payments in 1999. Inward remittances continued to increase (by just under 12 per cent) from \$1.5 to \$1.7 billion between 1998 and 1999. However, the deficit in net payments of interest, profits and dividends went up by over one third (to \$135 million) and the current account deficit was estimated to reach \$394 million in 1999, an increase of almost 36 per cent over the 1998 level. There were lower net receipts from investment and short-term capital, totalling \$469 million in 1999, compared to \$760 million during 1998. All in all, the balance of payments surplus of \$82 million in 1998 was transformed into a deficit of \$171 million the following year. Meanwhile, the stock of foreign exchange reserves was down to \$1.5 billion in September 1999, an amount equivalent to two months of import cover. This was, however, expected to improve with falling import pressures as the country recovered from the floods and with the expected recovery in export earnings in 2000.

The vulnerable position as regards foreign exchange reserves was a matter of concern for investors in the oil and gas sector in Bangladesh; the government was committed to paying for gas and power in foreign exchange under current purchase agreements. This particular sector has been the target of large FDI inflows, which amounted to \$317 million in 1998, compared to \$141 million in 1997. Although highly critical at the margin, the flow constituted less than 1 per cent of the country's

GDP. Another source of external finance has been ODA: aid commitments and disbursement stood at \$2.2 and \$1.9 billion respectively for 1999. The bulk of such aid (\$1.3 billion) was allocated for various projects, including the construction of better flood protection systems and various rehabilitation needs; the remainder of just under \$600 million was to cover food and commodity requirements. In this connection, Japan agreed to provide Bangladesh with 4.8 billion taka in debt-relief grants as part of an international effort to ease the debt burden on heavily indebted developing countries. The grant will cover principal and interest repayments on yen-dominated loans that mature in the first quarter of 2000.

The volume of foreign currency reserves in Bhutan went up further to \$250 million, equivalent to 20 months of import coverage and more than half of GDP in 1999 as a result of continuing surpluses in the balance of payments. Capital inflows (\$128.2 million) consisted mostly of overseas aid and were allocated primarily for investment in infrastructure and hydropower projects. These flows far exceeded the current accounts deficits (\$86.9 million) in 1999. Grants and soft loans for the construction of power projects from India alone accounted for three quarters of such assistance during the period under review. External debts, however, had started to rise in recent years because of increased borrowing for the development of these infrastructure and energy projects. In June 1999, the total debt-to-GDP ratio reached almost two fifths, and the debt-service ratio was up to nearly 11 per cent. The final repayment of the largest commercial loan of \$22.6 million, obtained in 1987 for the purchase of a civilian aircraft, was made in 1999. Foreign investment was encouraged by Bhutan on a case-by-case basis; the preferred modality was joint venture, with foreign participation limited to a maximum of one fifth of the total equity. A recent investment of about \$1 million was made by ADB and Citibank in the Bhutan National Bank. A general framework for FDI in place of the current case-by-case approach is currently under discussion in the country.

Cambodia's stock of foreign exchange reserves had been rising steadily since 1995 to stand at some \$360 million at the end of August 1999. This was noticeably higher, by over two fifths, than the level of \$252 million in 1996 and was equivalent to just over 17 weeks of import spending based on

1998 trade figures. However, FDI remained relatively subdued, with 66 projects worth \$240 million approved during the first nine months of 1999; this was about 23 per cent lower year-on-year. These projects were largely in textile and garment manufacturing, and in hotel construction. IMF approved a new enhanced structural adjustment facility of \$81.6 million whose disbursement in seven instalments over three years would depend on progress in the implementation of key reforms in such areas as fiscal policy, logging and public administration. There was also a resumption of yen loans from Japan, which had been suspended since 1968, to upgrade the port at Sihanoukville at a cost of \$35 million, while France announced a \$3.3 million grant for technical assistance with the state-run electricity company as the target beneficiary.

The foreign reserve position slipped slightly in the Lao People's Democratic Republic to about \$113 million in August 1999, from \$117 million at the end of 1998, partly because of central bank intervention in defence of the value of the kip. At this level, the stock of foreign reserves was adequate to finance just over 10 weeks of import expenditure as per the 1998 figure. The high rates of domestic inflation and the falling exchange value of the local currency were behind the large increase in foreign currency deposits with commercial banks, from \$107 million in December 1997 to \$125 million, or over two thirds of the broad money supply, in May 1998. The services balance improved significantly to record a surplus of \$49.5 million in 1998 owing to higher tourism receipts, and lower payments for hydropower construction and associated services. This helped to offset a large deficit of almost \$35 million in the factor income account as a result of higher interest and dividend outflows, and rising interest payments on official borrowings.

The value of FDI in the Lao People's Democratic Republic went down in 1999 on account of the completion of the Theun Hinboun hydropower project as well as the general slowdown observed in capital inflows elsewhere in the subregion. The value of FDI approvals was about \$93 million, or around a third lower than the previous year. The cumulative amount of approved FDI projects, totalling about \$7 billion from 1988 to mid-1999, was primarily in hydropower generation, manufacturing, transport development and tourism. Thailand, followed by the United States, Malaysia, the Republic of Korea and France were the largest investors in cumulative value

terms. Macroeconomic instability, an inadequate legal and regulatory framework, shortages of infrastructure and skilled labour, and a long approval process were among the constraints on larger FDI inflows. As regards the transfer accounts, both grant and loan disbursements declined in 1998 and to reverse this trend, the Lao People's Democratic Republic identified for donor assistance eight priority programme areas, including food security, commodity production, human resources development and rural development. Debt to creditors other than the Russian Federation stood at over \$1 billion, or about four fifths of GDP at the end of 1998. Most of such external obligations were concessional in nature although the Theun Hinboun power company, majority-owned by the government, had a debt stock of about \$160 million from commercial creditors. By mutual agreement, no payment was made to the Russian Federation on the debt of 789 million roubles in 1999.

In Maldives, external reserves increased from about \$116 million in June 1998 to \$139 million in June the following year; the latter was equivalent to just under five months of imports. As discussed earlier, the country experienced a large and rising trade deficit, which was offset by larger surpluses in the services accounts, primarily because of tourism receipts. Deficits in the income and transfer accounts were comparatively much smaller. The deficit in the current accounts was more than made up by large inflows of capital for investment purposes. There were no exchange controls or restrictions on currency movements and the repatriation of funds and profits could be freely made.

The chronic shortage of foreign exchange in Myanmar was reflected in the low amount of international reserves. The country's external sector was beset with a number of problems which included a large volume of payment arrears on external debt, extensive import and exchange controls, limited availability of imported inputs and a large differential between the official and parallel market exchange rates. Gross international reserves, consisting of overseas deposits by the Central Bank of Myanmar and the large state-owned banks, amounted to about two months of import cover in 1998. During the same year, the current accounts deficit was funded largely by FDI inflows; such inward investment, however, decreased to \$290 million in 1998, partly due to the completion of large energy and tourism projects and partly due to the Asian economic crisis.

Meanwhile, disbursements from new borrowings relating to airport construction, an expansion in shipping capacity and agricultural and telecommunication projects from Asian creditors were estimated at \$300 million, or equivalent to nearly half of the current account deficit in fiscal year 1998. The external debt profile had been shifting from long-term concessional obligations to short-term commercial debt and supplier credit. The stock of external debt stood at \$5.9 billion at the end of March 1999; of this amount, \$460 million was in interest arrears.

Nepal's foreign exchange reserves increased considerably to 11 months of import cover (or \$1.1 billion) in 1999, from just over seven months (or \$700 million) in the previous year. The country's large trade deficit was bridged by surpluses in services transactions, notably tourism receipts, and the transfer account, including overseas assistance and workers' inward remittances. There was thus a small surplus in the balance of payments in 1999. Inward FDI was down by over three fifths in the past two years, from 1.6 billion to 600 million rupees between 1997 and 1999. However, the free trade agreement between India and Nepal transformed the Terai into a minor magnet for FDI, as both Indian and third-country companies began to open plants aimed at serving the north Indian market. Foreign investment came primarily from China, India, Japan and the United States. The servicing burden of external debt, which went down slightly from just over 31 to 28.3 per cent of budgetary expenditure between 1997 and 1998 was further aggravated by a depreciation of the local currency in recent years.

Financial and fiscal sector developments

Through prudent fiscal management, Bhutan was able to ensure that domestic revenue met current expenditure needs, while grants and soft loans financed capital outlays of the public sector. The country has been one of the few developing economies to have realized an overall budget surplus or to have had a comparatively small fiscal shortfall in recent years, aided by a doubling of export prices of electricity and a sharp decline in capital spending. The surplus for 1998 was estimated at 3.3 per cent of GDP. The introduction of a personal income tax system is expected in 2000, and this will help significantly to broaden the current

base of government revenue that is currently heavily reliant on electricity exports.

Under the programme of financial sector reform, a series of initiatives were undertaken to deregulate interest rates in Bangladesh. Interest rate bands and subsidies for term lending to agriculture and cottage industries were withdrawn in July 1999, while the gradual withdrawal of the interest rate band on export credit was under consideration. Commercial banks currently fixed their own lending and deposit rates independently, in response to market conditions, and adjusted them periodically without interference from the monetary authorities. The central bank rate was lowered from 8 to 7 per cent in August 1999 and the cash reserve ratio from 5 to 4 per cent in September 1999 to stimulate domestic borrowings and investment. Concessional refinance facilities were replaced by a single common window for rediscounting facilities at the applicable bank rate.

The financial sector in Bangladesh suffers from a serious weakness in the form of problem loans. Classified bank lending went up from about 32 to over 39 per cent of the total loan portfolio between 1995 and 1998. However, the percentage of substandard loans, which remained overdue for more than three months, fell from 13 per cent in 1995 to 4.7 per cent in 1998, while the percentage of doubtful loans which were overdue for more than six months declined from 12 to 8 per cent in the same years. Nevertheless, some 24 out of the 39 banks were behind in making adequate provision for various categories of problem loans.

Stock exchanges were in operation in Chittagong and Dhaka, and a national stock exchange was being planned. For a variety of reasons, however, share prices and market capitalization at the Dhaka Stock Exchange were on a downward trend, with the latter falling from \$1.1 billion in 1997 to just under \$600 million in 1999. The Securities and Exchange Commission was recently under reorganization and a capital market development programme was being implemented to raise savings and investment rates and to improve efficiency in resource allocation. The various reforms aimed at capital market development included the automation of trading at the Dhaka and Chittagong stock exchanges, greater transparency and public disclosure by both stockbrokers and share issuers, the introduction of new mutual fund

regulations allowing private parties to float a mutual fund and the establishment of a depository company for scripless trading.

To improve the efficiency and flexibility of the financial intermediation process, the Royal Monetary Authority of Bhutan removed administrative controls on sectoral interest rates in its revised prudential guidelines effective April 1999. A number of other measures were also adopted. The capital adequacy ratio was increased from 6 to 8 per cent of total assets (excluding liquid assets), and NPLs were redefined as those overdue for 91 days or more (instead of 180 days or more). The latter regulation, in effect, raised the volume of non-performing assets from 9.8 to 12.4 per cent, but all financial institutions maintained financial reserves well in excess of the new capital adequacy requirements. Legislation was in place (for example, the Moveable and Immovable Property Act, 1999) to strengthen the legal framework for loan recovery. Meanwhile, the Royal Securities Exchange of Bhutan, established in 1993, continued to play an important role in the divestment of government interests in public sector enterprises and in broadening the ownership base of large companies. There were 13 listed companies and the value of market capitalization tripled to 1.6 billion ngultrum between 1993 and 1998. No primary offerings were made through the exchange in fiscal year 1999, although the total turnover in secondary market trading doubled at 10 million ngultrum.

Under the new legislation on financial institutions scheduled for presentation to the National Assembly in late November 1999, regulations governing the 33 commercial banks in Cambodia would be reviewed and the existing banks would be required to reapply for licences. Banks would have to merge or close if they were unable to fulfil or comply with the criteria specified, while technical assistance would be given to the remaining banks. In a parallel measure, the minimum level of capital requirement for banks was recently raised from \$5 million to \$13.5 million (or 50 billion riels). A grant for technical assistance from ADB would assist the central bank authorities to improve the regulatory framework for organizations providing low-income borrowers with microfinance and to strengthen skills in the financial management of these institutions.

Customs-related receipts have dominated the revenue side in Cambodia, but this revenue source is much constrained by the porous border on several sides and, in the near future, trade liberalization measures in line with the country's commitments under AFTA. The flows of unrecorded, cross-border trade were estimated to have caused the government substantial losses of tax income. Lower import tariffs could discourage smuggling but the net effect on government revenue is uncertain. Further progress in demobilization and the streamlining of public spending, supplemented by higher levels of cost efficiency in the delivery of public sector goods and services, will be essential on the expenditure side.

Domestic excise taxes were expected to replace the decline in relative importance of customs duties with the operation of AFTA. The 1 per cent VAT applicable to large enterprises introduced in January 1999 accounted for nearly a quarter of total revenue within the first nine months of the year. A surcharge on petroleum products to be earmarked for road maintenance faced strong political opposition. Local authorities were expected to determine the surcharge rate on alcoholic beverages which would be channelled for infrastructure development. Non-tax revenue raised from the agricultural sector, including royalties on logging and fisheries, was also expected to be replaced by taxes, along with better controls of the activities concerned.

The banking system in the Lao People's Democratic Republic was also under a restructuring process with technical assistance from ADB. There were a substantial number of NPLs and recapitalization was estimated to require some \$70 million. In 1999, six state-owned commercial banks were consolidated into two financial institutions headquartered in Vientiane, prudential regulations were being more strictly enforced and a credit information bureau was established for sharing information on loans and borrowers among state-owned commercial banks. Interest rates, which were still determined administratively, became significantly negative in real terms with high and rising inflation. Nominal rates on deposit instruments were raised in 1998 and 1999, but still fell considerably short of the inflation rate.

Four commercial banks operated in Maldives and their loans to the most important domestic sector, tourism, increased by 55 per cent between June 1998 and June 1999. However, the development of tourist resorts and associated facilities required major and lumpy capital resources, the bulk of which came from overseas, including in the form of FDI. There was as yet no stock market, although public sector corporations issued shares from time to time. Commercial banks in Maldives maintained a similar interest rate structure and lending and deposit rates remained more or less unchanged, with United States dollar lending rates being in the range of 14-15 per cent and rufiyaa-denominated rates being two percentage points lower as of mid-1999. Interest rates on foreign currency deposits, at 5.5 to 6.8 per cent, were also higher than those paid on rufiyaa deposits, which ranged from 5 to 6.5 per cent.

In Myanmar, the 20 private banks held 56 per cent of total deposits and extended just over one fifth of domestic loans. The remaining credit needs were provided by the Central Bank of Myanmar (about 63 per cent) and the four state banks (16 per cent). To stimulate bank lending, interest rates were lowered in April 1999. A reduction of three percentage points in the discount rate (to 12 per cent) served to lower interest rates on commercial bank loans and medium-term government securities. Although the rate of inflation fell sharply from around 51 to 38 per cent between 1998 and 1999, the negative interest rates on deposits in real terms remained a constraint on domestic savings and hence on the supply of investible funds. Foreign exchange business was conducted by state banks. Foreign banks were only able to open representative offices and the number of these offices declined upon the revocation of their foreign exchange trading licences in 1998. Private banks were reported to have been in compliance with the central bank's prudential regulations on reserves, minimum liquidity, capital adequacy and loan provisioning. Capital adequacy and reserve requirements, however, were not enforced at state-owned banks. The economic slowdown in recent years and the drop in FDI inflows contributed to an increase in NPLs, estimated in the range of 1 to 18 per cent of the total credit portfolio of individual banks.

The Government of Nepal was in the process of strengthening the regulatory framework for financial institutions through, for example, the introduction

of new sets of legislation on bankruptcy and debt recovery, the opening of local markets to international accounting and auditing firms, and the licensing of foreign bank branches in the country. Most banking system assets and liabilities, some 70 per cent in 1999, were accounted for by two banks, the Nepal Bank Limited and the Rastriya Banijya Bank. Commercial banks and other financial institutions were strongly encouraged to improve and diversify their services and to meet the need for credit in priority sectors and activities. In line with this policy, banks were requested to contain the spread to within five percentage points of the weighted difference of their interest rates on loans and deposits. In addition, they were urged to provide credit facilities at an interest rate of 10 per cent for the financing of exports in excess of the 1998 export base; refinancing of such facilities would be available from the Nepal Rastra Bank (central bank) at 7 per cent interest.

Policy issues and responses

Within the broader context of macroeconomic stability and domestic resource mobilization, managing public finances is one of the critical issues facing least developed countries. During the last few years, most of them have implemented a variety of reforms to enhance government revenue. These have included the introduction of value added taxes, rationalization of exemptions and allowances, simplification of tax structures, strengthening of the tax collection machinery and measures to encourage voluntary compliance. Yet, most of them have not been able to raise tax/GDP ratios significantly. To a large extent, structural factors impede resource mobilization efforts. The dominance of the subsistence agricultural sector poses a formidable problem for widening the tax base. A significant part of the urban economies in these countries is informal in nature. Within the formal urban economy, the maintenance of records of transactions and accounting standards is of poor quality. Trade-related taxes have traditionally been the most important source of tax revenue in many of these economies. They are under increasing pressure to reduce these taxes as they seek greater integration with the global economy. At the same time, only limited scope exists for decreasing government expenditure in view of the rising need for public investment in such sectors as health, education and infrastructure.

Measures were introduced in virtually all of the Asian least developed countries for the restructuring and reform of the financial and corporate sectors. The recent changes and reforms to strengthen the financial sector have been discussed at some length. A major aim of these efforts has been to ensure greater transparency and disclosure of information and put in place a sounder regulatory framework governing financial sector institutions. However, many of the weaknesses in these institutions are attributable to poor performance by the corporate entities, in both the private and the public sectors. This is further compounded by inadequate supervisory and implementation capacity in the regulatory authorities.

Efforts are being made to rationalize public sector undertakings, including through the divestment of government interests in state-owned enterprises and the promotion of a greater role for the local and external private sector in economic activities. However, domestic private entrepreneurship is weak in many least developed countries. Small market size, limited growth prospects, an insufficient and unreliable infrastructure and the generally poor state of human resources development are some of the factors which severely limit the attractiveness of least developed countries to foreign investors. In some countries, political instability has tended to discourage both domestic and foreign private investment.

Investment in human resources is a key factor for the sustainability of long-term growth, competitiveness and innovation. Least developed countries have been making efforts to raise the quality of their human resources. Several of them have considerably increased public expenditure on primary education, working literacy, primary health and reproductive health care, and the prevention of HIV/AIDS, including through the reallocation of public expenditure on defence and civil administration. Cost-sharing has been attempted through the introduction of or an increase in tuition fees, particularly for higher education. Priorities were also accorded to the promotion of technical and vocational training, as well as to the generation of skills which would better match private sector requirements, and their rapid changes as well. Success in these efforts remains constrained by both the acute shortage of public resources and the low levels of per capita income of the populations.

Given the long-term nature of domestic constraints faced by least developed countries, as noted above, an essential prerequisite for their success is a propitious external environment. In this context, it is worth noting that some labour-intensive merchandise exports, such as textiles and garments, have recently displaced, or are fast displacing, traditional products as the most important source of foreign exchange earnings in several Asian least developed countries, including Bangladesh, Cambodia, the Lao People's Democratic Republic and Nepal. Perhaps the major factor behind the fast-paced emergence of these manufacturing activities has been a ready availability of country-specific export quotas, and their envisaged discontinuation under the Uruguay Round would mean much greater competition to be faced by least developed countries from alternative supply sources. It is therefore of critical importance that special and differential measures in favour of least developed countries, as contained in the Final Act of the Uruguay Round, especially the Marrakesh Declaration and the Ministerial Decisions, are implemented in full as a matter of priority and that new measures in their favour are considered urgently.

Within the regional context, in addition to guaranteed transit rights, a subregional network of transport and port facilities is necessary for landlocked, least developed countries like the Lao People's Democratic Republic and Nepal. The transport and transit agreement reached in November 1999 between the Lao People's Democratic Republic, Thailand and Viet Nam is one significant step in this direction. Since all Asian least developed countries are now members of one subregional organization or another, their trade prospects could be enhanced through the removal of often invisible trade barriers within the framework of AFTA or SAPTA. Such measures would furthermore positively influence FDI, which is inhibited by the relatively small domestic markets in least developed countries.

Finally, servicing external debt is a significant drain on fiscal resources in some least developed countries of the region. None of them has yet been a beneficiary of the highly indebted poor countries debt relief initiative. There is a strong case for an enhanced framework for deeper and broader debt relief for least developed countries in the region.

Pacific island economies

The Pacific island economies continued to display diverse patterns of growth. This subregion had not performed well during 1997 and 1998. During those two years, the highest growth rate recorded by any of the nine economies for which data are presented in table II.5 was a mere 3.4 per cent in Vanuatu in 1998. The picture changed noticeably in 1999 with the number of economies experiencing negative growth dropping to only two in 1999 as against three in 1998. More importantly, the resurgence of several economies, including the two largest ones, witnessed significant growth, ranging between 5 and 8 per cent. Among the major stimulants were improved agricultural performance in response to the return of more normal weather conditions, the upturn in commodity and oil prices, and the recovery of domestic and external demand, including from the economies in East and South-East Asia that had been hit by the economic crisis. As a whole, the outlook for further gains in output and employment in 2000 is reasonably promising for many countries of the subregion.

A development of some concern was the upsurge in inflation in 1998 across virtually the whole of the subregion. However, the rate of increase in retail prices moderated significantly in 1999, especially in countries hit by a steep price increase the year before, as a result of the improved supply conditions, in particular of food items, and the firmer exchange rates of several local currencies. Nevertheless, the rates of inflation ranged from 4–6 per cent in several countries to about 13 per cent in Papua New Guinea. These rates were comparatively high in relation to those of the major trading partners of the subregion (Australia, France, Japan, New Zealand and the United States)

Many Pacific island countries are making determined efforts to initiate and sustain domestic economic reform and restructuring. Major objectives are to improve public sector efficiency, to strengthen the fiscal position, to improve overall macroeconomic balance and to promote greater participation of the private sector, both domestic and foreign. In the latter context, there were some concerns arising from political instability and ethnic tensions in a few economies in the Pacific. This might have adversely affected investors' perceptions and market sentiment.

Table II.5. Selected Pacific island economies: growth rates, 1996-1999

(Percentage)

		Rate of growth			
		GDP	Agriculture	Industry	Services
Cook Islands	1996	-0.2	4.3	-5.0	-0.8
	1997	-0.5	..	..	..
	1998	-1.0	..	..	..
	1999	-1.0	..	..	..
Fiji ^a	1996	3.4	2.0	4.6	2.4
	1997	-1.8	-12.5	-1.3	1.8
	1998	0.5	-2.2	1.5	1.0
	1999	7.8	23.6	11.3	2.9
Kiribati	1996	6.3	4.7	-4.1	8.7
	1997	1.5	..	..	..
	1998	1.5	..	..	..
Papua New Guinea	1996	3.9	3.0	7.6	0.5
	1997	-5.2	-6.0	-12.3	4.2
	1998	3.1	-5.4	11.4	1.2
	1999	5.3	13.7	2.8	2.0
Samoa	1996	5.9	4.2	14.0	2.4
	1997	1.5	..	..	..
	1998	1.1	6.3	-11.7	5.8
	1999	6.1	5.0	6.0	6.5
Solomon Islands	1996	3.5	3.5	..	1.7
	1997	0.1	-2.7	0.3	3.5
	1998	-3.9	-4.9	-0.4	-4.0
	1999	4.8	6.5	18.4	-1.5
Tonga	1996	-1.5	-5.4	2.9	0.1
	1997	-6.6	-3.0	-28.1	-2.4
	1998	-0.3	-3.8	1.9	1.6
	1999	-1.1	-8.0	0.9	2.3
Tuvalu	1996	20.4	0.8	82.6	13.4
	1997	2.5	..	..	..
	1998	2.0	..	..	..
Vanuatu	1996	2.6	4.0	2.4	2.1
	1997	2.4	4.6	1.1	1.8
	1998	3.4	3.7	4.3	3.1
	1999	1.1	0.0	2.8	1.2

Sources: ESCAP secretariat calculations based on ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999) and *Asian Development Outlook 1999* (Oxford University Press, 1999); and national sources.

Notes: Data for 1999 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

^a Real GDP at factor cost.

Growth performance

Fiji had been in a recession with an average GDP contraction of just under 0.7 per cent in 1997 and 1998. This was caused by such adverse shocks as the El Niño-induced drought and, to a lesser extent, the economic crisis in East Asia. The economy, however, rebounded strongly in 1999, by 7.8 per cent, owing to a surge in Fiji's most important foreign exchange earners of sugar, garments and tourism. The drought had been largely responsible for the sharp drop in agricultural output, averaging 7.4 per cent a year in 1997-1998. The most important item, sugar cane (and by extension, the industrial processing of this crop), was most severely affected, with annual production falling by some 23 per cent during the period. Sugar cane output recovered strongly in 1999 as a result of better weather conditions and in response to the implementation of the crop rehabilitation programme initiated in 1998. Around 75 per cent of the estimated crop of 430,000 tons had already been harvested by mid-November 1999. Largely as a result, it is estimated that the agricultural sector will grow by an unusually high 23.6 per cent in 1999.

The decline in sugar-processing activities was largely behind the contraction of industrial sector value added during 1997 and 1998. The garment industry also experienced a similar decline, despite an improved competitive edge resulting from the depreciation of the Fiji dollar. However, the sector rebounded by as much as 11.3 per cent in 1999 through the upswing in sugar cane and garment production. The services sector expanded marginally, by an average of just over 1 per cent in 1997-1998. It had been feared that a decline in tourist arrivals from Asia would hurt the tourism industry, but, riding on the benefit of increased promotion overseas, enlarged aircraft-carrying capacity and a surge of tourists from Australia, New Zealand, the United Kingdom and the United States, the tourism industry was poised to record its best performance ever in 1999 with approximately 398,400 incoming tourists, an increase of 7.1 per cent over the previous year. Consequently, the services sector during the year was estimated to grow by 2.9 per cent. The future of this sector looks bright: the millennium celebrations, the

Sydney Olympics in mid-2000 and the America's Cup are expected to boost tourist arrivals by some 7.6 per cent in the year 2000.

The economy of Papua New Guinea recovered from a decline of 5.2 per cent in 1997 to grow by 3.1 per cent the following year, primarily as a result of increased mining and petroleum output. Industrial value added increased by 11.4 per cent, compared to a contraction of 12.3 per cent in 1997, following the first full year of production at the Lihir gold mine, the resumption of full production at the Ok Tedi and Porgera mines after drought-related disruptions, and the commencement of production at the Gobe oilfields. However, GDP growth in the near future is expected to be constrained by a steady decline in oil production unless this is adequately compensated for by higher gas exports to Australia via a proposed pipeline extension under the Torres Strait; there is still some doubt whether this project will go ahead.

Agriculture (including forestry), on the other hand, performed badly for the second time in a row, with total output falling by a further 5.4 per cent in 1998. A slump in East Asian demand for logs, down 55 per cent in 1998, was compounded by a drought-related drop in the production of other major export crops. In particular, the volumes of cocoa, copra and palm oil exports were 32-36 per cent lower in 1998. However, agricultural output recovered strongly in 1999, by 13.7 per cent, and became the main driving force behind the estimated GDP growth rate of 5.3 per cent for the year. The volume of log exports, for instance, jumped by 39 per cent along with the sharp upturn in the production of most other tree crops. Meanwhile, construction value added continued to be subdued in 1999, a reflection of the deterioration in investor confidence in recent years and the completion of several major projects in the country, including the Gobe oilfields and several infrastructure programmes. The growth of the services sector in 1999 was driven by an ongoing expansion of commerce and of financial and business services.

Economic performance in Samoa had been relatively weak in 1997-1998. The closure of coconut oil milling operations was further aggravated by scaling back in the production of automotive parts by the Yazaki plant, Samoa's largest private

sector employer. Largely as a result, industrial output went down by 11.7 per cent in 1998. At the same time, the completion of major projects relating to cyclone rehabilitation programmes implemented since the early 1990s contributed to a decline of 5.8 per cent in building and construction services during the same year. Aggregate production turned around sharply in 1999, with GDP expanding by 6.1 per cent, owing to the coming on-stream of a number of development projects and a considerable fiscal stimulus. The agricultural sector performed well, with favourable weather conditions and good fish catches.

The future growth in Samoa's agriculture, estimated at 5 per cent in 1999, will be underpinned by the continued expansion of commercial fishing, an industry which has grown rapidly in recent years. The services sector maintained healthy growth in 1998-1999. As in the case of most other Pacific island economies, tourism has been of great importance in Samoa. Receipts from this industry have been on an upward trend facilitated by an enlarged network of air links.

The Solomon Islands economy performed well, with GDP growth averaging about 5 per cent per annum during the first half of the 1990s. However, economic activities stagnated in 1997 and contracted sharply, by almost 4 per cent, during the following year. The economy recovered strongly in 1999 on account of a strong performance in the agricultural and industrial sectors; the services sector continued to deteriorate in part because of a fall in government services. Agricultural growth, estimated at 6.5 per cent for the year, was somewhat lower than originally anticipated owing to the constraining effects on production from ethnic conflicts which erupted during 1999. Another matter of concern is the exploitation of forestry resources which has, for some years now, considerably exceeded the sustainable level. The rate of log extraction during 1998, for example, was considered to be twice the sustainable rate previously estimated at around 350,000 cubic metres a year. Although log exports declined by 13 per cent, there was a substantial increase of 71 per cent in fish landings during the first quarter of 1999. Industrial value added, which had remained largely subdued in recent years, jumped significantly by 18.4 per cent. Behind this upturn was the Gold Ridge mine whose

first five months of operation in 1998 had yielded 45,500 ounces of gold and 47,000 ounces of silver, with gold production exceeding forecasts by 30 per cent; a total of 120,000 ounces of gold and 60,000 ounces of silver were expected in 1999. There are encouraging prospects for the further expansion of mining and prospecting investment in Solomon Islands.

Economic activities in Tonga consistently suffered contraction during the second half of the 1990s, with a large contraction of 6.6 per cent recorded for 1997. The mass destruction of the agricultural sector by a cyclone at the end of 1998 caused a further fall of 1.1 per cent in GDP in 1999. Agricultural output went down by an annual average of 4.1 per cent between 1996 and 1998 and an even sharper fall of 8 per cent was estimated for 1999. The poor performance in 1998 was precipitated by lower exports of squash as a result of the prolonged drought. Exports of kava, which have been the most important foreign exchange earner after squash and fish since 1997, were also reduced by 14 per cent in 1998. The rise in fish and vanilla exports, and a modest improvement in value added from industry and the services sector, were far from adequate to compensate for the setbacks in agricultural production and exports. Tonga's economic prospects are very much contingent on the further development of the tourism industry and on the weather-dependent agricultural sector. There is some promise of future development of off-season and other niche products, as the well-known success of the country's squash exports has demonstrated, but the realization of this potential will depend substantially on government facilitation and promotion of private sector initiatives and participation, including the identification and penetration of regional and global markets.

Vanuatu's GDP expanded strongly in 1998, by 3.4 per cent, as a result of higher output across the board. Agriculture grew by 3.7 per cent on account of a larger copra output of some 6 per cent while kava production went up more than six times in response to overseas demand. However, the economy slowed down significantly in 1999, with GDP rising by just over 1 per cent. The output of copra, the country's most important cash crop, dropped by 23 per cent during the first six months of

1999 compared to the same period in the year before, owing to unfavourably wet weather conditions. Kava production for export also declined sharply in the same period as a result of lower foreign demand. Another constraining factor was the lower number of tourist arrivals which, in turn, was partly due to the damage suffered by one of Air Vanuatu's jets during a hailstorm at Sydney in early 1999. Tourism is Vanuatu's primary foreign exchange earner and this sector has experienced a number of setbacks in recent years. The number of visitors declined by 21 per cent in 1997 and by a further 4 per cent the following year because of the declaration of a state of emergency in January 1998. Vanuatu's economic prospects look brighter, with investor confidence improving as a result of the introduction of a comprehensive reform programme which was initiated by the government in conjunction with ADB.

In the smaller Pacific islands, the public sector tends to have a greater role as a source of employment, incomes and, by extension, growth-promoting activities and services. In 1997 and 1998, the economy of Kiribati expanded moderately by about 1.5 per cent a year. Tuvalu recorded a slightly higher level of GDP growth, averaging 2.3 per cent annually over the same period, compared to a substantial expansion of 20.4 per cent in 1996. The economies of these two neighbouring countries are very similar in many respects, and economic performance is significantly determined by the inflow of worker remittances, especially from seamen working in foreign-owned and foreign-registered ships, and by investment income from their sizeable trust funds.

The available information indicates a contraction in economic activities in Cook Islands, the Federated States of Micronesia and Marshall Islands in 1998. The economy of Cook Islands has been in a recession since 1994 as a result of a persistent contraction in tourism and public sector activities. The number of tourist arrivals was 8 per cent lower during the first three quarters of 1998, compared to the same period in 1997, while the crisis in government finances led to a substantial reduction in public sector employment in 1998. The Marshall Islands economy also performed poorly, contracting by 5.3 per cent in 1997 and by an estimated further 5 per cent in 1998. The decline in output occurred in

most major economic sectors. The effect of cuts in government expenditure and employment as part of the policy reform programme, which began in 1996, was compounded by slippage in the agricultural and fishing sectors.

Inflation

Consumer prices in Pacific island countries are substantially influenced by the levels in their main trading partners, Australia, France, Japan, New Zealand and the United States, whose inflation was low in 1998. Nevertheless, most Pacific island countries recorded higher inflation rates in 1998, reflecting the general shortage of domestically produced goods, especially food, as a result of the drought conditions and the depreciation of their local currencies. The continuing low inflation rates of their trading partners, as well as the improvements in drought conditions, helped to lower inflation in 1999 with most countries recording single-digit inflation rates during the year.

Fiji had enjoyed relatively low rates of inflation averaging some 3 per cent a year in 1996-1997. This was the result of falling and weak oil prices, modest domestic demand and significant price stability in the country's major trading partners, especially Australia. Consumer prices, however, jumped by 8.1 per cent in 1998 following the devaluation of the country's currency by 20 per cent in January 1998. The inflation rate rapidly trended downwards to an estimated 1 per cent in 1999 (table II.6). Among the contributing factors were a decline in imported food prices following the reduction in import tariffs in August 1999 and the removal of VAT on "essential" consumer items. Inflation is forecast to rise to 6.0 per cent in 2000 on account of the very strong growth in domestic demand and the sharp upswing in oil prices during 1999.

In Papua New Guinea, the devaluation and flotation of the kina in 1995 contributed to a sharp rise in consumer prices, of 17.3 per cent in 1995 and 11.6 per cent in 1996. The rate of inflation dropped to below 4 per cent in the following year but then increased to 13.6 per cent because of the depreciation of the kina by over 40 per cent and a weather-induced reduction in agricultural supplies in

Table II.6. Selected Pacific island economies: summary of macroeconomic indicators, 1996-1999

(Percentage)

		1996	1997	1998	1999
Fiji	Savings/GDP	14.7	13.1	7.6	..
	Investment/GDP	11.0	11.1	11.3	10.5
	Budget balance/GDP	-4.6	-6.4	3.8	-2.6
	Trade balance/GDP	-7.9	-17.2	-14.3	-11.7
	Current account balance/GDP	0.6	-1.6	-1.1	0.6
	Money supply growth (M2)	0.9	-8.7	-0.3	0.0 ^a
	Inflation rate ^b	3.3	2.9	8.1	1.0
Papua New Guinea	Savings/GDP	32.1	23.0	28.3	..
	Investment/GDP	27.9	27.1	30.3	..
	Budget balance/GDP	0.5	0.1	-1.7	-1.6
	Trade balance/GDP	19.3	14.6	17.2	20.8
	Current account balance/GDP	3.6	-4.2	-0.5	4.3
	Money supply growth (M2)	30.7	7.7	2.5	7.7 ^c
	Inflation rate ^b	11.6	3.9	13.6	13.0
Samoa	Budget balance/GDP	1.5	0.2	1.6	-0.4
	Trade balance/GDP	-37.5	-36.1	-35.0	..
	Current account balance/GDP	5.7	3.9	9.2	..
	Money supply growth (M2)	4.9	16.5	2.2	9.1 ^a
	Inflation rate ^b	5.4	6.8	2.2	4.0
Solomon Islands	Budget balance/GDP ^d	-4.7	-4.6	-2.6	..
	Trade balance/GDP	3.2	-7.7	-8.8	6.1
	Current account balance/GDP	4.2	-7.4	-5.3	9.0
	Money supply growth (M2)	15.3	6.7	2.5	21.3 ^a
	Inflation rate ^b	11.8	8.1	12.0	5.0
Tonga	Budget balance/GDP ^d	0.8	-1.2	-4.5	-1.7
	Trade balance/GDP	-38.4	-31.0	-38.7	-37.2
	Current account balance/GDP	-5.9	-1.1	-12.2	-8.0
	Money supply growth (M2)	9.3	6.9	13.9	18.8 ^a
	Inflation rate ^b	3.0	2.1	3.4	6.0
Vanuatu	Budget balance/GDP	-2.3	-1.7	-0.8	-0.4
	Trade balance/GDP	-20.1	-17.2	-18.3	-18.5
	Current account balance/GDP	-10.7	-7.6	2.0	-0.4
	Money supply growth (M2)	10.1	-0.4	12.6	7.4 ^a
	Inflation rate ^b	0.9	2.9	4.1	0.5

Sources: ESCAP secretariat calculations based on ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999) and *Asian Development Outlook 1999* (Oxford University Press, 1999); IMF, *International Financial Statistics*, October and December 1999; and national sources.

Notes: Data for 1999 are estimates. Savings/GDP refers to gross domestic savings/GDP; investment/GDP refers to gross domestic investment/GDP.

^a January-June.

^b Referring to changes in the consumer price index.

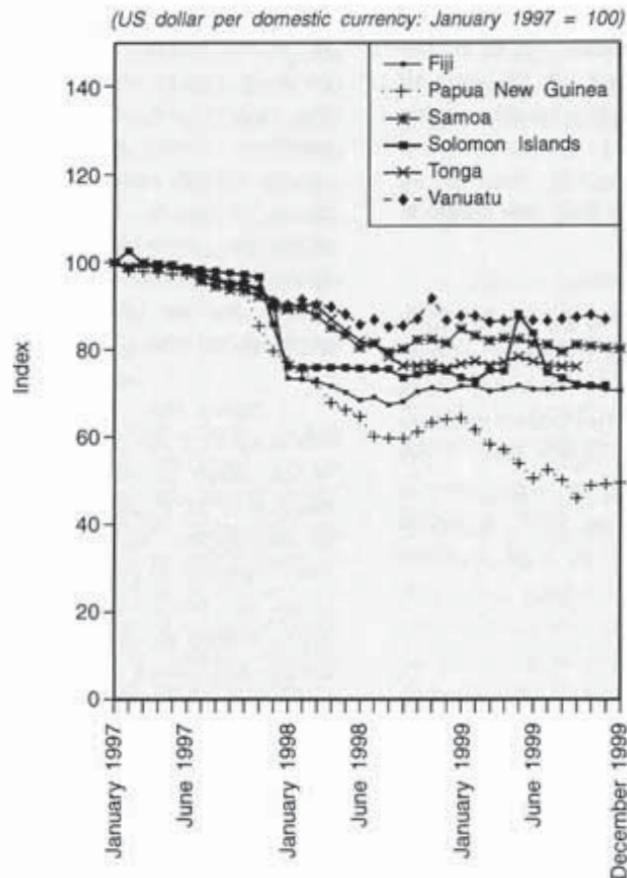
^c January-March.

^d Excluding grants.

1998 (figure II.2). The continued downward movement of the exchange rate was a reflection of lower-than-expected export earnings and inward FDI, falling foreign reserves, large injections of liquidity by the government, and market uncertainties. However,

renewed confidence in the wake of the formation of a new government appears to have had a stabilizing effect on the exchange rate during the second half of 1999; the rate of inflation was estimated to be around 13 per cent for the whole year.

Figure II.2. Index of exchange rates of selected Pacific island economies, 1997-1999



Source: IMF, *International Financial Statistics*, various issues.

In Samoa, a reduction in tariff rates and the relative stability of the tala exchange rate during the second half of 1998 played a stabilizing role and helped to reduce the inflation rate to 2.2 per cent in 1998 but, with higher oil prices, the rate is estimated to edge upward to around 4 per cent for the whole year of 1999.

Solomon Islands experienced high rates of inflation, often in excess of 10 per cent a year during most of the 1990s, largely as a result of rapid increases in the money supply associated with heavy government borrowing to finance its large fiscal deficits, a currency devaluation of 20 per cent and an accommodating monetary policy stance. Besides, the indexation of wage rates to inflation somewhat

limited the options for domestic price stabilization. This was modified in 1999 when a wage freeze was imposed and future wage increases were to be linked to the level of worker productivity. Given a stable exchange rate and improved financial management resulting from a series of reform measures under implementation, inflation should fall back to around 5 per cent in 1999.

Tonga consistently recorded low inflation rates during most of the second half of the 1990s. The situation, however, deteriorated in 1999 when inflation jumped by 6 per cent owing to the depreciation of the pa'anga towards the end of 1998 and the adverse impact of a cyclone on agricultural supplies.

Like Tonga, Vanuatu has experienced a remarkable degree of price stability in recent years. Retail prices, however, rose by 3.7 per cent in the third quarter of 1998 following the introduction of VAT and were 4.1 per cent higher for the whole year. With the dissipation of this one-off hike in prices and given the relative stability of the local exchange rate, inflationary pressures were disappearing for all practical purposes; retail prices were estimated to rise by just 0.5 per cent in 1999.

Most of the smaller islands in the Pacific have used the currencies of developed countries as their legal tender and as such, their inflation rates generally mirror those of the currency-issuing countries themselves. These rates ranged from 1 per cent in Cook Islands and Tuvalu to 4 per cent in Marshall Islands and Nauru during 1998; a similar degree of price stability prevailed in most of these economies in 1999.

Trade and exchange rates

Sizeable deficits in the merchandise trade accounts constitute the pattern rather than the exception in the Pacific island subregion; Papua New Guinea has stood almost alone with consistently large trade surpluses.

In 1998, Fiji's trade deficit fell to \$225 million, or 14.3 per cent of GDP, from 17.2 per cent in 1997, in part as a result of the currency depreciation in early 1998. The deficit is estimated to decline further to 11.7 per cent in 1999. As in previous years, sugar was the leading export but the relative importance of garments has grown rapidly to almost equal that of sugar. The strong export growth expected for 1999 was underpinned by a surge in earnings from both sugar and garments. However, the biggest source of foreign exchange receipts in Fiji has been tourism, and tourist arrivals were also estimated to have increased in 1999.

Papua New Guinea's trade surplus was equivalent to 17.2 per cent of GDP in 1998, although the export value of some \$1,800 million represented a decline of 16.1 per cent from the 1997 level. Most of the decline was due to the slump in earnings from forestry products and lower world prices for crude oil. The mineral sector accounted for over two thirds of total export receipts, with gold exports alone contributing about half of that share in 1998. For 1999, exports were expected to fall by 2.4 per cent in dollar value. The value of merchandise imports also declined by 27 per cent, to \$1,083 million, in 1998 and was estimated to fall by another 11.8 per cent in dollar value during 1999 (table II.7). The overall trade surplus is estimated to have increased to 20.8 per cent of GDP in 1999.

Table II.7. Selected Pacific island economies: merchandise exports and imports in United States dollar value and their rates of growth, 1996-1999

	Value (millions of US dollars)		Exports (f.o.b.)			Value (millions of US dollars)		Imports (c.i.f.)		
			Annual rates of growth (percentage)					Annual rates of growth (percentage)		
	1998	1996	1997	1998	1999	1998	1996	1997	1998	1999
Fiji	389.0	20.8	-21.3	-24.8	25.5	614.0	13.5	-1.9	-23.6	12.5
Papua New Guinea	1 800.0	-5.2	-14.7	-16.1	-2.4	1 083.0	19.9	-2.6	-27.0	-11.8
Samoa	18.3	11.1	50.0	25.3	-1.6	95.0	5.3	-3.0	-5.2	7.3
Solomon Islands	126.0	9.5	-4.9	-28.0	41.0	145.8	-2.6	12.6	-22.3	0.0
Tonga	7.2	-14.3	-8.3	-38.5	21.3	63.7	-2.6	-2.7	16.1	-5.3
Vanuatu	30.5	7.1	16.7	-0.7	-8.1	73.6	2.1	-3.1	-5.5	2.0

Sources: United Nations, *Monthly Bulletin of Statistics*, December 1999; and national sources.

Exports from Samoa jumped by 25.3 per cent to \$18.3 million in 1998, owing to the one-off sale of the container ship *Forum Samoa*; there were also higher earnings from fish and kava. The earnings from fish more than doubled to 28.4 million tala and accounted for about half of all commodity exports for the second consecutive year. Kava exports, at almost 5.5 million tala, represented an increase of 272 per cent over the 1997 figure. An offsetting influence was embodied in lower export receipts from coconut-based products, previously Samoa's most important commodity export. Imports fell by 5.2 per cent to \$95 million in 1998, largely on account of a small depreciation of the tala against the United States dollar. The overall trade deficit declined marginally during the year.

Forestry products, especially logs, have surpassed fisheries as the most important foreign exchange earner of Solomon Islands since 1992. Largely as a result of the economic crisis in Asia, the relative share of forestry exports went down to only 29 per cent, along with a decline of 13 per cent in log export volumes in 1998, from over 50 per cent in earlier years. In dollar terms, export receipts were 28 per cent lower while the value of imports was 22.3 per cent lower in 1998. The trade balance consequently deteriorated to a deficit equivalent to 8.8 per cent of GDP in 1998. It was, however, estimated to move to a surplus in 1999 with the rising importance of gold exports and some recovery in the production of palm oil, copra and cocoa. Gold has fast emerged as the second most important export commodity with the coming on-stream of the Gold Ridge mine. Copra exports were expected to come to an end by December 1999 and to be replaced by processed coconut products with the establishment of copra-processing mills throughout the country.

Tonga's sizeable trade deficit worsened in 1998 to a high of 38.7 per cent of GDP. Merchandise exports slumped by 38.5 per cent in 1998 to just \$7.2 million, while import spending amounted to \$63.7 million, an increase of 16.1 per cent mainly because of higher outlays on capital goods. The rebound of squash production from the drought should result in an upturn in trade earnings in 1999; the potential for further gains will come from an expansion of fruit and vegetable exports to new niche markets in Japan. The overall trade deficit in 1999 as a percentage of GDP was estimated to be slightly lower.

Booming world demand for, and hence earnings on, kava more than offset a decline in the value of exported copra, Vanuatu's most important export commodity in 1998. Beef exports were also lower. Both copra and kava exports were expected to fall sharply in 1999 so that the total trade deficit in 1999 was expected to be of the same order of magnitude as in 1998.

Capital inflows and outflows

Official capital inflows in Fiji were expected to increase considerably in 1999. The overall surplus in the balance of payments during 1999 significantly bolstered Fiji's foreign reserves to around five months of import cover. The burden of external debt servicing continues to be under 2 per cent of GDP.

Kiribati succeeded in achieving a surplus on its balance of payments for most of the 1990s and, in consequence, its official reserve assets rose significantly to \$A596.8 million in 1998; this was equivalent to 7.4 years of import cover, one of the highest levels in the world. Kiribati's public debt is mostly external; the total amounted to \$A17.3 million at the end of 1997 to which was added a more recent loan of \$A6.1 million from ADB. Under these circumstances, any small deficit in the balance of payments should not pose a major problem for financial management in the country.

In Papua New Guinea, the surplus in the trade balance was mostly negated by large deficits in the external balance on services and investment. As a result, the current account deficit of 0.5 per cent of GDP in 1998 is estimated to have increased to 4.3 per cent in 1999. A small surplus in the capital account was converted to a large deficit of \$177 million in 1998 because of a higher level of private capital outflows, reflecting increased loan repayments by mining companies and some capital flight as a result of the loss of confidence in the former government.

Samoa's large deficit in merchandise trade was more than made up for by a surplus on the services account, plus private and official unrequited transfers in 1998. Net unrequited transfers of foreign grants and personal remittances totalled \$36.5 million in 1998. The current account surplus of 9.2 per cent of GDP in 1998 was further reinforced by a surplus of \$12.1 million in Samoa's capital account.

However, this latter figure was somewhat lower than the outcome in the previous year owing to a larger outflow of capital for the acquisition of an aircraft and fishing boats. Other transactions in the capital account were of an official nature.

The current account of Solomon Islands improved moderately with a lower shortfall of 5.3 per cent of GDP in 1998. However, a surplus of 9 per cent of GDP was estimated for 1999 largely on the strength of forestry and gold exports that year, in spite of the adverse impact of civil unrest on other agricultural exports and on tourism revenue. The capital account surplus, which had spiked to \$24.2 million in 1997 from the inflow of investment for the Gold Ridge mining project, fell to an estimated \$10 million in 1998; this was expected to turn into a small deficit of \$5.5 million in 1999. The total external debt of \$128 million as of the end of 1998 was mostly of a long-term nature and on concessional terms; debt servicing absorbed just 1.7 per cent of GDP.

Tonga's deficit on the current account deteriorated sharply to 12.2 per cent of GDP in 1998 mainly because of poor trade performance. For reasons already noted, the current account balance was estimated to improve somewhat in 1999. The capital account, on the other hand, registered a higher surplus of \$8.4 million in 1998. The overall balance of payments was in deficit by \$5.5 million in 1998. A higher inflow of official capital, coupled with a demand-compressing depreciation of the local currency in late 1998, helped to avert a more sizeable drawdown of foreign reserves. External debt was equivalent to 42 per cent of GDP and, because of its favourable terms, debt servicing has not been a problem for the country.

There was a sharp improvement in the current account from a deficit of 7.6 per cent of GDP in Vanuatu in 1997 to a surplus of 2 per cent the following year. The reverse happened in capital transactions; a surplus of \$22 million in 1997 turned into a deficit of \$2 million in 1998. A large increase in official capital transfers through the drawdowns of the ADB loan under the comprehensive reform programme appeared to have been offset by a jump in private capital outflows in the aftermath of the rioting and unstable political environment of early 1998. Inward FDI had been at a low level but the outlook for the future improved with the adoption of

the new Foreign Investment Board Act and with the ongoing reforms in public administration and management under the comprehensive reform programme.

Financial and fiscal sector developments

Fiji had budget deficits in the 1990s, except for the 1998 surplus of 3.8 per cent of GDP. The surplus originated from the restructuring of the National Bank of Fiji, which had been a big drain on budgetary resources in 1996 and 1997; the returns from the sale of bank assets provided 24 per cent of total revenue. Other domestic sources such as customs and excise duties and VAT contributed to a substantial expansion of 42 per cent in total revenue; grants-in-aid have been relatively insignificant to Fiji. At the same time, government expenditure increased at a lower rate of 15 per cent in 1998; it was projected to rise by a further 11 per cent in 1999. The impact of the steep upturn in GDP growth on revenue collections helped to offset some of the impact from the cuts in VAT on "essential" consumer items. In consequence, the estimated budget deficit for 1999 was 2.6 per cent of GDP. However, provisional data show a much stronger outcome with an underlying surplus of 0.7 per cent of GDP for the first nine months of 1999. The new government in Fiji is committed to a number of expenditure reduction initiatives and fiscal deficit is projected to be 1.9 per cent of GDP in 2000.

One of the notable consequences of the devaluation of the Fiji dollar in January 1998 was a drop in quasi-money (time plus savings deposits), by as much as 23.6 per cent in mid-1999 from its peak in the first quarter of 1996. Monetary policy had generally been accommodative since 1996 and the commercial loan rates averaged 8.6 per cent in mid-1999, a drop from 9.1 per cent in 1998 and 11.6 per cent at the end of 1996; real interest rates, however, jumped to 6.6 per cent with the much lower rate of inflation in 1999, compared to 1 per cent in 1998. Restoration of confidence in the banking sector is well on track following the successful restructuring of the National Bank of Fiji.

Government expenditure has been the main source of growth in Kiribati, and the budget was in surplus in 1987-1998 and was expected to be

balanced in 1999. The major sources of government revenue came from fishing royalties, which had shown an upward trend, drawdowns from the Revenue Equalization Reserve Fund, and overseas aid. Fishing royalties brought in \$A29.4 million in 1997 and about \$A42 million in 1998. Such income, however, has been highly volatile and dependent on cyclical weather conditions. The relative importance of external budgetary grants which had declined sharply after 1993, has not been restored to its former level despite some upturn in such resources since 1997. Development grants, plus aid in kind, helped to finance Kiribati's development budget to the tune of about one third of such outlays in the period 1997-1999.

From 1996, Kiribati embarked on a national development strategy, embodying a series of structural adjustment policies to foster private sector participation, economic efficiency and flexibility, and a rationalization of public sector activities and services. While enabling changes have occurred, they have not been rapid and there has been public opposition to certain elements within this strategy. Several of Kiribati's public sector commercial enterprises have been corporatized, but not much progress appears to have been made since 1997. Meanwhile, the 1999 budget adopted performance accounting in relation to public finance.

Papua New Guinea's fiscal position deteriorated to a deficit in 1998 from a surplus in 1997, owing to higher government expenditure (by 6 per cent) compounded by a drop of 2 per cent in total revenue. Tax receipts declined by 6 per cent while overseas aid, mainly from Australia, fell by 15 per cent in 1998. The budget was again in deficit for the first six months of 1999, mainly because of the 18 per cent increase in expenditure and the 2 per cent decline in revenue (compared to the same period in 1998). The total public debt had expanded to 58 per cent of GDP by the middle of 1999. The domestic component amounted to 2,473 million kina in 1998, with 54 per cent held by the Bank of Papua New Guinea, and overseas public debt totalled 2,705 million kina. Debt servicing is estimated to account for 22 per cent of government expenditure under the 2000 budget; the servicing burden on external public debt, at 1.7 per cent of GDP in 1998, does not pose an immediate problem for Papua New Guinea.

The Bank of Papua New Guinea has maintained a particularly tight monetary policy since late 1997 to contain inflationary pressures arising from high levels of deficit financing and downward pressure on the local exchange rate. The latter can be attributed to a progressive fall in international reserves to less than a month's import bill by the end of June 1999. Lending rates became very high by international standards, rising from 10.6 per cent in 1997 to 20.2 per cent at the end of 1998 and 18.2 per cent in June 1999. Interest rate volatility and the downward trend in the kina exchange value have imposed a burden on private sector businesses and created external market uncertainties as well.

Samoa registered an overall fiscal surplus equivalent to 1.6 per cent of GDP during 1998 compared to 0.2 per cent in the previous year. This favourable outcome was the result of savings in current and development expenditure and government contributions to statutory corporations. Moreover, revenue collection was 5 per cent higher in 1998. External grants, however, dropped by 13 per cent on top of a decline of 21 per cent in 1997. An overall deficit of 0.4 per cent of GDP was budgeted in 1999 and, on available indications, Samoa's financial operations were well in line with the budget estimates. As of December 1998, the level of external debt stood at \$154.7 million, little changed from 1997 with a debt-to-GDP ratio at more than 70 per cent. However, debt servicing does not pose a significant problem for Samoa, the servicing burden being just 4 per cent of GDP in 1998.

Money supply (M2) growth in Samoa in 1998 was largely driven by external factors; the net increase in foreign assets negated a decline in net domestic assets. The government continued its reform agenda with the removal of interest rate controls in January 1998. Interest rates then remained stable with deposit rates averaging 5.1 per cent and lending rates 12.5 per cent at the end of the year.

The large budget deficits of Solomon Islands improved to 2.6 per cent of GDP in 1998 reflecting the new government's determination to raise revenue and restrain expenditure. This policy was implemented against a backdrop of declining fiscal receipts on log exports, the higher costs of and expanding demand for public goods and services, and the shortage of funds for financing public investment. Nevertheless, budget receipts rose by

11 per cent in 1998, largely because of the higher collection of company taxes, while expenditure fell by 7 per cent. Apart from lower recurrent expenses, on payroll especially, development expenditure was cut by 67 per cent relative to the level in 1997. The government aimed for a balanced budget in 1999 through strict control over recurrent outlays, while improving and strengthening the revenue base. Early indications suggested greater tax compliance, especially by importers, and increased revenue collection, including from the larger volume of log exports. Fiscal operations during the first quarter of 1999 were in line with budget estimates.

Such restored fiscal balance represented a notable improvement as the financial system of Solomon Islands had been under great pressure from non-performing public debt. It was estimated that payment arrears had reached 13 per cent of all external public debt by the end of 1997. A new government took office in August 1997 and, by the end of 1998, those arrears had been halved and were expected to be settled totally by the end of 1999. The country experienced a widening gap in commercial bank lending and deposit rates until recently. Average lending rates fell to around 14.5 per cent in 1997 and 1998, from a peak of about 18.3 per cent in 1992. However, deposit rates stood at 1.8 per cent in 1997, compared to 9.6 per cent in 1992; the gap narrowed considerably in 1998, with the average deposit rate rising to 4.4 per cent.

Interest rates in Tonga have been relatively stable in recent years, with the average deposit rate being 4.8 per cent at the end of 1998, compared to 5.1 per cent at the end of the previous year. The base lending rate remained at 9 per cent, though. The policy objective was to keep interest rates on deposits positive in real terms so as to encourage household savings. There would thus be strong upward pressure on interest rates in 2000, given the upsurge of inflation during 1999.

The budget deficit in Vanuatu has been on a consistently downward trend, falling to an estimated 0.4 per cent of GDP in 1999. Much of this improvement is attributed to the comprehensive reform programme which was introduced in 1997, with assistance from ADB, and covered a mix of structural adjustment policies with an emphasis on the promotion of growth led by the private sector and

improvements in public sector efficiency. VAT was introduced in 1998; turnover tax and most export taxes were abolished and import duties were simplified and reduced. These measures were meant to help to create a much friendlier environment for exports. In addition, several measures have been proposed to facilitate FDI as part of the liberalization of international capital and investment inflow.

Vanuatu has received limited budgetary support from overseas grants-in-aid; in 1998, for example, such grants accounted for only 5 per cent of total revenue compared to 9 per cent in 1997. Since 1997, there has been a significant increase in Vanuatu's public debt and this was expected to be of the order of 12 billion vatu by the end of 1999; of this amount, about three quarters consisted of external debt which was, in turn, equivalent to more than 20 per cent of GDP. Virtually the whole of this debt was sourced from official concessional loans. Monetary policy, which had been tightened in early 1998 in response to strong downward pressures on the vatu exchange rate, was subsequently relaxed. This was mirrored in a moderate, downward movement in interest rates on loans, which averaged 13.1 per cent in 1998 and 12.6 per cent by mid-1999.

In Tuvalu, drawdowns from the Tuvalu Trust Fund have provided approximately 20 per cent of recurrent revenue and all capital spending is funded from external sources. In 1998, higher receipts from fishing and telecommunications licence fees were behind the budget surplus, equivalent to 20 per cent of GDP. The financial crisis in Cook Islands in 1998 was the result of years of unsustainable fiscal expansion to finance a growing wage bill, an expanding welfare system and a surge in capital expenditure funded mostly by external borrowings. Despite efforts to balance the budget in 1997 and 1998, Cook Islands was unable to service fully an external debt of \$NZ143.9 million, or nearly the whole of GDP. Debt renegotiations brokered by ADB in September 1998 led to major concessions from creditors. The policy reform programme of Marshall Islands included a substantial drop in capital expenditure, a reduction in the number of public sector employees, and a wage freeze which has remained in force since 1995. All these contributed to a budget surplus in 1996 and 1997. Even though the 1998 budget projected a surplus of 11 per cent of

GDP, a supplementary budget introduced in March 1998 contained an increase of 13 per cent in expenditure, with revenue running below expectations. Thus, the likely outcome was a lower surplus of 4 per cent of GDP at the end of the year.

Policy issues and responses

The great importance of both subsistence and commercial agriculture in combination with the small size and undiversified structure of most Pacific island economies greatly heightens their vulnerability to exogenous shocks. This was again well illustrated by two almost concurrent developments in the period 1997-1998: the drought associated with the El Niño weather phenomenon and the fall in external demand due to the Asian crisis. These shocks had a major debilitating impact on most of the Pacific island economies in terms of output growth, employment, exports and government revenue. The high degree of exposure to factors outside their control severely limits the scope and effectiveness of domestic policy responses and tends to make them highly dependent on external assistance, which has been on a declining trend for several years.

Nevertheless, many countries in the subregion have undertaken a series of economic reforms and liberalization measures in recent years to improve the cost-efficiency of public sector activities, to promote a greater role for the private sector, to attract FDI and to prepare themselves for effective participation in the globalization process. Notwithstanding these initiatives at the national level, the island economies in the Pacific will continue to require substantial assistance from the international community, particularly in the form of preferential market access through, for example, the Lomé Convention, the generalized system of preferences, and the South Pacific Regional Trade and Economic Cooperation Agreement with Australia and New Zealand.

Agriculture will remain the backbone of many island economies as a source of subsistence for growing populations as well as of exports. There is considerable scope for diversification of exports. Some export success stories, as in the case of taro, squash and kava, illustrate the potential. Determined efforts should be aimed at the development of other environmentally preferable, natural products.

Remoteness is one of the major constraints faced by islands in the Pacific subregion, but it can be transformed into a comparative advantage as distance contributes to relative rarity, naturalness and pristine quality in the cultivation of crops, plants and species, both food and non-food in nature, which have not been genetically modified. There are a large, and probably expanding, number of niche markets for such organic and natural farm produce in the affluent countries.

Success in the identification and penetration of such markets obviously depends on the extent to which island products meet stringent quality and health requirements, as well as competition from alternative sources of supplies under a more liberalized world trade regime. National efforts in this direction will have to be pursued in an integrated, holistic manner. In particular, such production requires security of land tenure, a congenial environment, including the absence of ethnic tensions and conflicts, and the development of technology, including through FDI and local human resources development. The latter two prerequisites are essential to cope with more complex and exacting production techniques, processing, packaging, transportation, marketing, quality control and timely delivery.

Some value added manufacturing has taken place in timber and fishery products, in coconut oil extraction and in the prospective processing of kava for medicinal purposes. A few countries have also succeeded in such ventures as enhancing efficiency in sugar cane processing, the development and promotion of the garment industry, and the manufacturing of automotive parts. FDI and other forms of collaborative linkages with foreign investors have played an important role in some of these enterprises, as well as in more large-scale natural resources projects such as the production of oil, gas and other minerals, and forestry and fishery development projects.

Many island countries have liberalized their investment regimes considerably in recent years. However, the liberalization of policy regimes and the provision of incentives are not sufficient by themselves to attract and retain FDI. Other equally important factors that require attention in the Pacific subregional context include macroeconomic stability, good infrastructure, skilled human resources, security of property and land tenure, policy consistency, and

transparent and accountable governance. A great deal of business and market uncertainty has been created by frequent political volatility, ethnic conflicts, and law and order problems in several parts of the subregion. An improvement in these respects could have a beneficial impact on FDI inflows. At the same time, it is imperative for governments in the Pacific to ensure the compliance of investors with internationally accepted norms and practices relating to the sustainable development of natural resources and the protection of the environment, given the involvement of FDI in many non-renewable resources and the environmental fragility in the subregion.

North and Central Asia

Most economies of this subregion did not experience any direct setback in the immediate aftermath of the financial and economic crisis which hit East and South-East Asia in the second half of 1997, as was indicated in last year's *Survey*. Nevertheless, the widening reverberations of the crisis combined with pre-existing fiscal and other structural problems to produce a liquidity crisis of major proportions in the Russian Federation in August 1998. The multidimensional ripple effects of this crisis were felt virtually throughout the Commonwealth of Independent States (CIS); in particular, slippage in economic performance occurred in many constituent economies during 1999, including those in North and Central Asia. However, the economy of the Russian Federation turned around from the early part of 1999; its positive spillover effects are likely to work their way throughout CIS in the near term. As such, a revival may be expected in domestic production and employment among the North and Central Asian economies, and in intra- and extra-subregional flows of trade as well, in the latter part of 1999 and in 2000.

The economies in the subregion have managed to establish market-oriented financial systems in recent years. Most of them have also achieved a more diversified pattern of trade and financial interaction. However, progress in both structural and geographical diversification has been uneven within North and Central Asia; CIS still remained important both as a market and as a supply source for many of the subregional economies. The scope and depth of trade linkages served as the main channel of

transmission of external shocks between the Russian Federation and other subregional economies. Additional transmission mechanisms worked indirectly through a severe disruption of the prevailing matrices of financial relationships as well as of macro-economic stability among the economies concerned.

On the trade front, export receipts among most countries of North and Central Asia continued to decline, and many countries recorded a large and growing shortfall in fiscal receipts and trade deficits in 1999. There were also significant depreciations in exchange rates. This pushed up the rates of domestic inflation and compressed both import and domestic demand, and hence fiscal revenue, across a large part of the subregion. Stabilization policy measures then necessitated a restrictive monetary stance, thus constraining further domestic economic activities in several subregional economies. On the financial front, a contagious spillover was manifested in severe banking problems, which were then exacerbated by enhanced credit and other risks, including political and civil unrest in some economies, as perceived by external investors. Partly as a result, there was a sharp decline in private capital inflows, including FDI, while the yield spreads remained high in several instances. All these served thus to complicate and retard further the financial stabilization process, the development of domestic financial markets, resource exploitation activities and privatization programmes in several North and Central Asian economies.

Generally, most economies in the subregion remain highly fragile and the patterns and direction of their development will be conditioned, to a considerable extent, by the effectiveness and timeliness with which wide-ranging domestic problems and unpredictable external shocks are managed and tackled. These problems typically include the lack of structural diversification, inadequate infrastructure (both soft and hard) and human resources development, insufficient integration and flexibility in factor and product markets, and a weak financial sector. All these have hampered broad-based reforms for a faster transition to a market-oriented system. The concerted efforts made by North and Central Asian economies to lift domestic incomes, gainful employment and welfare were therefore greatly constrained and the vulnerability of these countries to a range of external shocks and swings was considerably increased.

Growth performance

The Russian Federation achieved remarkable progress in financial stabilization and economic recovery in the course of 1999. GDP is estimated to have expanded by 3.2 per cent in 1999 in contrast to the projection of a contraction of about 3 per cent made at the beginning of the year. The steep depreciation of the rouble against the United States dollar was halted in May and the monthly increases in consumer prices were contained to some 1.4 per cent in September 1999; in comparison, inflation had peaked at over 38 per cent in September 1998 but declined to 11 per cent three months later. The sharp upswing in oil prices from March 1999 provided a boost to export incomes, fiscal receipts and the recovery process.

Industrial output returned to an upward growth path, rising by 8.1 per cent in 1999, compared to a decline of 5.2 per cent during 1998. This turnaround was induced, to a considerable extent, by the much higher costs of imports, which served to shift domestic demand towards locally produced goods. Import spending fell by some 40 per cent from \$46 to \$29.5 billion during the first nine months of 1999, relative to the level of the same period of the previous year. However, some branches of industry such as construction did not fare as well. Their performance was constrained by a variety of structural and logistical factors, including production problems and transportation bottlenecks. Agricultural output rose by 2.4 per cent in 1999 on top of a major reduction of 12 per cent in 1998 (table II.8).

Several of the other economies in this sub-region (Armenia, Azerbaijan and Tajikistan) experienced a slowdown in GDP growth, and the deceleration was notably sharp in Azerbaijan. Uzbekistan managed to sustain, by and large, the same rate of GDP growth, while Kazakhstan staged a modest recovery following a contraction in 1998. In contrast, economic performance improved sharply in Turkmenistan and, to a much lesser extent, in Kyrgyzstan.

Turkmenistan recorded an economic boom, with GDP rising by 10 per cent during 1999, double the rate of the previous year. This exceptionally strong performance originated mostly within the primary sector, including a bumper grain harvest, a substantial growth in oil and gas extraction and

significantly higher oil prices from March 1999 onward. Kyrgyzstan was another economy in Central Asia which improved its performance noticeably in 1999. Nevertheless, such expansion remained modest compared to the high GDP growth path achieved in 1996-1997. The economy of Uzbekistan continued its respectable economic performance with agricultural production going up by 5.8 per cent and industrial production by 5.9 per cent in the first nine months of 1999. GDP growth of 4.4 per cent was estimated for 1999, the same as that achieved a year earlier.

A strong performance in the farm sector of Tajikistan helped to cushion the decline in GDP growth rate, from 5.3 to 3.7 per cent between 1998 and 1999, despite lower commodity prices and a tight monetary policy for stabilization purposes. In Kazakhstan, GDP in 1999 was expected to recover from the contraction experienced during 1998; domestic demand weakened considerably, a result of falling export prices and earnings and a poor grain harvest in 1998, as well as the liquidity crunch and a devaluation of the national currency in 1999. The pace of economic growth remained comparatively vigorous at some 6 per cent in Azerbaijan in 1999; nevertheless, it was slower than the 10 per cent rate achieved in 1998 owing to a fall in construction activities and a continued decline in manufacturing output.

The prospects for enhanced economic performance within North and Central Asia in 2000 and immediately beyond appear brighter. This positive outlook seems reasonable, with oil prices remaining high, the continuing recovery of other commodity prices and the prevalence of easier conditions in the global financial environment. Moreover, a stimulus to production may be provided through the ongoing economic recovery and financial stabilization in the Russian Federation, which will open up markets for exports within the region. In fact, the Russian Federation budget for the year 2000 assumed a marginally higher rate of GDP growth of 1.5 per cent; in this context, industrial output was projected to expand by 3-4 per cent, while domestic inflation was not expected to exceed 18 per cent.

It is expected that GDP in Azerbaijan will grow faster than in 1999 and reach 8 per cent in 2000. Kazakhstan experienced a recovery of domestic output as noted earlier. The government's economic

Table II.8. North and Central Asia: growth rates, 1996-1999

(Percentage)

		Rate of growth		
		GDP	Gross agricultural output	Gross industrial output
Armenia	1996	5.9	2.0	1.4
	1997	3.1	-6.0	0.9
	1998	7.2	13.0	-2.5
	1999	3.7	0.8 ^a	7.6 ^a
Azerbaijan	1996	1.3	3.0	-6.7
	1997	5.8	-7.0	0.3
	1998	10.0	4.0	2.2
	1999	6.0	3.4 ^b	2.7 ^c
Kazakhstan	1996	0.5	-5.0	0.3
	1997	2.0	-0.8	4.0
	1998	-2.5	-19.0	-2.1
	1999	0.3 ^a	..	0.0 ^a
Kyrgyzstan	1996	7.1	15.0	8.8
	1997	9.9	12.5	50.4
	1998	1.8	4.0	8.3
	1999	3.0	8.7	-1.7
Tajikistan	1996	-16.7	-18.0	-23.9
	1997	1.7	4.0	-2.0
	1998	5.3	6.5	8.1
	1999	3.7	3.8	5.0
Turkmenistan	1996	6.7	-2.0	17.9
	1997	-11.4	20.6	-32.3
	1998	5.0	24.4	0.2
	1999	10.0	10.0	24.0
Uzbekistan	1996	1.7	-6.0	2.6
	1997	5.2	4.0	4.1
	1998	4.4	4.0	5.8
	1999	4.4	5.8 ^a	5.9 ^a
Russian Federation	1996	-3.5	-5.1	-4.0
	1997	0.8	2.0	2.0
	1998	-4.6	-12.0	-5.2
	1999	3.2	2.4	8.1

Sources: ESCAP secretariat calculations based on Interstate Statistical Committee of the Commonwealth of Independent States, *Statistical Abstract* (Moscow, 1999); ECE, *Economic Survey of Europe 1999 No. 1* (United Nations publication, Sales No. E.99.II.E.2), p. 97 and *Economic Survey of Europe 1999 No. 2* (United Nations publication, Sales No. E.99.II.E.3), p. 34; The Economist Intelligence Unit, *Country Reports*, various issues, 1999; and national sources.

Note: Data for 1999 are estimates.

^a January-September.

^b January-May.

^c January-July.

programme for the period 2000-2002 has, as its main objectives, a GDP increase of 10-12 per cent by 2002, a fall in inflation to 4-5 per cent, and a reduction in the budget deficit to 1.2 per cent of GDP. Economic growth in Kyrgyzstan, which had become modest recently, was expected to reach 4 per cent in 2000; this noticeable improvement was to be fuelled by a 5 per cent rise in agricultural production and a 2 per cent increase in industrial output. Tajikistan is predicted to have an economic upturn with GDP growth of 4 per cent in 2000.

The agricultural sector plays a significant role in North and Central Asia, as a source of both subsistence and export earnings; its recent performance is reviewed below. Azerbaijan, Turkmenistan and Uzbekistan recorded good farm production in 1999. Outputs of cotton, fibre and grain in Turkmenistan were close to the official target set for the year. The grain harvest of 1.5 million tons in 1999 ensured self-sufficiency in grain for the second consecutive year. The cotton crop yielded 1.3 million tons, the highest level in the history of Turkmenistan. Uzbekistan also had a relatively good grain harvest for two years in a row, with grain production increasing from about 3.3 million to 3.9 million tons between 1998 and 1999; in comparison, domestic demand is estimated at some 4 million tons. The cotton sector remained the largest employer and exporter in Uzbekistan; output of cotton in 1999 was about 20 per cent higher than in 1998. Agricultural production in Azerbaijan expanded by 3.4 per cent in the first five months of 1999. The range and quantity of output were limited by a lack of fertilizers and pesticides, while agricultural productivity continued to be low. Azerbaijan intended to complete its land privatization programme in 1999. However, most farmers were able to buy only a small plot of land and the need to ensure economies of scale in agriculture was an issue of policy concern.

Land privatization was considered a principal source of growth in farm output and productivity in Kyrgyzstan and Kazakhstan. The former designed and implemented a programme to facilitate private land ownership and to ensure uninterrupted supplies of basic foodstuffs and raw materials for domestic consumption and external trade; a law on privatization of land was expected to come up for approval in Kazakhstan in 1999. Food grains were the country's largest export commodity, and

Kazakhstan was the only grain exporter within CIS. Despite some damage from locusts, some 15.9 million tons of grain were produced in 1999, more than double the 7.5 million tons harvested in the previous year. In Tajikistan, the agricultural sector yielded 385,000 tons of cotton and about 400,000 tons of grain in 1999; these were just over half of the planned targets and the shortfalls were attributable to shortages of fuel and spare parts for agricultural machinery and to torrential rain in some regions of the country. A number of measures were implemented to stimulate agricultural production and increase productivity, including land reform, repairs to and extension of the irrigation systems, increased access to and availability of short-term financing for farmers, the privatization of cotton mills and improved marketing mechanisms. The agricultural sector of the Russian Federation performed well in 1999 when agricultural production rose by 2.4 per cent. For 1999 as a whole, however, the harvest provided 57.8 million tons of grain; this was about 5.9 million tons higher than the amount in 1998.

Industrial performance improved considerably in many subregional economies during 1999. Driven by higher levels of gas and oil production, industrial output was estimated to rise by 24 per cent in Turkmenistan in the year. A new socio-economic programme envisaged significant increases in hydrocarbon products, with oil production projected to rise from 6.3 million tons to 48 million tons between 2001 and 2010, and gas production from 85 billion cubic metres to 120 billion cubic metres between 2005 and 2010. This upward expansion will have to be underwritten by sharply higher investment, estimated at more than 250 per cent in the oil and gas sector. In Azerbaijan, too, oil production was the main contributor to industrial growth, which amounted to 2.7 per cent in the first seven months of 1999; this was much higher than the rate achieved in the corresponding period in 1998. Industrial value added in Kyrgyzstan and Tajikistan was dominated by gold and aluminium respectively. Gold output had provided the main stimulus to industrial production in the former economy in 1998; the decline in such output caused a fall of 1.7 per cent in industrial production in Kyrgyzstan during 1999. Tajikistan's industrial value added was expected to be on the rise with an expansion of aluminium output of 22 per cent in the first five months of 1999.

In 1999, industrial activities in Uzbekistan were hit by the crisis arising from a substantial level of inter-enterprise arrears, such as in payments for raw materials and other inputs as well as finished products. Most small and medium-sized enterprises in the country had suffered from an acute shortage of credit for working capital and hard currency; this was partly a result of the diversion of resources in support of large state-owned enterprises. The inter-enterprise arrears problem escalated in Kazakhstan, where its magnitude is estimated to have risen from 3.5 to 5.5 per cent of GDP between 1998 and 1999. A number of policy responses were introduced: writing off the debt for some enterprises, holidays on tax arrears, debt repayments by government for thousands of firms and tighter enforcement of bankruptcy rules. The fiscal implications of this industrial policy are likely to be heavy. In the Russian Federation, the devaluation of the rouble served to enhance export competitiveness and compress import demand, as noted earlier. Partly as a result, industrial production went up by 8.1 per cent during 1999. Twelve of the 15 basic industries showed robust growth, including chemicals, pulp and paper, construction materials, the automobile industry, pharmaceuticals, machinery and textiles.

In the context of growth promotion, North and Central Asian economies continued their efforts to mobilize and attract investment resources, both domestic and external. The tax codes in many Central Asian countries were modified in 1999 to create a healthier investment climate and make them more investor-friendly. Legislation on foreign investment was liberalized and the judicial system was reformed to ensure legal enforceability of deals between state agencies and foreign producers; this also served to limit the interference of administrative bodies in the activities of foreign companies and joint ventures. FDI continued in 1999 to be an important bridge for the financing of current account deficits and, in the process, to provide macro-economic stability in several countries of North and Central Asia.

Foreign investment in Uzbekistan increased by 22.6 per cent to reach \$1.3 billion in 1998 and was expected to rise to \$2 billion in the following year. However, the share of FDI in the country's GDP remained at a relatively low level and accounted for 1-2 per cent in recent years. FDI flows into Arme-

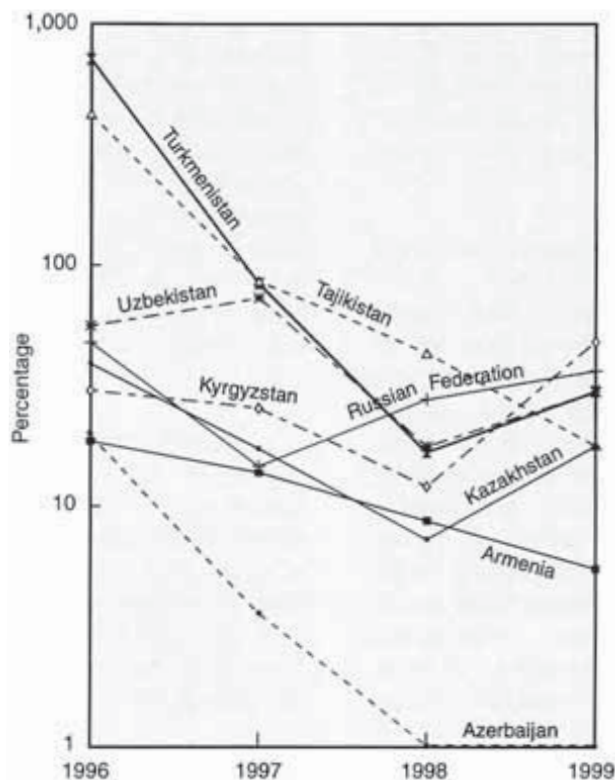
nia fell by about 40 per cent during the first half of 1999; they had totalled \$234 million in 1998. The aggregate volume of FDI in Kazakhstan amounted to \$5.5 billion, or 5 per cent of GDP in the period 1992-1998; the level of FDI in 1999 was expected to remain at the 1998 level of \$1.2 billion, while \$2.1 billion was projected for domestic investment. The flows of external capital into the Russian Federation fell drastically in 1998 and the downward trend continued, with such flows falling by 30.4 per cent during the first nine months of 1999 compared with the same period the previous year; 48 per cent of the total \$6.5 billion of foreign capital was for direct investment. The proportion of FDI in gross domestic capital formation slipped from 70 per cent in the period 1991-1995 to 36 per cent in 1996-1997, and to about one third in 1998. The National Investment Council was formed in October 1999 to supervise the repatriation of capital from other countries, to play a role in shaping national economic legislation relating to investment and to create an investment rating system for the regions within the Russian Federation.

Inflation

As expected, the behaviour of consumer prices remained diverse within North and Central Asia, and a common characteristic of the inflationary upswing registered in the majority of countries of the subregion was essentially that it was cost-push in nature. Armenia enjoyed exceptional price stability with a modest rise of 5 per cent in consumer prices, compared to 8.7 per cent in 1998 (figure II.3). A tight monetary policy, easier domestic supply conditions and currency appreciation in real terms were among the main causes of such stability. Azerbaijan, on the other hand, recorded some deflationary pressures, despite a looser monetary policy and a more flexible exchange rate policy. Consumer prices fell by 9.7 per cent in the first eight months of 1999, and by 4 per cent for the whole year. The steady progress achieved by Kazakhstan in containing inflation was reversed by the devaluation of about 50 per cent in the national currency in April 1999. The consequent increases in both local and import prices raised inflation from 7.3 per cent in 1998 to 18 per cent in 1999.

Higher rates of inflation prevailed in other parts of the subregion. Consumer prices in Kyrgyzstan

Figure II.3. Inflation rates of selected North and Central Asian economies, 1996-1999



Sources: ECE, *Economic Survey of Europe 1999 No. 2* (United Nations publication, Sales No. E.99.II.E.3); and The Economist Intelligence Unit, *Country Reports*, various issues, 1999.

Notes: Data for 1999 are estimates. Inflation rates refer to changes in the consumer price index. The vertical axis of the figure is a logarithmic scale.

could increase by 50 per cent in 1999, a much higher increase than the government target of 18 per cent for that year. A shortage of hard currency and the plunging value of the national currencies forced prices to go up by some 30 per cent in both Turkmenistan and Uzbekistan in 1999. The declining trend in inflation continued in Tajikistan although the rates remained comparatively high: 85.4 per cent in 1997, 43.1 per cent a year later and 18 per cent in 1999. Monetary policy was tightened by the Russian Federation central bank in the aftermath of the steep devaluation of the rouble in August 1998. Monthly inflation had peaked at 38 per cent in September of that year, but for all practical purposes consumer prices stabilized in the latter part of 1999. For the year as a whole, inflation totalled 36.5

per cent, although the monthly rate of increase in such prices was limited to 1.4 per cent in October and to 1.2 per cent in November.

Trade and exchange rates

Trade performance in North and Central Asia saw little improvement, with the value of both exports and imports in 1999 remaining well below the level achieved prior to the 1998 crisis in the Russian Federation. This reflected the combination of a sharp contraction of demand in the Russian Federation, lower effective demand in other economies, higher nominal prices of imports and the induced shifts in favour of locally produced import substitutes.

However, there were two elements of silver lining. One related to some diversification of trade away from the CIS region, including towards Western Europe. This trend can be expected to continue, given the recently improved economic performance of EU countries. The second element was embodied in higher levels of surplus or reduced amounts of deficit in the trade or external current accounts, partly an outcome of import reduction following exchange rate adjustments.

The most significant development of 1999 was the steep contraction in the dollar value of merchandise imports and, to a lesser extent, exports of the Russian Federation. The former fell by 40 per cent during the first nine months of 1999, following modestly positive growth in the previous year (table II.9). The devaluation of the rouble helped to boost domestic production and domestic demand for import substitutes in the Russian Federation. But such a large decline in imports produced negative ripple effects of varying magnitudes on the export earnings of several other economies in North and Central Asia. Merchandise exports from the Russian Federation, however, performed comparatively better; earnings declined

but by only 7.3 per cent during the same nine months of 1999. The value of exports to other CIS countries fell considerably, in part because of the spillover impact of the crisis in the Russian Federation on export earnings of and consequently import spending by neighbouring economies. Exports to non-CIS destinations were reduced by a lesser magnitude while the upswing in oil prices helped to raise earnings in the latter part of 1999. Improved export performance and compressed import spending were expected to generate a higher merchandise trade surplus, an increase from \$17.4 billion to \$29.6 billion between 1998 and 1999. The current account balance was also estimated to be as much as \$10 billion, equivalent to more than 5 per cent of GDP in 1999.

Despite robust economic growth in Armenia, exports fell by 4 per cent to \$111.8 million and imports by 8 per cent to \$381.5 million in the first half of 1999. There was some trade diversification reflecting, by and large, a declining trend in intra-CIS trade. The share of the CIS countries in the aggregate value of Armenia's trade fell from 43 per cent in the first half of 1998 to 25 per cent in the corresponding period of 1999.

Table II.9. North and Central Asia: merchandise exports and imports in United States dollar value and their rates of growth, 1996-1999

	Value (millions of US dollars)		Exports (f.o.b.)			Value (millions of US dollars)		Imports (c.i.f.)		
			Annual rates of growth (percentage)					Annual rates of growth (percentage)		
	1998	1996	1997	1998	1999	1998	1996	1997	1998	1999
Armenia	224	7.0	-19.7	-3.9	-4.0 ^a	896	27.0	4.2	0.4	-8.0 ^a
Azerbaijan	550	16.0	23.8	-29.6	14.0	1 050	44.3	-17.4	32.2	-19.8 ^a
Kazakhstan	5 300	12.6	7.7	-16.7	-21.8 ^b	4 100	11.4	0.8	-4.1	-35.5 ^b
Kyrgyzstan	537	23.0	19.6	-11.1	-8.0 ^a	818	61.2	-15.3	15.2	-30.0 ^a
Russian Federation	70 000	9.8	-3.1	-19.3	-7.3 ^b	44 000	2.2	12.3	2.8	-40.0 ^b
Tajikistan	602	-13.1	14.6	-19.3	0.0 ^a	771	-5.8	-1.7	2.8	-6.0 ^a
Turkmenistan	..	..	-55.6	..	136.0 ^c	..	..	-6.5	..	9.0 ^c
Uzbekistan	3 528	48.1	-1.7	-18.7	-18.4 ^a	3 289	62.8	15.3	-17.7	-14.6 ^a

Sources: United Nations, *Monthly Bulletin of Statistics*, September 1999; Interstate Statistical Committee of the Commonwealth of Independent States, *Statistical Abstract* (Moscow, 1999); and The Economist Intelligence Unit, *Country Reports*, various issues.

^a January-June 1999.

^b January-September 1999.

^c January-July 1999.

Kazakhstan had also run a large and growing trade deficit from 1997 until the early part of 1999, when the local currency was devalued in April. Its trade deficit, for example, was equivalent to 1.7 per cent of GDP in 1997 and 3.6 per cent in 1998; it reached 6.1 per cent in the first quarter of 1999. The currency devaluation was combined with a series of tariff and non-tariff measures during 1999 to restrain imports and lower the large trade deficit. The current account deficit was expected to reach \$678 million (or 4.4 per cent of GDP) in 1999, relative to \$1.2 billion (or 5.4 per cent) in 1998.

Kyrgyzstan became the first and the only WTO member country among the CIS economies in 1999. However, the country had to face new tariffs imposed by Kazakhstan, the Russian Federation and Uzbekistan subsequent to the accession. Partly as a result, export earnings of Kyrgyzstan declined by 8 per cent and reached \$223 million during the first six months of 1999. At the same time, imports fell by 30 per cent and totalled around \$268 million, compared with \$385 million in the first half of 1998. The dramatic fall in imports was also attributed to the drop in purchasing power of the national currency, which was devalued by over 30 per cent during the first eight months of 1999. Kyrgyzstan's trade deficit, which had exceeded \$220 million in 1998, was expected to be lower in 1999 owing to a sharp drop in imports. The current account deficit remained exceedingly high in 1999 and could account for more than 18 per cent of GDP.

In Tajikistan, export earnings remained largely unchanged from the 1998 level; export of aluminium contributed some 45 per cent of such earnings. Import value, at \$346 million, represented a drop of 6 per cent in the first six months of 1999. The Russian Federation remained the main trade partner of Tajikistan. Exports of goods and services reached \$1.7 billion in Uzbekistan in the first half of 1999. This amount was 18.4 per cent lower than in the corresponding period in 1998, a drop attributable mainly to falling world prices for cotton and gold, the main export commodities from the country. On the other hand, imports totalled \$1,550 million, resulting in a trade surplus of \$150 million for the first half of 1999.

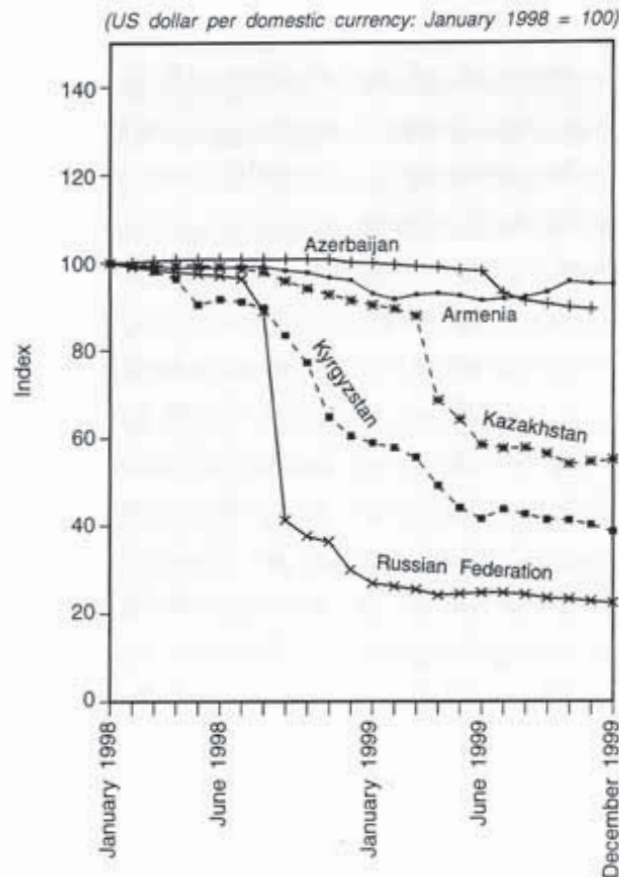
The patterns of foreign trade in Azerbaijan and Turkmenistan were the few exceptions among the North and Central Asian economies during 1999. In

the former country, export earnings were expected to rise by 14 per cent, to \$627 million, in 1999; the stimulus came from oil and gas exports. Stronger economic growth and a more flexible exchange rate during the year were also anticipated to increase domestic consumer demand for imports. In the first six months of 1999, however, the value of imports was down by 19.8 per cent year-on-year, partly due to lower prices of imports from CIS. The current account deficit had remained high in Azerbaijan; it was projected to decrease from 33 per cent of GDP in 1999 to 27 per cent in 2000, on account of stronger export performance and the upswing in oil prices. Turkmenistan experienced a substantial rise in export receipts, due also to strong earnings from gas exports. Import spending went up modestly; higher output in the food-processing sector contributed to lower demand for food imports. Merchandise exports were forecast at around \$1.2 billion and imports at \$1,150 million in 1999. The trade surplus stood at \$80 million in July 1999, compared with a deficit of \$293 million recorded one year previously.

As regards developments in exchange rates, the Russian Federation currency, the rouble, lost almost 73 per cent of its value (against the United States dollar) during the first half of 1999, and its nominal exchange rate was expected to weaken in the remainder of the year (figure II.4). The floating rate of the rouble was supported by a tight monetary policy and by some limited intervention from the central bank. The exchange values of the national currencies of several Central Asian countries were also on a downward trend during 1999. The som in Kyrgyzstan, for example, fell by 30 per cent in the first eight months of 1999. In Kazakhstan, the tenge, was devalued and floated in April 1999. Its nominal value fell by 40 per cent in May and, on a year-on-year basis, the tenge had declined by 72 per cent by July; however, the exchange rate stabilized towards the latter part of the year. The Tajik rouble also registered a sharp depreciation, by about 45 per cent during the first nine months of 1999.

More modest adjustments in the exchange rates were recorded by the other economies in North and Central Asia. The Azeri manat in Azerbaijan, for example, was devalued by 7 per cent in June 1999, but its nominal exchange value was kept relatively stable afterwards. The dram in Armenia was also fairly stable during the middle part of 1999, following

Figure II.4. Index of exchange rates of selected North and Central Asian economies, 1998-1999



Source: IMF, *International Financial Statistics*, various issues.

a small depreciation earlier in the year. Its stability was helped by the tight monetary policy and a relatively comfortable level of foreign reserves. Turkmenistan and Uzbekistan continued to have two exchange rates. In Uzbekistan, the commercial bank rate exceeded the official exchange rate by 28.3 per cent in July 1999, implying an erosion in the exchange value of the som. Full convertibility of the national currency was expected to be introduced from January 2000 in order to stop capital outflows and to be in compliance with Article VII of the IMF Articles of Agreement. The official exchange rate of the national currency of Turkmenistan, the Turkmen manat, was considerably lower than the value of the currency on the black market; the implicit depreciation was about 20 per cent as of June 1999.

Capital inflows and outflows

International financial institutions remained the major source of foreign credit for most economies of North and Central Asia. Such credit was provided mainly to support macroeconomic stabilization, economic restructuring and policy reforms. In 1999, IMF continued to provide the economies of North and Central Asia with financial assistance through its enhanced structural adjustment facility arrangements. The associated conditions included increased tax collection and tighter budgets, regular audit of the central banks and the adoption of international accounting standards. For example, Armenia was able to reach an agreement with IMF on the release

of a vital \$28 million loan tranche in October 1999 after approving a package of austerity measures aimed at reducing the large budget deficit. The IMF loan also paved the way for an additional loan worth \$25 million from the World Bank to counter a fiscal shortfall which was larger than anticipated. The funds so secured also enabled the Government of Armenia to reduce widespread arrears in pension and wage payments within the public sector. Kazakhstan was requested to speed up reforms, cut budget spending, improve tax collection, keep interest rates high and remove import controls in order to qualify for further loans from IMF. Bond issues worth \$200 million were launched in September 1999 to help to meet the payment obligations from some \$550 million in external debt in 1999.

In 1999, the Russian Federation also succeeded in reaching a \$4.5 billion loan agreement with IMF and a subsequent debt-restructuring package with the Paris Club of sovereign creditors and the London Club of commercial creditors. However, not much of the amount agreed upon with IMF was released. During the same year, Kyrgyzstan and Tajikistan obtained loans amounting to \$27 million and \$40 million respectively under their current three-year enhanced structural adjustment facility programmes with IMF. In addition, the World Bank released a number of loans in support of structural reform and the rehabilitation of the agricultural sector in Tajikistan. The World Bank also disbursed loans to promote the manufacture of export-oriented and import-replacing products in Kyrgyzstan.

Policy issues and responses

The North and Central Asian subregion consists of economies in transition. All of them have to face an array of difficult challenges in economic restructuring and policy reforms necessary to bring performance closer to potential within a market-oriented system. For most of these economies, the challenges to economic management have become much more daunting. Their exports remain comparatively small in volume and undiversified in both composition and destination. These factors make them particularly vulnerable to any shocks that may occur in the largest economy in the subregion.

A key issue in macroeconomic policy facing most, if not all, countries of the North and Central Asian subregion in the short to medium term is to improve the fiscal position, which has remained fragile up to the present. The chronic budget deficit reflects a combination of weak tax collections and a narrow tax base. To address this problem the tax base must be widened and the tax collection capacity improved, and management of public expenditure must be more efficient. Another key matter of policy concern relates to the width and depth of financial intermediation for the effective mobilization and allocation of resources for investment and development. As in the case of many other economies in transition, the financial sector and its regulatory framework are relatively less developed in North and Central Asia. An improved performance of the banking sector would also involve rationalization of state-owned enterprises, given the close relationships between them.

The countries of North and Central Asia have reformed their tax policy and tax administration, some more successfully than others. New tax laws have been adopted to bring about a tax structure that is more in conformity with a market-based economic system. Much progress appears to have been achieved in reforming tax policies, especially in the elimination of export taxes and excess wage taxes. Mixed progress has occurred in the introduction of appropriate value added tax, excise tax and personal income tax regimes, and in the simplification of the rate structure within various tax categories. Perhaps less progress has taken place in the introduction of new accounting systems and standards, the elimination of exemptions and the effective taxation of small businesses and the agricultural sector.

Tax administration reform in these economies has focused on the enactment of tax administration legislation consistent with the new tax structure. Reform measures have included management and organizational reforms, the development of systems and procedures, and the enforcement and determination of the scope of non-compliance. Nevertheless, the progress in implementing tax reforms has turned out to be slow for several reasons. First, in some economies, uncertainties continue to prevail with regard to the determination of actual tax liabilities, partly because of poor accounting systems

which make it difficult to determine the tax base accurately. Second, the tax administration is not adequately equipped to handle the significant increase in the number of taxpayers and the different types of taxpayer, particularly small and medium-sized taxpayers in the private sector, which have emerged in the course of the economic transformation. Third, the pervasiveness of barter trade and non-cash transactions has complicated the task of collecting taxes.

The budget deficits of Armenia and Uzbekistan were higher than the official target just after the first six months of 1999; they accounted for 12.2 and 2.2 per cent respectively the GDP of these countries. The government authorities were unable to collect sufficient taxes in the face of falling output and trade, while social spending remained high. In response, the Government of Armenia introduced in August 1999 an emergency package which included higher taxes and excise duties. In Uzbekistan, there was a shortfall of revenue as a result of lower cotton exports and reduced collection of excise taxes while the burden of inter-enterprise arrears grew. In the first half of 1999, tax and other payment arrears accounted for as much as 14.5 per cent of GDP. Tough measures had consequently to be taken against insolvent enterprises and the implementation of bankruptcy procedures was speeded up.

Severe budget constraints in Turkmenistan and Kazakhstan necessitated a considerable reduction in government spending in 1999. The tax base was broadened and the privatization programme was accelerated to help to close the fiscal gap in the latter country. During the first half of 1999, Kazakhstan earned almost \$190 million from such divestiture; annual revenue from privatization was expected to increase from an average of 2 per cent of GDP in the period 1994-1998 to 3.2 per cent in 1999. In comparison, the consolidated budget deficit of 1999 is estimated to have reached 3.7 per cent of GDP. Tajikistan also speeded up the implementation of its privatization programme and its package of structural reforms to reduce the budget deficit and to foster a faster and more durable pace of economic growth. A total of 2,300 small enterprises were privatized in 1998, treasury bills were issued and tax receipts were raised in 1999. The draft budget of Kyrgyzstan for the year 2000 envisaged an increase

of 12 per cent in revenue and a cut of 17 per cent in government spending; if this is the case, there could be a first budget surplus of 2.5 per cent of GDP.

The recent increase in prices brought in higher fiscal receipts than originally expected in the Russian Federation. Indeed, the federal budget could receive an additional \$1.5 billion in oil export duties in 1999. In addition, the sales of state shares in promising oil companies, shipping industries and international airlines could yield up to 15 billion roubles (or approximately \$600 million). However, the main boost to the budget came from improved collection of existing tax obligations; tax collections went up by 72 per cent during the first nine months of 1999, compared with the corresponding period of 1998. Among the main fiscal contributors were the transport sector, and the fuel and energy complex. Additional measures introduced during 1999 included several new taxes, various amendments to the tax code and a strengthening of the taxation service. The tax codes on the value added tax and on corporate profit taxation were amended. The value added tax was to be reduced from 15 to 10 per cent and the state taxation service would have the right to recover debts on taxes and fees, as well as to set up tax inspection in organizations that had not paid taxes for three or more months.

Financial sector reform continued to occupy the attention of governments in the North and Central Asian subregion during 1999. As was to be expected, the extent of success varied considerably. Based on a new law on bank insolvency adopted in 1999, the number of credit organizations in the Russian Federation was reduced from 1,477 to 1,390 and the number of banks with authorized capital exceeding 40 million roubles (\$1.6 million) increased from 201 to 242. In Kazakhstan, the number of banks was further reduced to 71 as a result of efforts to consolidate the banking sector. Significant progress was achieved in enforcing prudential norms, with 13 banks in full compliance by the end of 1998. In addition, the government decided to forgive some tax arrears of local firms, thus releasing resources for their repayment of overdue bank loans. Azerbaijan has made considerable progress in reforming its financial sector, including through privatization and allowing foreign participation in the

banking system. Nevertheless, improvement is needed in more vigorous enforcement of prudential standards and the establishment of a clear legal framework for dealing with non-viable banks. The main challenges for the banking sector restructuring and consolidation in Azerbaijan were twofold. Most banks were too small, inefficiently run and weakly capitalized, and a high proportion of NPLs existed in their balance sheets.

Financial sector reforms in Armenia and Kyrgyzstan in 1999 were aimed at further strengthening and enforcing the prudential regulatory framework for banks, and improving their governance. Among the main changes in the conduct of the monetary policy of the central bank of Armenia was the introduction of a target range for the monetary base to achieve price stability in the economy. The central bank stopped issuing direct credits to the government and financing the budget deficit. It also refrained from interventions in the foreign-exchange market. Interest and exchange rates are being determined mainly by market forces. The National Bank of Kyrgyzstan strengthened its supervision of the banking system and continued to pursue the floating exchange rate policy despite the considerable devaluation of the national currency, the som.

South and South-West Asia

Most of the five economies in this subregion experienced a deceleration in growth in 1999, with Turkey recording negative growth. The only exception was the Islamic Republic of Iran, where growth performance showed a modest improvement on the unusually low rate in the previous year. A number of country-specific factors were in operation behind the general scenario, but there were some common factors as well. The latter included uniformly poorer agricultural growth and, to a lesser extent, weaknesses in export performance. A positive development in this subregion during 1999 was that most countries succeeded in reducing the rate of inflation, in some cases substantially. However, the rate was still quite high, exceeding 5 per cent in all cases. Turkey recorded the highest rate in the subregion at 66 per cent, but this represented a dramatic reduction of about 20 per cent relative to the year before.

Growth performance

The moderate deceleration of GDP growth in India, from 6.8 to 5.9 per cent between 1998 and 1999, was underpinned by marginal growth in agriculture and allied sectors and strong growth in the industry and services sectors. Industrial growth went up from 4 to 6.9 per cent during the same years (table II.10). This upward trend in non-agricultural value added was mirrored by the rising investment to GDP ratio, by over two percentage points in 1999. Despite a normal monsoon, the agricultural sector did not perform well; unseasonal rain in some states caused the production of wheat, pulses and oilseed to decline. The strong surge in industrial activity during 1999 came largely from higher levels of value added, by 7-8 per cent in manufacturing and in electricity generation, and a more modest expansion of 4 per cent in mining and quarrying activities. Within the manufacturing sector, consumer durable goods were the lead performer, increasing by 12.8 per cent in the period April-September 1999, compared to the same period of the previous year; output of capital as well as intermediate goods was also higher, at over 9 per cent during the same period.

The services sector has been performing robustly since the mid-1990s. The strong performance in 1999 was largely the result of the derived demand from government activities in food grain procurement, the upswing in industrial value added, as well as the increase in public sector spending on administration, social services and rural extension programmes. Social and personal services, as well as the finance, insurance, real estate and business subsectors, recorded high growth.

These favourable outcomes were partly attributable to a variety of supply-side incentives, facilitation measures to boost industrial production and infrastructure development, including greater private sector participation. The simplification and rationalization of both direct and indirect taxes on industrial products and a reduction in prime lending rates by the commercial banks and financial institutions were other stimulating factors.

India's economic prospects are encouraging in the short to medium term. The ninth five-year plan

Table II.10. Selected South and South-West Asian economies: growth rates, 1996-1999

(Percentage)

		Rate of growth			
		GDP	Agriculture	Industry	Services
India	1996	7.8	9.4	6.0	8.0
	1997	5.0	-1.9	5.9	9.0
	1998	6.8	7.2	4.0	8.3
	1999	5.9	0.8	6.9	8.2
Iran (Islamic Republic of)	1996	5.8	3.6	7.8	5.0
	1997	3.4	3.5	5.4	5.0
	1998	1.6	8.1	2.1	-0.9
	1999	2.5	3.5	-1.5	1.5
Pakistan ^a	1996	6.8	11.7	5.4	5.0
	1997	1.9	0.1	0.6	3.6
	1998	4.3	3.8	6.8	3.2
	1999	3.1	0.4	3.8	4.1
Sri Lanka	1996	3.8	-4.1	6.5	6.0
	1997	6.4	3.0	8.5	7.2
	1998	4.7	2.5	5.9	5.1
	1999	4.0	2.4	5.2	4.1
Turkey	1996	7.0	4.4	6.9	7.8
	1997	7.5	-2.3	9.5	9.0
	1998	2.8	7.4	1.4	2.5
	1999	-2.3	-5.5 ^b	-3.9 ^b	-4.7 ^b

Sources: ESCAP secretariat calculations based on ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999) and *Asian Development Outlook 1999* (Oxford University Press, 1999); The Economist Intelligence Unit, *Country Report: Turkey*, fourth quarter 1999; and national sources.

Notes: Data for 1999 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

^a Real GDP at factor cost.

^b January-June.

(1997-2002) envisages an average GDP growth rate of 6.5 per cent per annum on the basis of projected annual agricultural and industrial expansion of 3.9 and 8 per cent respectively. The required level of gross domestic investment was equivalent to 28.2 per cent of GDP, given an incremental capital/output ratio of 4.34. Given that the slight deceleration in savings/GDP ratio observed earlier has been reversed, most of the required investment can be financed by domestic savings, leaving a small gap to be met by foreign capital inflows. Indeed, even a higher rate of growth of 7 per cent annually could be entertained for the years 2000-2002, assuming that there are no major internal and external shocks and that the pace of second-generation economic reforms is sustained.

In the Islamic Republic of Iran, economic performance recovered noticeably with GDP expanding by 2.5 per cent in 1999 after a slowdown in the previous year. The strong growth of 8.1 per cent in agriculture in 1998, which accounted for about a quarter of GDP, was offset significantly by lower output growth in industry (with a relative share of 16 per cent) and a negative growth of less than 1 per cent in the services sector. The total output in the oil and construction subsectors fell by 0.8 and 10.6 per cent respectively. The latter outcome reflected a sharp decline in government capital expenditure and reduced construction activities by the private sector after a boom in the previous two years. Lower oil revenue also created some negative ripple effects on the non-oil sectors.

Favourable weather conditions and government technical and financial assistance were among the major factors behind the sharp rise in agricultural output in the Islamic Republic of Iran in 1998/99. On the other hand, the relatively steep downward trend in international crude oil prices caused the decline of output in the oil sector. The East Asian economic crisis, a mild winter in the Atlantic area and the return of Iraq to the oil market were among the main factors behind this adverse outcome.

Meanwhile, manufacturing value added benefited considerably from an increase (of 12.4 per cent) in the financing facilities extended to industrial units and the operation of 1,548 new industrial projects in the Islamic Republic of Iran in 1998/99. In addition, the production index of large manufacturing establishments grew by 8 per cent as compared to the previous year. The output of petrochemical products, for example, reached 11.1 million tons, while that of edible oil, sugar and cement went up by 23.5, 9.9 and 4 per cent respectively. There was, moreover, an expansion in the metal and mining industries, with production gains in the range of 11-23 per cent in iron ores, coal, copper and aluminium. Indeed, the mining and minerals subsectors were identified in the five-year plan as a key area for non-oil export growth and were to receive priority attention in the future.

The estimated recovery of GDP growth, by 2.5 per cent in 1999/2000, would be largely underpinned by an estimated rise of more than 10 per cent in aggregate output of the oil sector as a result of the sharp upturn in oil prices. This would also boost non-oil economic activities.

In Pakistan, where the average growth rate exceeded 5 per cent over the period 1991-1996, an uncharacteristically low rate was recorded in 1997. Following a significant improvement in 1998, there was a deceleration again in 1999. The marginal slippage in 1999 was attributable to lower growth in both agricultural and industrial output. The fall in output was accompanied by lower savings and investment rates. Agriculture remains the major engine of growth in Pakistan not merely in terms of its own contribution to GDP, but also as a locomotive for the associated processing and manufacturing activities. The impressive performance of such major crops as rice and sugar cane, with production levels surpassing their respective targets, was in part offset by declines in cotton and wheat outputs. The

cotton crop was 16.2 per cent less than its target and 4.3 per cent lower than the level of the previous year. Affected by the long dry spells during the sowing season, the estimated wheat harvest of 18 million tons was 7.7 per cent less than the target and 3.4 per cent lower than the volume in 1998.

The expansion in large-scale manufacturing decelerated noticeably to 2.7 per cent in 1999, against 7.6 per cent in the previous year, on account of reduced cotton output as well as severe restrictions on imports, part of the measures taken to protect Pakistan's balance of payments from the adverse repercussions of external economic sanctions. Cooking oil, cotton ginning, leather, cement, air conditioners, billets, sewing machines and diesel engines were among the affected industries, with negative growth rates in 1999. The spillover from poor agricultural and industrial performance served to constrain somewhat the services sector which nevertheless expanded from 3.2 to 4.1 per cent between 1998 and 1999. There was lower value added in transportation, storage, communications, and wholesale and retail trade, but such other subsectors as public administration and defence showed some positive growth during the year.

Economic performance in Sri Lanka was also on a slightly lower trend after the boom in 1997. GDP growth was 4.7 per cent in the following year and 4 per cent in 1999. The growth rate for the year 2000 is projected to be marginally higher, in the range of 4-5 per cent, on the basis of a moderate upturn in industrial production underpinned by some 2 per cent growth in agriculture and an expansion of 6.7 per cent in the services sector.

All three major plantation crops performed well in 1999, with the tea harvest being 3.6 per cent higher, rubber 5.5 per cent and coconut 6 per cent. However, paddy production between September/October 1998 and March 1999 during the Maha, the main rainy season slipped by 2 per cent as a smaller crop area was sown and harvested as a result of the delay in the north-east monsoon rains; there was also some crop damage from floods in a number of provinces. The estimated expansion of 5.2 per cent in industrial activities in 1999 was contingent on the sustained performance in such export-oriented industries as textiles and apparel, leather goods, and non-metallic mineral products. There would be consequent growth in the domestic wholesale and retail trade sector reinforced by a

larger volume of imports of intermediate goods and other inputs. All these would generate a favourable impact on transport, communications and port services. The volume of transport, storage and communication activities was estimated to rise by 8.1 per cent in 1999, compared to 7.7 per cent in 1998. Tourism services, which had continued to recover from a major slowdown in 1996, improved further during the first six months of 1999 when the number of tourist arrivals jumped by 23 per cent over the corresponding period of the previous year. A high rate of growth of 16 per cent was estimated for this sector for the year as a whole.

The economy of Turkey started to slow down noticeably from the middle of 1998 following a robust expansion averaging over 7 per cent a year from 1995 to 1997; GDP growth declined to 2.8 per cent in 1998 and there was a contraction of over 2 per cent in the following year. The deceleration, partly associated with the implementation of a medium-term structural adjustment and stabilization programme, was exacerbated in the last quarter of 1998 by the financial and economic crisis in the Russian Federation. Capital outflows resulting from this crisis led to a substantial increase in interest rates, which constrained domestic demand and output. The deepening recession exhibited signs of recovery in the second quarter of 1999. The process was, however, suddenly halted by the devastating earthquake which hit the most prosperous, heavily populated and industrialized part of Turkey on 17 August 1999. The negative impact of this exogenous shock was estimated at one percentage point of GDP.

Agricultural activities (contributing 17 per cent to the total value added) increased marginally by 0.2 per cent in the first quarter of 1999 but declined sharply by over 7 per cent in the following quarter. Industry (with 20 per cent of the total value added) exhibited a reverse pattern, with a steep fall in the first quarter and a modest recovery of 1.2 per cent in the second quarter. The gain was driven by an increased output of 7.6 per cent within the public sector. Private sector manufacturing firms, on the other hand, suffered considerably from weak domestic and external demand, partly the result of the crises in East Asia and the Russian Federation. Exports of such products as textiles and garments were also hit by intense competition from cheaper Asian products in third markets.

The August earthquake temporarily halted the recovery process in industry whose output fell by 12.7 and 9.7 per cent in August and September 1999 respectively largely because of the absence of workers and damaged infrastructure. However, there was no significant damage to industrial capacity. There have been few signs of any appreciable recovery in investment activity. The value of investment projects receiving incentive certificates from the Treasury declined in the months of June and July 1999 while, on a year-on-year basis, the number of new companies formed in the second quarter of the year was down by 48.2 per cent following a decline of 69.2 per cent in the first quarter. However, the outlook for economic performance was much brighter, with GDP growth forecast at 4.6 per cent in 2000. External demand was expected to strengthen considerably while local demand would be bolstered by large outlays on reconstruction and rehabilitation.

Inflation

Rates of inflation moderated across South and South-West Asia in 1999, except for a small increase in the Islamic Republic of Iran. Inflation in India picked up considerably and was 13.1 per cent in 1998, in spite of a marginally smaller fiscal deficit and lower money supply growth (see table II.11). The unprecedented seasonal rises in the price of fruit and vegetables, coupled with the upward revision of the administered prices of sugar, food grains and petroleum products, were among the major supply-side factors responsible for the escalation in retail prices. Inflationary pressures, however, eased considerably to stand at 7 per cent in 1999 in the wake of the continued fall in money supply growth and the more effective distribution of essential commodities. In addition, excess capacity in the manufacturing sector and durable price stability in India's major trading partners exerted a stabilizing influence on domestic prices, notwithstanding a higher level of industrial activity and the sharp upturn in oil prices. The annual rate of wholesale and consumer prices in 2000-2002 would probably be around 5 per cent which, by the standards of recent years, would represent a remarkable degree of price stability.

Inflation in the Islamic Republic of Iran has been on an upward trend since 1997, rising to 23.3 per cent in 1999. A major demand-pull force was the sharp rise in the fiscal deficit and domestic

Table II.11. Selected South and South-West Asian economies: summary of macroeconomic indicators, 1996-1999

(Percentage)

		1996	1997	1998	1999
India	Savings/GDP	26.1	24.7	22.3	24.8
	Investment/GDP	27.3	26.2	23.4	26.5
	Budget balance/GDP	-5.2	-4.7	-4.5	-5.0
	Trade balance/GDP	-4.1	-3.8	-3.1	-3.7
	Current account balance/GDP	-1.2	-1.3	-0.9	-1.6
	Money supply growth (M2)	18.7	17.7	14.7	11.1 ^a
	Inflation rate ^d	9.4	6.8	13.1	7.0
Iran (Islamic Republic of)	Savings/GDP	18.0	20.7	20.3	21.0
	Investment/GDP	15.3	16.2	14.9	15.1
	Budget balance/GDP ^c	-0.2	-1.0	-5.2	-1.1
	Trade balance/GDP	5.5	2.7	-0.9	2.3
	Current account balance/GDP	3.9	1.4	-2.2	0.3
	Money supply growth (M2)	37.0	15.2	27.1	..
	Inflation rate ^d	23.2	17.3	20.0	23.3
Pakistan	Savings/GDP	14.2	12.6	16.0	12.2
	Investment/GDP	18.6	17.8	17.1	14.8
	Budget balance/GDP	-6.4	-6.4	-5.4	-4.2
	Trade balance/GDP	-6.2	-6.2	-3.0	-1.6
	Current account balance/GDP	-7.2	-7.0	-2.8	-2.5
	Money supply growth (M2)	20.1	19.9	7.3	6.6 ^e
	Inflation rate ^d	10.8	11.8	7.8	5.7
Sri Lanka	Savings/GDP	15.5	21.4	19.3	20.8
	Investment/GDP	24.2	24.4	26.6	28.6
	Budget balance/GDP	-7.8	-5.0	-8.9	-7.9 ^c
	Trade balance/GDP	-9.7	-8.1	-7.4	-10.3
	Current account balance/GDP	-4.9	-2.6	-2.2	-3.7
	Money supply growth (M2)	10.5	13.8	13.2	13.0
	Inflation rate ^d	15.9	9.6	9.4	6.0
Turkey	Savings/GDP	20.3	20.4	21.2 ^f	..
	Investment/GDP	24.9	25.6	25.8 ^g	..
	Budget balance/GDP	-8.4	-7.6	-7.0	-12.0
	Trade balance/GDP	-5.8	-8.1	-7.2	-2.7 ^h
	Current account balance/GDP	-1.3	-1.4	0.9	3.5 ^h
	Money supply growth (M2)	117.3	97.5	89.7	83.2 ^g
	Inflation rate ^d	80.4	85.7	84.6	66.0

Sources: ESCAP secretariat calculations based on ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999) and *Asian Development Outlook 1999* (Oxford University Press, 1999); IMF, *International Financial Statistics*, January 2000; World Bank, *World Development Report* (Oxford University Press), various issues; The Economist Intelligence Unit, *Country Report: Turkey*, fourth quarter 1999; and national sources.

Notes: Data for 1999 are estimates. Savings/GDP refers to gross domestic savings/GDP; investment/GDP refers to gross domestic investment/GDP.

^a January–September.

^b Consumer price index for industrial workers.

^c Excluding grants.

^d Referring to changes in the consumer price index.

^e January–June.

^f Referring to gross domestic savings/GNP.

^g Referring to gross domestic investment/GNP.

^h January–March.

liquidity (M2) in 1998/99. Almost three quarters of the increase in such liquidity occurred in the last quarter of the financial year, and its lagged effect could cause a further increase in the consumer price index estimated at 23.3 per cent in 1999/2000. The rising trend in inflation in the Islamic Republic of Iran has partly been the result of cuts in subsidies on a number of goods, including fuel.

Pakistan had experienced double-digit inflation during the first seven years of the 1990s, but inflationary pressures have been noticeably lower in the last two years. The consumer price index rose by 5.7 per cent in 1999. Large price increases of 8.3 per cent were recorded in transport and communication services and 5.7 per cent in food, beverages and tobacco in 1999. Nevertheless, the overall inflationary pressures were kept in check, on the supply side, through the stocking of essential food items and close monitoring of their availability. The latter was to facilitate timely responses, including through the import of such essential items as wheat, pulses, milk powder and edible oil, as well as suitable adjustments in import and export duties and taxes. A network of 715 utility stores, run by a public sector agency, was also established to ensure the availability of essential goods for the daily use of the common people at cheap prices. These supply-side measures were reinforced by a restrictive stance on fiscal and monetary policies reflected in the falling budget deficit and a sharp reduction in money supply growth.

The relatively high rates of inflation in Sri Lanka have been falling over the past few years and came down sharply in 1999 to 6 per cent. The major contributory factors were improved domestic supplies, particularly of food items, prudent monetary management and lower imported inflation. Despite a depreciation of the local currency by 5 per cent in the period January-June 1999, the prices of major imports such as wheat flour and sugar were on the decline so that administered prices on items of mass consumption were either reduced or not increased. There were also more limited fluctuations in the prices of food products, especially vegetables. This favourable development was attributable to government efforts in developing a marketing network and related infrastructure, as well as in ensuring greater availability of daily information on wholesale prices which served, in turn, to raise market efficiency and flexibility in the matching of supplies and demand.

Money supply growth remained moderate. The absence of excess demand helped to contain the wage push in both the government and the plantation sectors.

Turkey had experienced very high rates of inflation, averaging more than 80 per cent between 1996 and 1998. The rate fell dramatically in 1999, although it remained quite high at 66 per cent. The government policy of keeping a stable exchange rate in real terms by depreciating the currency in line with the upward movement in prices continued to generate strong inflationary expectations. Nevertheless, the upswing in prices was moderated by a slowdown of wage increases, from 97.8 per cent in the first quarter of 1998 to 77.7 per cent in the second quarter of 1999. The year-on-year increase in consumer prices, at 63 per cent as of May 1999, was the lowest in the last six years. However, inflation was edging marginally upward in the later months of 1999 on account of higher prices of oil and some public sector services, especially electricity, health care and housing.

Trade and exchange rates

Export performance deteriorated across virtually the whole of South and South-West Asia in 1998, an unfavourable development which continued the following year, except in India and the Islamic Republic of Iran. India had experienced a contraction of 2.6 per cent in merchandise export earnings in 1998/99 (table II.12) partly because of the steep depreciation of the currencies of countries hit by the crisis in East and South-East Asia. This was offset by a slowdown (due to lower oil prices) in import spending, from 8.5 to 3.9 per cent in 1998/99, so that the trade deficit in 1998/99 was somewhat higher than the level recorded in the previous year. On the other hand, large gains in exports of services, especially of Y2K-related software, helped to reduce the shortfall on the external services account.

Subsequently, both exports and imports expanded, with trade earnings of \$14.1 billion during the first five months of the 1999/2000 fiscal year, an increase of 4.6 per cent over the 1998/99 year-on-year. Import spending in April-August of the current fiscal year increased by 4.1 per cent on an year-on-year basis, resulting in a slightly higher (by 2.3 per cent) trade deficit, which stood at just under \$4 billion during the same period. Nevertheless, the

Table II.12. Selected South and South-West Asian economies: merchandise exports and imports in United States dollar value and their rates of growth, 1996-1999

	Value (millions of US dollars)	Exports (f.o.b.)					Value (millions of US dollars)	Imports (c.i.f.)				
		Annual rates of growth (percentage)						Annual rates of growth (percentage)				
		1998	1996	1997	1998	1999		1996	1997	1998	1999	
India	33 656	8.1	4.4	-2.6	4.6 ^a	42 765	9.3	8.5	3.9	4.1 ^a		
Iran (Islamic Republic of)	12 982	22.0	-17.4	-29.3	23.7	13 608	17.2	0.0	-3.6	-0.5		
Pakistan	8 501	16.6	-6.3	-2.6	-10.5	9 315	5.8	-4.3	-19.8	-8.2		
Sri Lanka	4 734	7.8	13.1	2.2	-3.1	5 917	2.0	8.1	1.1	6.0		
Turkey	25 938	7.3	13.0	-1.2	-7.1 ^b	45 369	22.2	11.4	-6.6	-20.0 ^b		

Sources: United Nations, *Monthly Bulletin of Statistics*, September 1999; IMF, *International Financial Statistics*, November 1998 and November 1999; and ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999).

^a April-August.

^b January-August.

trade deficit for the whole fiscal year 1999/2000 was expected to widen to 3.7 per cent of GDP, from 3.1 per cent in 1998/99, owing to increased oil prices and greater import outlays on intermediate goods and other inputs necessitated by greater industrial activity and higher output. Manufactured goods figured prominently behind the rise in export receipts while the value of bulk imports increased by 25.2 per cent on a year-to-year basis in the period April-June 1999. These compositional shifts in favour of value added exports and imports of intermediate raw materials were, by and large, consistent with a recovery in the export-oriented sector and in the domestic industry.

An important feature in India's trade and payments during the 1990s was a noticeable movement towards a more sustainable balance of payments position. Foreign exchange assets were built up considerably from \$1 billion in June 1991 to more than \$30 billion in November 1999. The invisible accounts improved to a great extent while there was a major shift in the capital accounts in favour of non-debt-creating financial flows such as equity and portfolio investment. The current accounts deficit, although persistent, remained manageable; it was estimated to increase from 0.9 per cent of GDP in 1998 to 1.6 per cent in 1999 largely as a result of a higher trade deficit. Meanwhile, exchange rate management had to face several challenges over the years 1997 to 1999, including the contagion effects

of the East and South-East Asian financial and economic crisis from July 1997 and the unfavourable reaction of the developed countries to India's testing of nuclear devices in 1998. Speculative activities then accentuated the leads and lags in the receipts of and payments for foreign exchange. Through various interventions by the Reserve Bank of India, the depreciation of the nominal value of the rupee was contained to only 4 per cent against the United States dollar in 1999.

Export performance in the Islamic Republic of Iran remained dominated by movements in international oil prices whose sharp fall was behind a reduction of 36 per cent in the value of oil and gas exports in 1998/99. Despite higher earnings of 4.5 per cent from non-oil exports, the total export receipts were 29 per cent lower than in the previous year. Import spending declined by only 3.6 per cent, causing a trade deficit equivalent to almost 1 per cent of GDP in 1998/99, compared to a surplus of 2.7 per cent a year earlier. Larger net transfers, mainly workers' inward remittances, were insufficient to negate the deficit in the services account so that the shortfall in the current accounts was about 2.2 per cent of GDP in 1998/99, relative to a surplus of 1.4 per cent recorded in the previous year. The recent upswing in oil prices was expected to raise earnings on oil exports by over 20 per cent, while import expenditure was projected to be on a slightly downward trend, resulting possibly in an overall

surplus in both the trade balance and the current accounts balance in the current fiscal year.

The official exchange rate, which had remained more or less unchanged for the previous three years, was set at 1,751 rials to one United States dollar; it was applicable to the purchase of essential imports such as foodstuffs, intermediate inputs and raw materials. There was also another official exchange rate of 3,000 rials to the dollar for transactions such as non-oil exports. The legal floating rate available through the Tehran Stock Exchange was close to the parallel market rate of 8,750 rials to the dollar during the fourth quarter of 1999. Efforts by the central bank are under way to unify the exchange rates.

Pakistan's merchandise exports, at \$7.7 billion in 1998/99, represented a steep decline of over 10 per cent from the level of the previous year. There was an even sharper fall in the export value of primary commodities, with earnings on raw cotton being halved as a result of production shortfalls and low international prices. The export values of fish, leather, crude animal materials and oilseed were also down for the year. Apart from lower prices (except for rice, fruits, vegetables, oilseed and nuts), the country's exports faced increasing competition from Asian and Pacific countries, where currencies had depreciated quite steeply. In the case of fish exports, there were also more stringent regulations and standards, including in EU markets, and cheaper exports from South America. For several major export categories, there were reduced volumes of shipments as well; earnings on textiles, for example, were about 0.6 per cent lower because of reduced quantity.

Meanwhile, there had been a deep cut of almost 20 per cent in imports in 1997/98, followed by a further reduction of 8.2 per cent the following year. All major categories of imports were down in value, for example, by 13-14 per cent in foodstuffs, textiles and machinery, and by 7.2 per cent in petroleum products. Such compression partly reflected the slowdown of economic growth since 1997. There were, moreover, concerted policy efforts to conserve limited foreign exchange resources in the wake of external economic sanctions imposed after the detonation of nuclear devices in May 1998. These included a suspension of withdrawals from foreign currency accounts and a tightening of some exchange control regulations; the latter were liberalized somewhat afterwards. A dual exchange rate

system was also introduced temporarily, consisting of an interbank floating rate and a composite rate set by the State Bank of Pakistan; dual arrangements were replaced by a unitary rate in May 1999.

Regarding other external transactions, the amount of residents' foreign currency deposits did not increase significantly in 1998/99 apparently because of an erosion of depositors' confidence and lower workers' inward remittances, which were down by about 29 per cent compared to the previous year's receipts. Nevertheless, the current account deficit narrowed, largely owing to import compression. The level of foreign exchange reserves fell to \$440 million at the end of October 1998 from \$930 million as of June the same year. After the conclusion of an agreement with IMF in January 1999, the flow of funds from the international institutions was restored and the Paris Club of donor countries agreed to reschedule Pakistan's external debt. Largely as a result, the stock of foreign exchange reserves increased to some \$1,730 million at the end of June 1999.

The lagged effects of the East Asian crisis, falling commodity prices, including that of tea, and lower demand from the Russian Federation and Japan were behind the declining trend in export growth of Sri Lanka in 1998 and 1999. Export earnings were down by 9 per cent in the first half of 1999 on a year-on-year basis, with agricultural exports (mainly tea) falling by 21 per cent. Exports of manufactured goods, accounting for 76 per cent of the export value, were dominated by textiles and garments which, despite a 7 per cent increase in the shipped volume, brought in some 4 per cent less in foreign exchange because of unfavourable prices. Earnings from prawn exports also declined because of a disease-related suspension of prawn cultivation in certain areas, while earnings from diamonds and other gems increased in response to higher demand from Belgium, Japan and the United States.

Export value for the whole year, however, was estimated to decline by a smaller margin of 3.1 per cent owing to the recovery in most of the economies hit by the crisis in the region and in external demand from elsewhere, plus some upturn in non-oil commodity prices during the latter part of the year. It was envisaged that imports would grow by 6 per cent for the year, although the actual outlays on imports dropped by 13 per cent in the first half of 1999 largely because of lower import prices; only 1

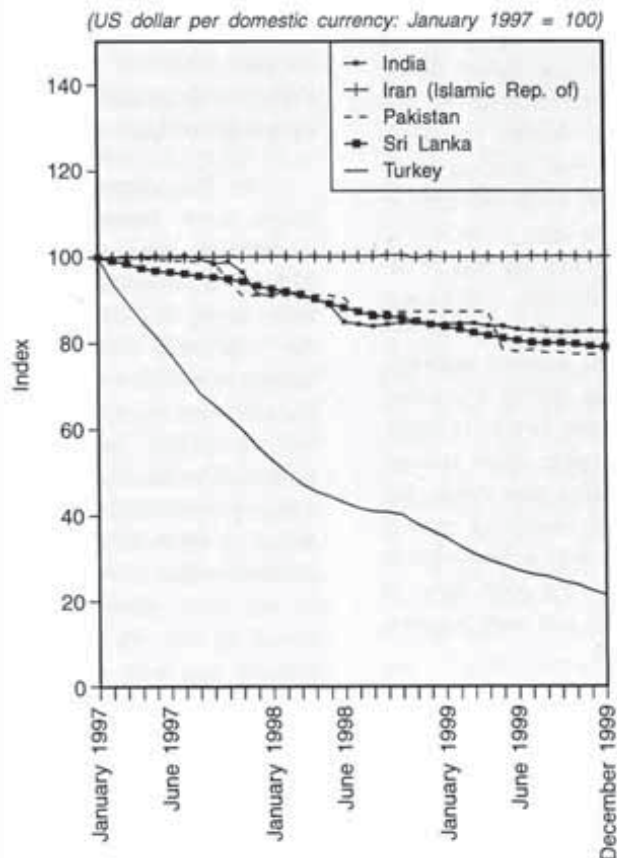
per cent was accounted for by the reduction in volume. The import value of consumer goods and intermediate goods (with a relative share of 22 and 51 per cent respectively) was each about 11 per cent lower, while that of investment goods (with a relative share of 24 per cent) was 17 per cent lower. The projected positive expansion in import expenditure for 1999 as a whole was largely attributable to the importation of three aircraft, plus higher oil prices in the second half of 1999.

Exports of services were expected to perform well with the recovery in the tourism sector, with travel receipts growing by 20 per cent and net earnings in services by 18 per cent in 1999, compared to the previous year's level. Net current

transfers were expected to be largely the same, so that the widening trade deficit from 7.4 per cent of GDP in 1998 to 10.3 per cent in the following year would impact heavily on the external current accounts. The consequent shortfall was estimated to grow from 2.2 to 3.7 per cent of GDP between 1998 and 1999. The adverse pressures on external payments led to a depreciation of about 7.5 per cent in the exchange rate of the Sri Lanka rupee between September 1998 and the same month of 1999 (figure II.5).

Turkey's export receipts were also on a downward trend in 1998 and 1999; on a year-to-year basis, they were 7.1 per cent lower in the period January–August 1999 as a result of weak economic

Figure II.5. Index of exchange rates of selected South and South-West Asian economies, 1997-1999



Sources: IMF, *International Financial Statistics*, various issues; *Far Eastern Economic Review*, various issues; and *The Economist*, various issues.

growth in Europe, a contraction of demand in CIS, sharp devaluation in several East Asian currencies and the erosion of competitiveness as a result of high domestic inflation and hence burdensome interest rates. During the first half of the year, in particular, exports of garments declined by 13 per cent, and iron and steel products by 19 per cent; setbacks were recorded for many exported agricultural products as well. The fall in the value of these exports was the result of both lower prices and lower volumes. However, exports of motor vehicles and parts went up significantly, by 50 per cent, and exports of furniture by 14 per cent in the same period.

The economic slowdown compressed imports by 20 per cent during the first eight months of 1999, compared to the same period in 1998. Import spending was reduced by 21.9 per cent in the first half of 1999, with outlays on capital goods dropping steeply by 27.8 per cent, followed by those on intermediate goods (21.5 per cent) and consumer goods (14.7 per cent). The sharp compression of imports substantially lowered the trade deficit during the same period. Meanwhile, the surplus in the services accounts was nearly halved primarily because of the sharp fall in net revenue from tourism compounded by an equally large increase in net interest payments. There was also a decline in some invisible receipts, although some compensation for this came from workers' remittances, grants and earthquake-related claims on foreign reinsurance companies. All in all, the current account balance, which had shown a small surplus during the previous year, was envisaged to increase further in 1999. Reflecting higher inward FDI, among other factors, foreign reserves reached \$24.1 billion just before the August earthquake. The nominal exchange rate of the Turkish lira was kept in line with movements in domestic consumer prices. Given the high rates of inflation, the lira depreciated by 60 per cent between September 1998 and August 1999.

Capital inflows and outflows

In India, private capital flows started to fall in the wake of the East Asian crisis and weakened further after the imposition of international sanctions following India's testing of nuclear devices in May 1998. Among other measures to arrest the decline was the sale of Resurgent India Bonds to non-

resident Indians, which yielded \$4.2 billion. Capital inflows recovered strongly with improved investor sentiment towards emerging markets from the beginning of 1999; such foreign resources amounted to \$1,802 million between April and July or almost triple the level of \$661 million in the corresponding period of the previous year. The stock market index also recorded sizeable gains in the year. The Bombay stock index, which was in the range of 3,122–3,784 in the first quarter of 1999, rose to a range of 4,271–5,057 in the fourth quarter.

External debt, standing at \$98.2 billion at the end of March 1999, was largely long-term in nature; short-term liabilities had declined substantially in recent years to be just 4 per cent of the total while the share of concessionary debt averaged 45 per cent at the end of March 1999. The debt to GDP ratio stood at 22 per cent in 1999, a sharp drop from 38 per cent in 1991, while the ratio of debt service to export of goods and services was equivalent to 17.1 per cent, reflecting a consistent decline over the past few years. These favourable trends, coupled with the rising stock of foreign reserves, partly underpinned India's impressive success in securing non-debt-creating financial inflows.

In the Islamic Republic of Iran, a series of steps were taken to rationalize existing foreign investment laws and regulations and to simplify various administrative procedures involved. Legislation being drafted for this purpose was designed to open up new areas for foreign participation, while foreign investment under buy-back and build-operate-transfer modalities was already being undertaken in the oil sector. Nevertheless, net capital inflows remained volatile as well as relatively small, with FDI totalling some \$800 million in 1999; portfolio investments of \$800 million in 1998 were likely to decline to \$400 million in 1999. Net commercial bank credit, on the other hand, went up significantly from \$400 million in 1997/98 to \$1 billion in the following year. Overall, the debt stock of the Islamic Republic of Iran had peaked at \$23 billion in 1993/94 and fell to \$14.1 billion in 1998/99.

Capital transactions in Pakistan were closely associated with the state of debt-service payment in 1999. The outstanding external (medium-and-long term) debt was close to \$23 billion while the debt-service burden almost doubled from \$1,316 million (or 13.7 per cent of foreign exchange earnings) in 1990/91 to \$2,577 million (or 23.3 per cent of foreign

exchange earnings) in 1998/99, thus embodying an average increase of 8.8 per cent a year. However, the servicing burden amounted to 32 per cent of export earnings in 1998/99. There was, in the same year, a slightly higher net inflow of \$1,804 million in total external capital, compared with \$1,395 million in the previous year. The net inflow of private long-term capital, however, declined (by \$186 million) to \$549 million, reflecting a fall in both FDI and portfolio investment

Sri Lanka recorded higher inflows of FDI (by some 23 per cent) and other capital in 1999; in particular, private long-term resources were estimated at \$449 million (or a threefold rise in comparison to the level of the previous year) on account of foreign borrowings by the national airline, and communications and port authorities. As regards short-term capital, there was a net outflow associated with the build-up of foreign assets by commercial banks, a development reflecting limited domestic opportunities for profitable lending and, on the other hand, the continuous strengthening of the United States dollar. However, the economic recovery in the region is expected to restore and boost portfolio investment in Sri Lanka, the net inflow of which reached \$1 billion in 1999 compared to a net outflow of \$24 million the previous year.

In Turkey, capital movements in the first half of 1999 were back on track again compared to the situation in 1998 when the financial crisis in the Russian Federation occasioned a dramatic outflow of portfolio capital of over \$6 billion. Portfolio investment recovered noticeably in the first two quarters of 1999, with an inward flow of nearly \$2 billion while FDI inflow at \$468 million was in line with the target of \$1 billion for the year. The drawdowns in foreign reserves to finance scheduled debt repayment by the public and the banking sectors were largely offset by higher net inflows of commercial credit.

Financial and fiscal sector developments

The 1999/2000 budget in India sought to lower (by half a percentage point) the fiscal deficit to 4 per cent of GDP and to promote industrial growth and infrastructure development through fiscal incentives, including an extension of tax holidays to many sectors, a further simplification of customs and excise duties, and the maintenance of a tariff rate

ceiling at 40 per cent. On the revenue side, there were new tax measures, and an increase in various levies and in administered prices of certain food items, but direct tax rates were kept unchanged. A commitment was also made to adopt a fully fledged VAT and to lower customs tariffs to ASEAN levels within the next five years.

Meanwhile, the basic objective of monetary policy was to contain inflation at around 5 per cent and to help to sustain a GDP growth rate of 6–7 per cent. In response to the improved inflation outlook, monetary policy was eased somewhat through a reduction of the cash reserve ratio from 11 per cent in 1998 to 9 per cent in April 1999, the bank rate from 9 to 8 per cent, and the prime lending rate from 13 to 12 per cent. Liquidity had been abundant in the system, but banks adopted more stringent credit appraisal to minimize the possibility of non-performing assets. NPLs amounted to 8 per cent of net advances in 1998 compared to 9.2 per cent in 1996. Substantial investment was made by banks in government securities and bonds, debentures, and shares of the corporate sector thus contributing to an ongoing shift in the banks' asset portfolio mix, a change made possible by financial sector deregulation. Almost all public commercial banks had attained the capital adequacy ratio of 8 per cent by 1999.

Government revenue fell by 14 per cent in the Islamic Republic of Iran in 1998/99 largely because of lower fiscal receipts from the export of oil and gas. Their relative share in total public revenue fell from 41.6 per cent in 1997/98 to 34.7 per cent the following year. An adverse trend on the expenditure side was the rising share of current to total public spending, with the former accounting for as much as 75.3 per cent in 1998/99. The sharp deterioration in the fiscal position was reflected by a significant increase in the budget deficit to 5.2 per cent of GDP in 1998/99 compared to 1 per cent the previous year. This undesirable fiscal position was to be rectified with the deficit lowered to 1.1 per cent of GDP in 1999/2000 through, among other measures, a cut in current expenditure, as well as higher revenue from oil and gas against the backdrop of the sharp upturn in oil prices.

In the Islamic Republic of Iran, monetary policy was oriented towards meeting the priority credit requirements of the production sectors while ensuring adequate systemic liquidity in a non-inflationary

manner. In this context, bank credit extension was planned and executed with government approval and the bulk of these facilities (around 95 per cent) was to be provided for agriculture, manufacturing, mining and housing, and for the export sector. However, the widening budget deficit, primarily financed by the central bank, was behind the acceleration in money supply growth (M2) of over 27 per cent in 1998/99, almost twice of that recorded in the previous year. Meanwhile, the Tehran Stock Exchange was very active, with an increase of almost 120 per cent in the number of shares traded (to 1,211 million) and of just over 57 per cent (or 3,170 billion rials) in turnover value in 1998/99. Furthermore, during the same year, the number and value of shares offered by private and government-affiliated companies expanded sharply, by more than sixfold for the former category of companies and more than double for the latter, indicating an increasing trend in private sector participation.

Pakistan introduced a wide range of structural reforms and stabilization measures to foster greater fiscal consolidation and rationalization in the interest of durable macroeconomic stability. During most of the 1990s, tax rates were reduced, the tax base was broadened and the incidence of taxes was shifted from imports and investment to consumption and incomes. The overall tax to GDP ratio did not change appreciably but the revenue structure was altered considerably; for example, the relative share of direct taxes went up from 18 per cent in 1990/91 to almost 35 per cent in 1998/99 with a corresponding decrease in the share of indirect taxes. The tax and tariff reforms, supplemented by strict discipline on both development and non-development spending, have led to a steady decline in the budget deficit in recent years, reaching 4.2 per cent of GDP in 1998/99.

Further tax reforms foreshadowed in Pakistan's 1999/2000 budget included a further simplification of the tax system and the introduction of a new universal self-assessment system. A substantial increase in tax revenue was projected; the budget shortfall was targeted at 3.3 per cent of GDP. An additional package of sweeping reforms, announced by the new government in late 1999, consisted of new measures for revenue generation (such as the proposed introduction of an agricultural income tax) as well as expenditure control (through, for example, a voluntary cut in the defence budget by 7 billion

rupees or about \$140 million). The persistence of high levels of budget deficits in earlier years had resulted in rapid growth of public debt; the total level stood at 50.5 per cent of GDP while debt servicing absorbed more than 80 per cent of tax revenue and some 65 per cent of total revenue in 1998/99, thus considerably compromising the government's ability to spend on key development activities.

Foreign currency accounts were frozen to conserve foreign assets in the wake of economic sanctions and the restrictive impact of this policy response on domestic liquidity was eased somewhat by the introduction, from June 1998, of such expansionary measures as a reduction in the statutory liquidity ratio and in the cash reserve ratio on rupee deposits. The sanction-generated uncertainties, coupled with a more cautious approach in bank lending and a concerted effort in loan recovery, slowed down domestic demand for bank credit. Monetary growth (M2) decelerated sharply from almost 20 to 7.3 per cent between 1997 and 1998. Partly in response, the central bank lowered its repurchase rate consecutively from 15.5 per cent in March 1999, to 14 per cent in April and to 13 per cent from mid-May. Nevertheless, expansion in the money supply remained subdued at 6.6 per cent during the first half of 1999.

Loan recovery had been much strengthened under the newly enacted Banking Companies Act of 1997, and the amount of NPLs recovered by banks and development finance institutions in Pakistan was boosted from 7,420 million rupees in 1996/97, to 12,950 million and 16,180 million in the following two years. Tough penalties of up to 14 years in jail for those convicted of graft or refusing to pay back bank loans were recently introduced by the new government after it came to power in October 1999. Meanwhile, a series of steps were also taken to revitalize the capital market, including the introduction of a central depository system in September 1997 and a significant increase in the number of brokerage houses with foreign collaboration. There were 49 corporate brokerage houses at the Karachi, Lahore and Islamabad stock exchanges as of June 1999.

The budget deficit in Sri Lanka, which had widened considerably from 5.0 to almost 9 per cent of GDP between 1997 and 1998, was contained to an estimated 7.9 per cent of GDP in 1999 through enhanced efforts in both revenue mobilization and

expenditure controls. Total government revenue, at 17.7 per cent of GDP, represented an increase of 14 per cent over the level collected in 1998. There were higher receipts from better tax administration, as well as from an increase in the national security levy from 4.5 per cent in 1998 to 5.5 per cent in 1999. Meanwhile, higher payments of public sector salaries and wages and a larger bill of interest on domestic debts raised current outlays by about 5 per cent in 1999; however, the ratio of such expenditure to GDP went down to 18.2 per cent, compared to 19.7 per cent in 1998. This permitted a sharper expansion in capital spending and net lending, by about 21 per cent for the same year.

Money supply (M2) in 1999 was projected to grow at the same pace (about 13 per cent) as in the preceding two years. The contractionary impact of a larger shortfall in the external current accounts was neutralized by increases in credit to the public sector. A higher rate of credit extension to government corporations was expected on account of an upturn in several categories of import prices (especially oil) in the second half of 1999. Credit to the private sector was also projected to increase while interest rates remained largely stable in the first half of 1999, implying an increase in real terms given the declining trend in inflation. In the wake of the Asian crisis, foreign banks scaled down their operations in Sri Lanka, and banks generally have become more cautious in granting loans denominated in foreign currencies.

The fiscal position in Turkey was already adverse, with budget deficits persisting at 7-8 per cent of GDP during the last three years; it was exacerbated further in 1999, reaching 12 per cent. Among the contributory factors were lower revenue collections due to falling output, the high cost of public debt servicing, public sector wages and the August earthquake, which exerted pressure for additional spending on relief and reconstruction.

In the past several years, the money supply (M2) in Turkey has continued to grow at very high rates, well above the sum of real GDP growth and inflation rates. During the first six months of 1999, monetary expansion stood at just under 85 per cent compared to the same period in 1998. The nominal rates of interest of more than 20 per cent were high in absolute terms, but significantly negative in real terms, given current inflation. At the same time, the

volume of credit extension to the commercial sector continued to lag because of the deteriorating economic situation, high nominal interest rates and certain crowding-out effects from the financing of fiscal shortfalls, and there were also a sizeable number of NPLs. Regarding structural reforms, a new banking law was enacted in 1999 to establish an independent bank regulatory and supervisory agency as an important step in reforming and strengthening the financial sector.

Policy issues and responses

A common policy concern in most countries of the subregion is the concerted implementation of further structural adjustments and policy reforms to enhance domestic economic efficiency and external competitiveness. In this context, some of the key areas that will require urgent attention include trade policy reforms, control over the public sector deficit and inflation, the strengthening of the financial sector, improvements in conditions for the private sector to play a more effective role and further increases in productivity across a broad range of economic activities.

A series of policy reforms implemented in India since the early 1990s appear to have put the country firmly on a higher trajectory of growth. Nevertheless, a broad set of the so-called second-generation reform agenda needs to be defined. The elements of this set could include well-conceived programmes of privatization of public enterprises, the elimination of entry barriers to SMEs in certain sectors, the easing of restrictions on the ability of firms to lay off workers and the establishment of an effective exit strategy for bankrupt firms.

Notwithstanding the substantial progress in trade policy reforms in India in recent years, there remains scope for further improvement. The maximum ceiling of custom duties was reduced from 125 to 29 per cent between 1990 and 1999 and many quantitative restrictions were relaxed, but the average tariff rate is still one of the highest in the world and the trade regime remains complex, with a variety of concessions, exemptions and certain quantitative restrictions on imports. The government has indicated commitments to further lower customs tariffs in the next five years. Concerns remain regarding the long-term sustainability of the consolidated fiscal

situation with the total public sector deficit (of the central government, state governments and public enterprises) estimated to have exceeded 9 per cent of GDP in 1998 causing public sector debt to reach nearly 80 per cent of GDP. The financial sector in India has been considerably strengthened since 1992 with improvements in the prudential and supervisory system and enforcement of risk-weighted capital adequacy ratios. The sector remains dominated by public sector institutions and there is considerable room for improving their efficiency as some of them continue to record losses.

The medium-term policy agenda in the Islamic Republic of Iran includes the stabilization and strengthening of the economic and financial sectors to encourage higher investment and structural diversification, and to contain inflation. Market-oriented structural reforms and policy adjustments will serve to enhance domestic efficiency, competitiveness and diversification. A series of steps have indeed been taken or will be introduced shortly to ensure more rational domestic pricing of various commodities and products, including oil, and more widespread use of a market-determined exchange rate in trade and other transactions. These steps will be supplemented by a prudent stance of fiscal and monetary policies to reduce high inflation.

Economic performance has moderated considerably in Pakistan in recent years. To restore economic growth to higher rates, it is essential to arrest the declining trend in investment, including public investment. The latter is particularly crucial to reclaim arable agricultural land and to prevent extensive water logging and salinity. In this context, the effective mobilization of domestic resources is a major challenge. The proportion of tax receipts to GDP has not improved significantly over the last decade. Lower receipts from a reduction in the levels of customs duties, previously a major source of domestic revenue, have not yet been adequately offset through an extension of the general sales tax. The effect of measures introduced by the new government cannot be evaluated as yet. The country also faces a high debt-servicing burden against the backdrop of falling exports over the past three years. The enhancement of export competitiveness is thus an urgent priority.

In Sri Lanka, the gradual removal and elimination of various structural weaknesses and other

impediments to higher savings and greater private sector participation constitute some of the major policy tasks in the medium to long term. Accordingly, recent reforms included the promotion and facilitation of a greater role for the private sector in such key areas as gas production and distribution, telecommunications, plantations and airlines. Parallel and complementary actions have also been undertaken as regards the divestiture of state-run enterprises, the simplification of the tax system as well as tax reductions, including lower tariff rates, and the introduction of a tax on goods and services. The government is also aiming at higher levels of efficiency and cost-effectiveness in the delivery of public sector activities through the introduction of skills development programmes and productivity-enhancing incentive schemes, and at improving the operational efficiency of state-run banks and financial institutions. The large and persistent budget deficit remains a matter of concern.

The immediate policy priority in Turkey is the restoration and maintenance of macroeconomic stability. The present high level of inflation is hardly conducive to sustainable growth. In this context, the government has announced the implementation of a renewed and comprehensive programme of reforms and adjustments in various sectors, including the fiscal position. An important element of this programme is that income policies, including those relating to public sector wages and salaries, are to be aligned with the inflation target. In addition, agricultural support prices will also be determined in conformity with the targeted inflation while quantitative limits will be imposed on state procurement of the relevant farm products.

South-East Asia

The most striking feature of economic development in the South-East Asian landscape during 1999 was that all the countries which had suffered a decline in 1998 recorded positive growth. The rates of growth were, of course, modest by the historical standards of these countries, or relative to the dynamic pace of recovery in the Republic of Korea or the resilient expansion in China. They were nevertheless remarkable because of the deep output contraction in many of these countries in the previous year.

A second important feature was the steep drop in inflation as measured by consumer prices. The remarkable deceleration in inflation partly reflected substantial appreciation in exchange rates; it was also symptomatic of feeble aggregate demand. The latter is particularly evident from the fact that the investment/GDP ratio in most of the countries remained at about the same level as in 1998, which was considerably lower than in the preceding years.

The deceleration in inflation permitted expansionary fiscal policy, which was seen as essential for economic revival. However, the rising fiscal deficit may become a cause for concern in the future. There are substantial fiscal implications of the remaining agenda for the reform and restructuring of the financial and corporate sectors, including public sector enterprises in the subregion. The resurgence of broad-based durable economic growth will be key to the emerging revenue needs of governments.

An upturn in exports was another source of stimulus for recovery in South-East Asia in 1999. This turnaround became marked during the second half of the year. The gains were relatively strong in all the economies except Indonesia, which suffered a decline in the absolute value of its exports, though of a much lower magnitude than in the previous year. Better commodity prices will be a helpful factor for the subregion, while the large increase in oil prices will provide an extra stimulus to oil exporters, of which there are quite a few in the subregion. Manufacturing activities and business confidence are likely to be revived further through strong export growth. However, there are risks in relying on exports as the principal stimulus for sustained recovery, especially if the export growth simply reflects a cyclical increase in external demand rather than enhanced competitiveness. This consideration underscores the need for revival of domestic demand.

Growth performance

The economic growth of Brunei Darussalam, though modest compared to that of its neighbours, was respectable in 1996-1997, averaging close to 4 per cent per annum (table II.13). The economy was, by and large, insulated from the direct impact of the Asian economic crisis owing to its large hydrocarbon resource base. Nevertheless, growth fell noticeably

and remained stagnant at 1 per cent in both of the following years. The persistence of low oil prices in 1998 and up to early 1999 reduced both government revenue and capital spending, although the latter was in part offset by a supplementary budget introduced in 1998 to help boost economic activities. Among other factors causing a deceleration of growth were a decline in domestic consumption, a fall in construction spending, the collapse of the Amedeo group of companies (the country's largest conglomerate) and increased shopping across the border in neighbouring Malaysia as a result of the relative appreciation of the domestic currency (pegged to the Singapore dollar). The outlook appears much brighter for 2000. The government fiscal position improved considerably because of the recent sharp upturn in oil prices, as well as a higher level of oil production. Most of the citizens of Brunei Darussalam are employed within the public sector. The limited number of new government jobs is likely to lead to greater participation of the local workforce in the private sector and, hence, displacement of foreign workers. The importance of transforming the country into the region's service hub for trade and tourism by 2003 has again been emphasized by the government. Singapore is collaborating in the process through the construction of ancillary facilities and infrastructure.

Indonesia was hardest hit by the crisis. The process of recovery was considerably delayed in comparison with other economies in South-East Asia because of a variety of economic and non-economic problems. A contraction in economic activities, first registered in the last quarter of 1997, deepened into an overall drop of 13.7 per cent in GDP during 1998 and was both the effect and the cause of much of the paralysis in the country's banking system and business investment, as well as of social and political problems. An unusually high rate of inflation, at just under 78 per cent, along with the battered rupiah exchange rate, severely undermined investor confidence, prolonged the credit crunch and caused steep falls in overall production, investment and household spending. Massive unemployment and spreading poverty heightened further business uncertainty, consumer insecurity, the already deteriorating balance sheets of financial institutions, social unrest and political tensions. On the supply side, the small rise in agricultural value added was insufficient to stem the tide of output declines in all other sectors. Construction and finance performed badly and the

Table II.13. Selected South-East Asian economies: growth rates, 1996-1999

(Percentage)

		Rate of growth			
		GDP	Agriculture	Industry	Services
Brunei Darussalam	1996	3.6	5.1	1.3	6.6
	1997	4.1	5.5	2.0	6.7
	1998	1.0	3.4	-1.2	3.6
	1999	1.0	..	..	..
Indonesia	1996	7.8	3.1	10.7	-5.6
	1997	4.9	0.7	5.6	19.6
	1998	-13.7	0.2	-15.6	-16.6
	1999	0.1	0.9	1.3	-3.3
Malaysia	1996	8.6	2.2	11.2	7.6
	1997	7.8	1.3	10.5	6.3
	1998	-7.5	-4.5	-11.6	-4.6
	1999	5.4	4.6	6.1 ^a	2.4
Philippines	1996	5.8	3.9	6.4	6.4
	1997	5.2	2.9	6.2	5.4
	1998	-0.5	-6.6	-1.7	3.5
	1999	3.2	6.1	0.2	4.0
Singapore	1996	7.5	6.0	7.2	7.7
	1997	9.2	-5.8	7.3	10.3
	1998	0.4	-5.7	0.9	0.1
	1999	5.4	-5.2	6.4	4.1
Thailand	1996	5.5	3.8	7.0	4.6
	1997	-0.4	1.4	-0.1	-1.1
	1998	-10.4	-0.3	-11.6	-9.0
	1999	4.1	1.9	10.5	1.5
Viet Nam	1996	9.3	4.6	14.5	8.4
	1997	8.2	5.0	12.6	6.6
	1998	5.8	2.8	10.2	4.1
	1999	4.8	4.4	7.7	2.7

Sources: ESCAP secretariat calculations based on ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999); and national sources.

Notes: Data for 1999 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

^a Comprising mining and quarrying, manufacturing and construction.

sizeable manufacturing sector recorded a huge contraction. The severe impact of the domestic crisis on capital formation reversed the savings-investment gap from a long-standing deficit to a large surplus in 1998, a shift which was also in line with the surplus in the current account.

GDP growth in Indonesia became only marginally positive in 1999, but the positive growth was remarkable for two reasons. First, the country had suffered the deepest contraction and the highest

inflation in the subregion a year earlier. Second, the recovery occurred despite a highly charged political atmosphere. The sectoral stimulus came from a strong performance in agriculture and a pickup in manufacturing industries from the second half of 1999, the latter embodying improved private and government consumption, enhanced competitiveness from falling input prices, and increased export earnings from textiles and garments, electronic products and cement. Higher levels of capacity utilization were evident across the manufacturing sector,

particularly in the textiles, garment and leather subsectors. However, private investment remained subdued partly because of problems in the financial sector and partly because of the political uncertainty prevailing throughout most of 1999. The economic recovery is being helped along by higher export prices of both oil and, to a lesser extent, non-oil commodities. Besides, there was much less volatility in the exchange value of the rupiah, and interest and inflation rates became much lower in the course of the year. These favourable developments, reinforced by a democratically elected government, should greatly bolster consumer demand, as well as the confidence of both domestic and foreign investors, and thus provide grounds for optimism for improved economic performance in the current year. However, what is actually achieved will be significantly influenced by the degree of success in resolving the remaining political tensions.

In Malaysia, GDP declined by 7.5 per cent in 1998, the first recession after 12 years of uninterrupted expansion averaging 7.8 per cent per annum. Economic performance was adversely affected in all sectors, including agriculture (except mining); there was a steep decline of 11.6 per cent in industrial value added during 1998 as a whole. The contraction, which was felt most severely in the construction and the manufacturing subsectors, began to gather pace from the second quarter of the year. The initial contractionary monetary and fiscal policy stance had been gradually relaxed and was reversed to counter falling domestic demand, restore domestic liquidity and lower the rates of interest, prevent a further deterioration in the financial sector balance sheets and speed up the processes of corporate and financial sector consolidation. These stimuli were underpinned by the imposition of selective capital controls from 1 September 1998 to restrict the possible outflow of short-term capital; the ringgit was also pegged at a higher rate of 3.8 to the United States dollar (compared to the rate of 4.22 prevailing in August 1998).

GDP expanded by 4.1 per cent on a year-on-year basis in the second quarter of 1999, the first turnaround after five consecutive quarters of output contraction, while full-year growth stood at some 5.4 per cent. Significantly higher government spending was the main motive force on the demand side. Such expenditure was directed to a large number of sectors and activities, including agriculture, low- and

medium-cost housing, education, health, rural infrastructure, technology development, and financial sector consolidation and strengthening. In consequence, the earlier budget surplus turned into a deficit, which rose from 3.4 per cent of GDP in 1998 to 5.7 per cent in 1999. An upswing in merchandise exports, led by electronics items, added another motive force. There was only a modest, albeit crucial, improvement of 3.5 per cent in private consumption. However, high levels of excess capacity in various sectors and some business uncertainty were among the reasons behind low private investment during 1999 in spite of declining interest and inflation rates, the stabilization of the ringgit exchange rate and greater injections of liquidity into the financial system.

The contraction and, since February 1999, the upswing in manufacturing production outpaced most other sectors and industries. Growth for the year as a whole, at 8.9 per cent, was largely characterized by the exceptional performance of the export-oriented subsectors, primarily electrical and electronic goods. Revived local demand fuelled growth in such domestic-oriented industries as transport equipment, food processing, chemicals and plastics, paper and paper products, and basic metal products. The turnaround in agricultural value added, from a contraction of 4.5 per cent in 1998 to positive growth of 4.6 per cent in the following year, was largely due to the sharp rebound in palm oil revenue. A decline of 8.3 per cent in the price of this export product in 1998 was reversed by a sharp increase of 19.4 per cent in 1999. The comparatively modest growth in services (2.4 per cent) reflected, in part, the still dampening effects of the crisis on the corporate and financial sectors.

The forecast level of 5.8 per cent growth in Malaysia's GDP for 2000 embodies higher aggregate demand on both the domestic and the export fronts. Greater private consumption and investment are envisaged, with the former projected to expand by 9.2 per cent in 2000. This should ease the pressure to rely on public expenditure to stimulate growth. Together with improved prospects for resource mobilization, the fiscal deficit is expected to decline to about 4 per cent of GDP in 2000 compared with 5.7 per cent in 1999. On the supply side, export-oriented manufacturing, led by the electronic and electrical subsectors, is expected to have a strong influence on near-term expansion in output and employment.

GDP growth turned marginally negative in the Philippines during 1998 but GNP remained almost unchanged because of a strong flow of net factor income from overseas. A resilient services sector, the ongoing robust export performance, stable domestic consumption and a sound financial system largely compensated for the weather-induced setback of 6.6 per cent in agriculture and a slippage of 1.7 per cent in industry, the latter reflecting a decline in construction and manufacturing activities. On the demand side, however, personal consumption and government spending slowed down, while gross domestic capital formation contracted somewhat in 1998. Aggregate production started to gather pace early in 1999 to result in a GDP expansion of 3.2 per cent for the full year. Agricultural value added improved sharply, by over 6 per cent; the major crops of rice and corn posted a record harvest, and a higher output was also achieved in the sugar cane, bananas and livestock subsectors. The services sector, another motive force, expanded by 4 per cent as a result of buoyant activities in transportation, communications, trade and storage.

The sustaining influence for growth on the demand side included an expansionary policy stance and merchandise exports, which continued to perform strongly in 1999. Despite easier monetary conditions and lower interest rates, industrial production remained sluggish, a reflection of slow growth in private consumption, the ongoing but moderated fall in construction activities and reduced investment spending within the private sector. The strong recovery in manufacturing production, combined with a strong performance in services and agriculture, is expected to lift GDP growth to 4.5 per cent in 2000. It is likely that domestic demand will receive a boost from higher consumer spending as a result of the full implementation of the minimum wage orders approved in late 1999 and a more conducive investment climate. The prospects for robust export growth are also encouraging.

Demand-side factors were largely behind the marked slowdown in growth in Singapore, from 9.2 to 0.4 per cent between 1997 and 1998. Manufacturing and exports were adversely affected by global excess capacity in the electronics industry, lower demand as a result of the Asian crisis and some erosion in cost competitiveness associated with the larger depreciation of regional currencies (relative to the Singapore dollar). Most sectors tended to perform poorly but a steep contraction of 8.8 per

cent was borne by financial services, which was partly a reflection of methodological changes in estimating their contribution to GDP. A steady decline in entrepôt trade, due to the regional recession and weak domestic demand, served to cause a decline in trade services of about 4 per cent. Industrial value added increased by just under 1 per cent in 1998, reflecting unfavourable developments in export-oriented manufacturing activities and shrinking domestic demand. Positive consumption growth, helped mainly by public spending, could not offset the impact of cutbacks in gross fixed capital formation and inventory drawdowns.

In 1999, manufacturing, financial services and commercial activities in Singapore benefited positively from stronger external demand, which contributed to an expansion of GDP of 5.4 per cent. A comparable growth rate of 5 to 6 per cent is officially forecast for 2000. Growth in manufacturing has been driven by a solid performance in several subsectors, especially the chemical and electronic subsectors. New capacity was added to the pharmaceutical segment of higher value and fine chemicals for export to European and American markets. Consumer spending picked up, with higher employment, wage increases in the private sector and growing tourist arrivals. To maintain its multi-sided competitive edge, the financial sector was further liberalized and business operating costs were reduced or contained through lower government fees and charges, bigger tax rebates and smaller contributions of employers to the central provident fund. Moreover, cuts in wages and salaries, as suggested by the National Wages Council, were instituted in 1998 and the Council's proposal on wage restraint was also adopted by the government for 1999.

GDP registered a steep downturn of 10.4 per cent in Thailand in 1998 owing to sharp falls in private consumption and investment. Open unemployment doubled to 4 per cent during the year, relative to the pre-crisis level, with a dampening impact on consumption. Economic performance deteriorated virtually across the board, especially in manufacturing, construction, real estate, trade and financial services, so that value added within the industrial and services sectors dropped by 11.6 and 9 per cent respectively. Export earnings in dollar terms were down despite the large depreciation of the baht, although a few items such as fishery products enjoyed strong external demand. At the

same time, government expenditure was lowered to contain the cash deficit within the limit agreed with IMF in the face of falling government revenue. Inflation in Thailand was comparatively moderate at 8.1 per cent in 1998; but the substantial worsening of asset prices, private sector debt overhang and liquidity crunch further aggravated the prevailing perception of uncertainty and insecurity by investors and consumers alike.

Positive growth was restored from early 1999 driven by higher levels of exports and government expenditure. Full-year GDP was about 4.1 per cent higher. Manufacturing activities expanded strongly by 12.6 per cent, and capacity utilization increased from 51 to 60 per cent between the end of 1998 and the end of 1999. An additional push came from the recovery in agriculture with a 1.9 per cent expansion in sectoral value added. The initially tight fiscal stance was also relaxed and some half a million new jobs are expected from the two stimulus packages of 130 billion baht and 102 billion baht introduced respectively in March and August 1999. The packages included several measures. First, outlays were made for new investment, job creation, social welfare programmes and safety nets. Second, cuts in various taxes and import tariffs, mainly on industrial raw materials, were supplemented by more generous tax exemptions to lighten the burden on various business and consumer groups. Third, capital financing was provided in support of new home buyers, small and medium-sized enterprises, and the financial and corporate recapitalization and restructuring process. Three funds were established in this context: an equity fund, a Thailand recovery fund, and a fund for venture capital investment for smaller enterprises.

The consequent fiscal deficits, including expenditure of public enterprises, were expected to be considerably higher at around 5.5 per cent of GDP in 1998/99. An expansionary fiscal stance is to be maintained with the targeted deficit of 5 per cent of GDP for 1999/2000. Easier liquidity conditions, low inflation and a stable exchange rate augur well for a positive outlook on Thailand's economic performance. The consequent improvement in domestic consumption and investment, together with anticipated robustness in these export earnings, is expected to endow industrial activities with the lead role in GDP expansion officially forecast at about 4.4 per cent in 2000.

The downward trend in economic activities continued in Viet Nam and the GDP growth rate of 5.8 per cent in 1998 was the lowest since 1991. Agricultural output decelerated significantly, from 5 to 2.8 per cent between 1997 and 1998, because of bad weather conditions, including a long drought and flash floods. Weaker domestic and external demand, due in part to the economic crisis in Asia, and poorer performance in commodity production lowered the rate of growth to just over 10 per cent for industries and to 4.1 per cent for services in 1998. Exports slowed sharply, with earnings in dollar terms rising by only 2.3 per cent in 1998, compared to 26 per cent during the previous year. On the demand side, a lower level of implemented FDI projects caused a fall in total investment during 1998 and, as a result, the ratio of investment to GDP dropped from 28.3 per cent in 1997 to 25.1 per cent the following year.

A considerable upturn in agricultural production, by 4.4 per cent in 1999, proved inadequate to offset decelerating growth in the industry and services sectors so that GDP went up by only 4.8 per cent in Viet Nam, one full percentage point lower than in the previous year. A bumper paddy crop yielded 32.8 million tons in 1999, or 1 million tons higher than the 1998 harvest. Investment and domestic consumption expanded at a lower rate in 1999, although merchandise exports performed much better than in 1998; in dollar value, exports jumped by 17.5 per cent in 1999. A bilateral trade agreement, reached in July 1999, conferred most-favoured nation status on Viet Nam in its exports to the United States and boosted the country's bid to join WTO. Improved access to the United States market, higher oil and non-oil commodity prices and the gathering pace of economic recovery in East and South-East Asia should enhance the prospects for trade and FDI. Together with an expected improvement in consumer demand, the official target for GDP growth in 2000 is moderately higher at between 5.5 and 6 per cent.

Inflation

In common with several economies in East Asia, a deflationary tendency arose in parts of South-East Asia during 1999 (table II.14). Indonesia had suffered the highest rate of inflation, at 77.6 per cent, in 1998. This resulted from a combination of a steep depreciation of the rupiah, a disruption in the

Table II.14. Selected South-East Asian economies: summary of macroeconomic indicators, 1996-1999

(Percentage)

		1996	1997	1998	1999
Indonesia	Savings/GDP	30.1	31.0	26.2	25.4
	Investment/GDP	30.7	31.3	18.5	17.5
	Budget balance/GDP ^a	1.4	-0.9	-2.3	-6.8
	Trade balance/GDP	2.6	4.7	19.6	19.5
	Current account balance/GDP	-3.4	-2.3	4.2	3.5
	Money supply growth (M2)	29.6	23.2	62.3	16.1 ^b
	Inflation rate ^c	6.5	11.1	77.6	20.4
Malaysia	Savings/GDP	42.6	43.9	48.1	46.4
	Investment/GDP	41.6	42.5	25.8	27.4
	Budget balance/GDP ^a	0.7	2.4	-3.4	-5.7
	Trade balance/GDP	4.1	3.9	24.9	24.1
	Current account balance/GDP	-4.9	-5.5	12.9	11.4
	Money supply growth (M2)	19.8	22.7	1.5	10.6 ^d
	Inflation rate ^c	3.5	2.7	5.3	3.0
Philippines	Savings/GDP	14.6	14.0	12.4	13.5
	Investment/GDP	24.0	24.9	20.3	20.3
	Budget balance/GDP	0.3	0.1	-1.9	-2.4
	Trade balance/GDP	-13.7	-13.5	0.0	1.1
	Current account balance/GDP	-4.8	-5.3	2.0	3.8
	Money supply growth (M2)	23.2	26.1	8.5	10.2 ^e
	Inflation rate ^c	8.4	5.1	9.0	7.0
Singapore	Savings/GDP	49.3	50.4	49.9	50.0
	Investment/GDP	37.0	38.7	33.5	34.5
	Budget balance/GDP	6.8	3.3	-0.3	-3.5
	Trade balance/GDP	2.4	1.2	17.4	13.3
	Current account balance/GDP	15.2	17.9	25.4	25.3
	Money supply growth (M2)	9.8	10.3	30.2	28.4 ^e
	Inflation rate ^c	1.4	2.0	-0.3	0.4
Thailand	Savings/GDP	35.8	35.1	38.7	33.2
	Investment/GDP	41.7	35.0	23.7	24.7
	Budget balance/GDP	0.9	-0.3	-2.8	-5.5
	Trade balance/GDP	-5.1	1.0	14.6	6.9
	Current account balance/GDP	-7.9	-2.0	12.8	8.7
	Money supply growth (M2)	12.6	16.5	9.7	2.3
	Inflation rate ^c	5.8	5.7	8.1	0.3
Viet Nam	Savings/GDP	17.2	20.1	21.4	22.0
	Investment/GDP	28.1	28.3	25.1	25.5
	Trade balance/GDP	-9.4	-7.7	-7.0	2.3
	Current account balance/GDP	-9.8	-5.4	-3.6	0.9
	Budget balance/GDP ^a	-3.0	-4.0	-3.3	-3.6
	Money supply growth (M2)	22.7	26.1	27.5	27.9
	Inflation rate ^c	4.5	3.6	9.2	2.5

Sources: ESCAP secretariat calculations based on ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999) and *Asian Development Outlook 1999* (Oxford University Press, 1999); IMF, *International Financial Statistics*, October 1999 and January 2000; and national sources.

Notes: Data for 1999 are estimates. Savings/GDP refers to gross domestic savings/GDP; investment/GDP refers to gross domestic investment/GDP.

^a Excluding grants.

^b January-November.

^c Referring to changes in the consumer price index.

^d January-October.

^e January-September.

distribution networks for basic necessities, a poor rice harvest and excessive accumulation by traders of essential household items. Inflationary pressure began to subside in the last quarter of 1998, in line with improvements in the distribution system to channel essential items. More specifically, inflation peaked at 82.4 per cent in September 1998 compared with the same month in the previous year. Subsequently, this monthly inflation rate began to decelerate and more rapidly so in 1999, reaching 1.6 per cent in November 1999. Prices of food items in fact started to decrease in the last few months of 1999 compared to the same months in 1998. The supply of food items improved as agricultural production increased owing to favourable weather. Trade liberalization in the main food products also increased the food supply in the domestic market. The average inflation for the full year was estimated at 20.4 per cent.

The inflation rate in Malaysia fell progressively after June 1998 to stand at a relatively modest 5.3 per cent for the year as a whole compared to 2.7 per cent in 1997. The deceleration continued into 1999 so that the full-year consumer price index was just 3 per cent higher. This reflected weakened domestic demand, partly because of an erosion of consumer confidence and a feeling of job insecurity. The stabilization of the exchange rate of the ringgit also had a moderating impact on inflation. The pressures of imported inflation, which can be quite high in Malaysia owing to its substantial reliance on food imports, were effectively removed with the appreciation of the ringgit and its pegging after September 1998. In addition, the government exercised control over the prices of basic food items. The food subgroup within the consumer price index went up by 5 per cent in 1999; to a significant extent, this was offset by lower increases in other subgroups. For example, the retail costs of the clothing and footwear component of CPI went down by 3.6 per cent.

In the Philippines, a higher inflation rate of 9 per cent in 1998 was triggered by weather-related shortfalls in agricultural output and compounded by a sharp depreciation of the peso and high interest rates. Upward pressure on retail prices eased gradually during 1999 with a year-on-year rise of 3.9 per cent in November, the smallest change for

12 years. Inflation stood at 7 per cent for the whole year. Food prices remained generally muted, with a bumper harvest of the major crops of rice and corn. The upward pressure came from the non-food components, particularly as a result of an increase of 23.4 per cent in retail oil prices following the sharp rise in oil prices in the world market. There was also a hike of some 20 per cent in transport fares. In addition, minimum wages were raised, with those in Metro Manila rising by 12.9 per cent.

For the first time in 12 years, Singapore experienced a marginal deflation of 0.3 per cent in 1998. CPI contracted in the second half of 1998, a result of feeble consumer demand coupled with keener competition in the retail market leading to price discounting. Other helpful factors included lower prices for oil and non-oil commodities, and falling transport and communication costs. These downward forces more than offset the higher costs of health care, education, housing and some (cooked) food items. Consumer prices continued to fall marginally in the first quarter of 1999 and then started to rise at a slow pace in the subsequent quarters, resulting in a marginal increase of 0.4 per cent for the whole year. Prices were relatively higher across a wide range of CPI subgroups, including food, clothing, transport and communications, education, health and miscellaneous categories. For all practical purposes, nevertheless, inflation was non-existent in the past two years and this allowed easier monetary conditions to facilitate the recovery of domestic demand and economic growth in Singapore.

Inflation in Thailand rose to 8.1 per cent in 1998. Prices of imports, as well as some domestically produced items, increased after the sharp depreciation in the exchange rate. Another contributory factor was higher taxes (for example, increased valued added tax and a higher tax on petroleum) imposed between the second half of 1997 and early 1998. Consumer prices started to fall from June 1998 and deflation persisted for some months in 1999. Upward pressure from dearer oil prices in the last few months of 1999 was more than negated by the dampening effect of the relative stability of the baht, a reduction of VAT from 10 to 7 per cent in April 1999, the downward adjustment in utility prices and subdued domestic

demand. For the year as a whole, CPI increased by only 0.3 per cent.

The falling trend of inflation in Viet Nam was reversed during 1998, when consumer prices rose by 9.2 per cent, but the pressure on prices subsided significantly to average only 2.5 per cent higher in the following year. The upturn in inflation in 1998 reflected several supply-side factors such as a protracted drought in the central part of the country and the promotion of higher exports of food and non-food items. In addition, Viet Nam was obliged to resort to a gradual depreciation of the local currency in view of the lower exchange values of other countries in South-East Asia, poor export earnings, the persistence of large deficits in the current account and a limited supply of foreign reserves. The rate of inflation moderated substantially during 1999, in common with most other countries in South-East Asia. Some price increases occurred earlier in the year after the introduction of VAT but general price stability prevailed despite a larger budget deficit. The constraining forces on price rises included a lower level of investment activity, weak private demand, falling food prices resulting from a good harvest and the relative stability in the exchange value of the dong.

Trade and exchange rates

Merchandise exports played a crucial role, in combination with a fiscal stimulus in the economic recovery process in South-East and East Asia. Export earnings improved significantly in most parts of the subregion in 1999 (table II.15). A common denominator behind this upturn was buoyant world demand, especially for electrical and electronic goods, which could be met with relative ease because of high levels of excess production capacity and partial relaxation of the credit crunch. In parallel, there was also a notable increase in imports, particularly of raw materials. The import of capital goods remained subdued, reflecting lower levels of domestic investment. By and large, a sizeable surplus emerged in the trade and current accounts of South-East Asian countries.

Export earnings in United States dollar terms were down by 8.6 per cent in Indonesia during 1998 because of lower receipts from both the oil/gas and the non-oil/gas accounts. The former embodied lower unit values due to excess supplies, as well as smaller volumes due to shrinking demand. Manufactured exports, the most important category of non-oil/gas exports, suffered because of fiercer regional

Table II.15. Selected South-East Asian economies: merchandise exports and imports in United States dollar value and their rates of growth, 1996-1999

	Value (millions of US dollars)	Exports (f.o.b.)				Value (millions of US dollars)	Imports (c.i.f.)					
		Annual rates of growth (percentage)					Annual rates of growth (percentage)					
		1998	1996	1997	1998		1999	1998	1996	1997	1998	1999
Indonesia	48 847	9.7	7.3	-8.6	-2.0	27 337	5.7	-2.9	-34.4	-10.5 ^a		
Malaysia	73 304	6.2	0.6	-6.9	15.7	58 326	1.0	0.8	-26.2	12.6		
Philippines	29 496	16.7	22.9	17.0	18.6	29 524	20.4	12.2	-18.8	6.8		
Singapore	109 905	5.7	0.0	-12.1	8.4	104 728	5.5	0.8	-20.9	9.4		
Thailand	54 455	-1.2	3.4	-6.8	7.2	42 971	2.5	-13.1	-33.8	17.6		
Viet Nam	9 356	33.2	26.0	2.3	17.5	11 390	36.7	4.3	-1.0	-3.0		

Sources: United Nations, *Monthly Bulletin of Statistics*, September 1999; IMF, *International Financial Statistics*, November 1998 and November 1999; ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999); and national sources.

^a January-September.

competition and sluggish demand against the backdrop of regional crisis. Poor performance was displayed by such major items as textiles and garments, plywood, palm oil, electrical appliances and footwear. There was a considerable increase in the volume of agricultural export commodities, but this was not adequate to offset the impact of lower external prices on the dollar value. Trading activities were further constrained by various disruptions in the country's financing facilities and distribution infrastructure for a large part of the year.

The contraction in export earnings bottomed out from the second half of 1999, along with the economic upturn in East and South-East Asia and the recovery in Japan, Indonesia's main export market. Cuts in oil production among OPEC member countries from the first quarter of the year were more than compensated for by the sharp oil price upswing which, in turn, helped to boost overall earnings on hydrocarbon products. Exports of mining products also registered positive growth. However, the value of manufactured exports fell largely because of reduced volumes while agricultural commodities continued to suffer from low export prices for most of 1999. Merchandise export earnings were estimated to have declined by 2 per cent for the year as a whole.

The contraction in import spending was comparatively much deeper in Indonesia, falling by 34.4 per cent in 1998 and a further 10.5 per cent in the first three quarters of the following year. In 1998, the contributing factors had included substantially high import prices in rupiah terms, a lack of consumer confidence and a major slowdown in production and investment activity in the country. Consumer and producer goods, both raw materials and capital equipment, all registered a major contraction. The import of shipping containers went up significantly, although it was not easy for exporters to secure adequate and timely supplies of such containers. Raw materials, followed by capital goods, remained the largest components in Indonesia's import structure while Germany, Japan and the United States were the leading supply sources.

The trade balance had registered a much larger surplus in 1998 compared to the previous year and there was a smaller deficit on the

services account because of lower transportation charges. However, inward receipts from tourism and workers' remittances were falling. Nevertheless, in 1998 the current account showed a bigger surplus, equivalent to 4.2 per cent of GDP, against a deficit of 2.3 per cent of GDP in the previous year; a somewhat smaller surplus was also generated in 1999.

Export earnings in dollar value fell by 6.9 per cent in Malaysia in 1998. Most of the decline took place during the first three quarters, largely because of lower prices as the volume of exports remained relatively stable for the full year. Some 83 per cent of trade receipts came from manufactured exports which, after a long contraction, expanded by 8.8 per cent in the fourth quarter owing to a surge in external demand for electrical and electronic equipment and parts, and for rubber products. The export volume of manufactured goods was 1.4 per cent higher but earnings fell off by 4.6 per cent during the year. Higher exports to the United States, the single largest market for Malaysia, helped to offset somewhat lower shipments to Asian destinations. Trade receipts on commodities declined considerably in 1998, by 17.1 per cent, as a result of lower prices for almost all major commodities.

The situation was reversed in 1999, with an expansion of 15.7 per cent in merchandise trade receipts derived from the robustness of the American economy and higher demand from within the region. Structurally, this expansion was driven by manufacturing exports (primarily electrical and electronic products), largely because of buoyant demand, and by crude petroleum, the price of which increased significantly in the world market.

Outlays on merchandise imports in Malaysia fell by 26.2 per cent in 1998 as result of both lower volume and lower international prices on most major import commodities. As was the situation elsewhere in the subregion, the decline in volume reflected weak domestic demand compounded by more limited export-oriented manufacturing activities, and the postponement of non-critical infrastructure and other large projects by both the public and the private sector. In value terms, imports of capital goods declined by 40.3 per cent, following the sharp contraction in private investment during the year,

while those of intermediate products and consumer goods fell by 21.3 and 32.7 per cent respectively. In line with the economic recovery, however, import spending went up by 12.6 per cent during 1999. Imports of both capital goods and consumption goods were higher in response to a more active programme of infrastructure development and improved consumer confidence, but expenditure on intermediate imports exhibited a substantial decline.

The surplus in the trade account, which rose sharply in 1998, was more than sufficient to cover a higher shortfall in the services account due to the repatriation of investment income, normally the biggest outflow, and a one-time remittance made by nearly half a million foreign workers returning to their home countries. In consequence, the persistent deficit in the current account over the 1990-1997 period turned into a surplus equivalent of 12.9 per cent of GDP, surpassing the previous high of 8.9 per cent achieved in 1989. Both the merchandise trade surplus and the services account deficit were expected to increase in 1999, but the larger size of the former would contribute positively to another current account surplus in 1999.

The particularly strong export performance of the Philippines, with earnings expanding by 17 per cent in United States dollar value in 1998, was a surprise to many observers. The gain of 20.4 per cent in earnings on manufactured exports was led by the electronics subsector (31.4 per cent) and machinery and transport equipment (23.5 per cent). However, bad weather conditions, combined with depressed world prices for commodities, contributed to lower trade receipts on non-manufactured exports such as mineral products and agro-products. The further improvement in export earnings, by 18.6 per cent in 1999, was again led by manufactured goods while receipts from agricultural and mineral items (for example, coconut, sugar, forest and mineral products) continued to slide downward. The electronics subsector accounted for over 58 per cent of total exports, although its growth moderated slightly from the rate achieved in 1998. On the other hand, higher demand for automatic data processing machines and magnetic readers for transcribing data was behind the impressive expan-

sion of some 50 per cent in earnings from the export category of machinery and transport equipment.

In the Philippines, lower aggregate demand led to a steep reduction in import spending in 1998 across all major commodity groups, totalling 18.8 per cent, the sharpest decline (34.3 per cent) was registered by imported mineral fuels and lubricants, followed by raw materials and intermediate goods. In line with the subsequent recovery of domestic economic activities, imports resumed an upward trend from June 1999, with raw materials and intermediate goods leading the way. The generally weak investment demand contributed to a decline of 7.6 per cent in capital goods imports, thus moderating full-year import growth to about 6.8 per cent in dollar value.

These trends in merchandise trade combined to bring about a dramatic improvement in the trade balance, with an insignificant trade deficit of only \$28 million in 1998, relative to \$11.1 billion a year earlier. On the other hand, a substantial rollback, to \$880 million from \$5.7 billion in 1997, was registered in the services account surplus owing to lower receipts (by 39 per cent) from travel, investment and personal income. The largest adjustment, however, was a reduction of 42 per cent in peso conversions of foreign currency deposits, given the prevailing uncertainty in the currency markets. The overall outcome in 1998 was a large surplus of \$1.3 billion (2 per cent of GDP) on the current account, compared to a shortfall of \$4.4 billion in 1997. The surplus was forecast to reach 3.8 per cent of GDP in 1999.

The value of Singapore's domestic exports was 12.1 per cent lower in 1998 than the previous year because of weak demand, especially of electronics goods from the developed countries as well as reduced regional requirements for intermediate goods. The downward trend was reversed from the second quarter of 1999. Domestic exports grew by 8.4 per cent in 1999, fuelled by higher earnings on electronics, chemicals and oil-based products owing to higher unit values. Uncertain economic conditions and weakening demand were behind the sharp compression of import spending, by 20.9 per cent in 1998, as producers preferred to

delay imports and run down inventories. Imports picked up by 9.4 per cent in 1999. The items recording larger increases in import expenditure included integrated circuits, semi-conductors, capacitors, printed circuits, aircraft parts, cellular phones, and chemicals and chemical products.

Trade in services deteriorated in Singapore during 1998, causing a reduced surplus due to lower regional demand for tourism and financial and medical services. The tourist industry was hit particularly hard, with arrivals falling by 13 per cent; transportation services, especially freight and port services, suffered from weak external trading activities. Nevertheless, the current account surplus jumped from 17.9 to 25.4 per cent of GDP between 1997 and 1998, an improvement attributable largely to the higher merchandise trade surplus caused by the sharp contraction of imports. Net exports of services benefited from enhanced demand for financial and business services in the wake of the regional economic upturn and, partly as a result of this, a sizeable current account surplus was also recorded in 1999.

In the case of Thailand, the increase in export volume was negated by a sharp decline in export prices to reduce export earnings by 6.8 per cent in United States dollar value in 1998. The growth rate of exports became positive in April 1999 and the 7.2 per cent rise for the year owed much to increased receipts on industrial and agro-industrial products. The export value of automobile and parts, in particular, was up by 64 per cent in the first nine months, followed by a wide range of other merchandise items, including electrical and electronic parts and components, plastic pellets, gems and jewellery, wooden furniture, leather products, ceramics and cement. On the other hand, earnings from agricultural exports were smaller than the previous year, despite a significant rise in volume. In terms of destinations, there was a contraction in exports to EU, particularly of canned and processed seafood, textiles, plastic products and rice; the loss of GSP privileges contributed to the sluggish performance of some of those exports. Gains were made in other markets such as ASEAN (excluding Indonesia, where exports fell), Australia, Japan and the Republic of Korea, and in Africa, Eastern Europe and the Middle East.

Reduced import spending, by 33.8 per cent in 1998, was attributable to lower import volume across the board in tandem with the contraction in domestic demand. A turnaround in imports occurred in the latter part of 1998 and an increase of 17.6 per cent on expenditure on imports was estimated in 1999. Import spending on raw materials increased considerably to meet the rapid growth in export-oriented activities and there were more modest rises in outlays on consumer and capital goods.

The trade balance increased in 1998. The large surplus on the services account was mainly the result of falling payments for outward travel by Thais. There was, moreover, a lower outflow of investment income due to the economic slowdown. The current account recorded a surplus equivalent to 12.8 per cent of GDP in 1998, the first in 12 years. Again, the merchandise trade and current account balances were estimated to be in surplus in 1999 but the magnitude involved was lower than in the previous year.

The rate of export growth in Viet Nam slowed down sharply to 2.3 per cent in 1998, the lowest rate since 1992, in part because of the steep export expansion averaging some 30 per cent annually between 1995 and 1997. There was a record increase in rice exports with earnings of \$1,050 million from 3.8 million tons; trade receipts from coffee were higher, too, on account of rising prices associated with poorer crops in other producing countries. But several major categories of primary and manufactured exports did not perform as well. Despite an increase of various degrees in the traded volumes, export earnings on oil, textiles and garments, and shoes remained almost unchanged in 1998. Geographically, the traditional markets (that is, China, Japan and the Republic of Korea) were gradually supplemented by sizeable export flows to the United States and some European countries. The economic recovery in most parts of East Asia and a significant increase in oil prices boosted export growth to 17.5 per cent in 1999. Rice shipments again hit a record of 4.4 million tons, the volume of coffee exports was higher, and significant increases were also recorded in export earnings from textiles and garments, footwear and handicrafts.

The marginal decline of 1 per cent in import expenditure in Viet Nam in 1998 reflected, by and large, the downward trend in import demand from foreign joint ventures associated with the relatively sharp decrease in FDI in recent years. The country also has in place administrative measures to control imports and protect domestic industries. The persistence of weak demand signalled by the slowdown of economic growth during 1999 was behind a further drop (of 3 per cent) in imports, notably raw materials, intermediate goods such as cement and petroleum products, and machinery and equipment. The current account deficit decreased by 29 per cent in 1998 compared to 1997, underpinned by a lower trade deficit and increased private transfers. The improvement in the current account was expected to continue with the large pickup in exports in 1999.

Capital inflows and outflows

A deficit in net private capital flows to Indonesia was covered by a larger transfer from official sources to yield a surplus of \$2.2 billion in 1998/99, against a deficit of \$7.6 billion the previous year. Lower levels of FDI and increased repayments of corporate external debt were behind the deficit in private capital flows in spite of a surplus in the portfolio account as a result of the disposal of bank assets and a sharp decrease in repayments to and redemption of domestic commercial papers held by foreigners. FDI amounted to only \$1.9 billion in the first half of 1999, compared to \$8.4 billion in the same period the previous year. The official capital transfer in 1998/99 was in the form of substantial loans for balance-of-payment support and other programmes from, among others, ADB, IMF, the Government of Japan and the World Bank. A rescheduling of sovereign loans lowered the outflows on account of official debt, which stood at \$67.2 billion as of March 1999 compared to \$83.7 billion in private external debt.

The large surplus in Malaysia's balance of payments during 1998, which lifted external reserves from \$21.7 billion at the end of 1997 to \$26.2 billion at the end of 1998, was due mainly to a substantial surplus on the current account. The net inflow of

long-term capital (both official and private) was lower because of a tightening of lending conditions in international debt markets, considerable economic uncertainty in the region and a cautious approach from foreign investors following the introduction of selective exchange controls in September. On the other hand, the economic slowdown and a liquidation of portfolio investment by foreign investors resulted in a substantial outflow of short-term capital for the second consecutive year. In June 1999, Malaysia raised funds through a sale of sovereign bonds worth \$1 billion in the international financial markets. In the private capital account, however, FDI continued to decline, along with an increased outflow of short-term funds, albeit much smaller than expected. In February 1999, the minimum 12-month holding period for the repatriation of liquidated foreign holdings of Malaysian shares was replaced with a graduated levy on remittances based on the length of time that shares were held; this was further eased to a 10 per cent tax on the remittance of share proceeds, irrespective of the time held, in September 1999.

The total external debt, at \$42 billion in 1998, was 5.3 per cent lower than the level of previous year largely because of reduced short-term debt, whose share in total external debt dropped to 18 per cent during 1998 from 25 per cent the year before. Federal government external debt, by contrast, expanded by 15.2 and 21.4 per cent in 1998 and 1999 respectively to finance domestic recovery measures. The amount of medium- and long-term obligations rose and the total external debt was marginally lower, by 0.2 per cent, in 1999.

A surplus of \$1,350 million in the balance of payments of the Philippines in 1998, a sharp turnaround from the \$3,360 million deficit recorded in 1997, was also mainly due to the large current account surplus. The capital and financial accounts showed a surplus of \$956 million (or 85 per cent smaller) as the corporate sector deferred borrowing plans. However, there were higher outflows of short-term capital, totalling more than \$3.5 billion, owing to net repayments of commercial banks and trading of bonds in the secondary market. In response to better economic and trade prospects, FDI went up by over 40 per cent in 1998; the main sectors

included the food and cement industries. There was also greater assistance from multilateral and bilateral creditors, including Japan's Miyazawa Fund and the World Bank, and quick-disbursing programme loans were put in place to compensate for the slow disbursement of project-related loans associated in part with the tight fiscal situation in the country in 1998 and 1999.

The Philippines took advantage of the generally improved market sentiment and floated bonds of over \$2 billion at the start of 1999, and FDI and portfolio inflows were higher as well. Reflecting these positive trends, net capital inflows amounted to \$1.5 billion over the period January–August 1999, compared to \$1.3 billion for the same period in the previous year. Surpluses in the current and capital accounts would yield another balance of payments surplus in 1999 so that the country's gross international reserves, at \$14.6 billion as of the end of October 1999, would cover about four months of import spending. As of the end of 1998, the external debt of \$47.8 billion consisted mostly of medium- and long-term loans (85 per cent), with official creditors supplying more than half of the total debt. Annual debt-service payments have increased somewhat as a result of larger public sector borrowings from the international market.

The surplus in Singapore's balance of payments was smaller in 1998 than previously, reflecting a substantial net outflow in the capital and financial accounts with the discharge of bank and other liabilities, amounting to S\$26.5 billion (compared to an inflow level of S\$53.6 billion in the preceding year). Both outward and inward FDI dropped in 1998. The situation improved in 1999 when net FDI inflows rose to S\$6.6 billion during the first nine months, from S\$5.2 billion for the comparable period in 1998.

In Thailand, a deficit of \$10.6 billion in the balance of payments during 1997 was transformed, through a rising current account surplus, into an overall surplus of \$1.7 billion as well as a higher level of international reserves of \$29.5 billion by the end of 1998. The significant outflows of private capital as a result of loan repayments by the Bangkok International Banking Facility, commercial

banks and private businesses were offset by net inflows from two main sources. The first was FDI destined for business acquisitions, to increase equity holdings in joint ventures with Thai companies and to provide affiliated companies with assistance. FDI in non-bank sectors reached a record \$7.6 billion in 1998. The second source was a number of disbursements under the IMF financial assistance package that helped to raise the surplus in the official capital account.

The international reserve position strengthened further in 1999. Additional drawing from the IMF financing package was not envisaged by the government after September 1999, though an early withdrawal from the IMF programme, which is to be wound up by June 2000, was not contemplated. FDI continued to be robust, amounting to \$4.7 billion in the non-bank sector in the first 10 months of 1999. As was to be expected, Thailand's public external debt almost doubled from \$16.8 billion at the end of 1996 to \$31.5 billion in December 1998, and further to \$36.1 billion in October 1999, the large bulk of such obligations being in the form of bonds and IMF-arranged long-term debt. On the other hand, private debt was down from a high of \$93.4 billion in 1997 to just over \$75.6 billion at the end of 1999, likewise, the short-term component fell from \$37.6 billion at the end of 1996 to \$18.2 billion in June 1999.

There was a balance of payments surplus in Viet Nam in 1998 and foreign reserves increased, in part as a result of both a lower current account deficit and inward FDI. Net increases in medium- and long-term receipts were equivalent to the net payments on short-term debts. ODA disbursement was higher and concentrated in such priority areas as infrastructure establishment, reforestation, various poverty alleviation programmes and the development of industries in rural areas. The World Bank, ADB, and the Overseas Economic Cooperation Fund of Japan remained the leading donors. In December 1999, a pledge of \$2.1 billion in development assistance for 2000 (roughly the same as in the previous year) was made by international donors at the Consultative Group Meeting for Viet Nam. An additional \$700 million would be available to finance economic reform in state-owned enterprises, the trade regime,

and the banking and finance sectors; a large proportion of this amount would be provided by IMF in the form of balance of payments support.

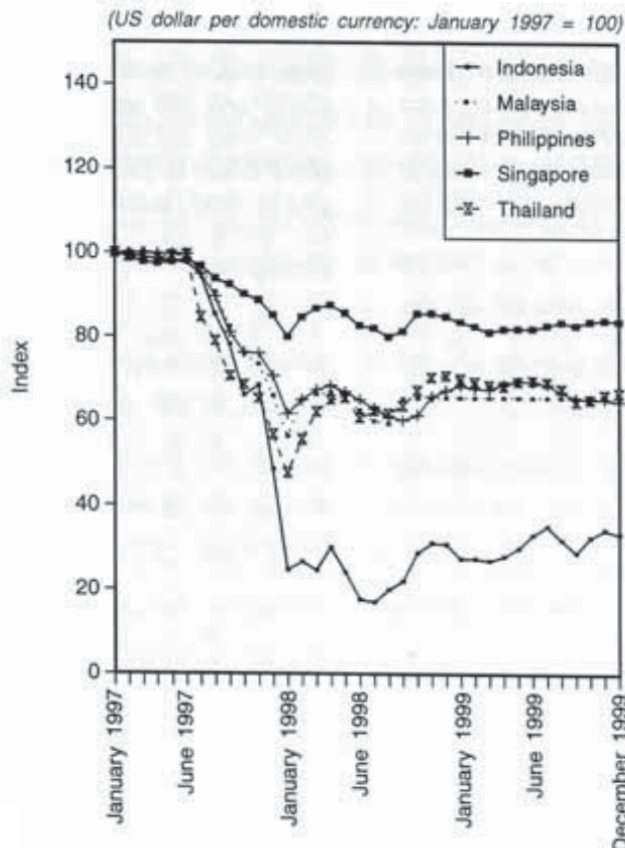
Of some concern was the downward trend in FDI inflows in recent years; during the first nine months of 1999, FDI commitments came to just \$921 million, or 46 per cent lower than in the same period the previous year. The share of inflows to Asian countries went down from 70 per cent in recent years to only 45 per cent in 1998 because of the economic crisis; this drop was only partly negated by higher inward FDI from European countries. A series of measures were introduced to improve the investment environ-

ment in the past two years. These are described below.

Financial sector developments

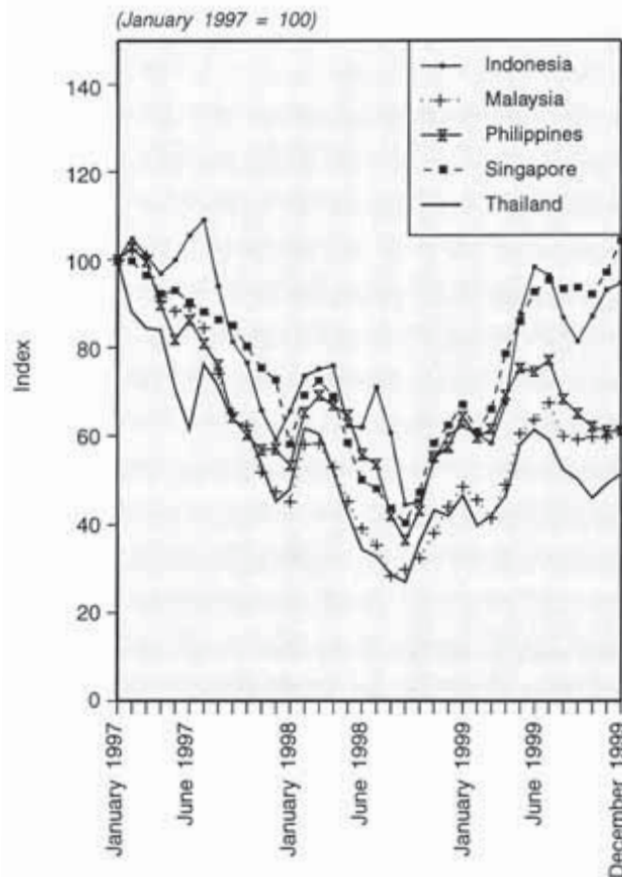
In line with the economic recovery, the financial market situation improved in South-East Asia in 1999, with exchange rates remaining relatively stable and the stock markets regaining some lost ground (figures II.6 and II.7). Rates of inflation and interest rates stabilized at lower levels. However, credit growth remained constrained owing to excess capacity in various sectors, the overhang corporate sector debt, the eroded capital base of commercial banks burdened with large NPLs, and the more cautious approach of commercial banks in

Figure II.6. Index of exchange rates of selected South-East Asian economies, 1997-1999



Sources: IMF, *International Financial Statistics*, various issues; and *Far Eastern Economic Review*, various issues.

Figure II.7. Index of stock markets of selected South-East Asian economies, 1997-1999



Source: *The Economist*, various issues.

extending credit. The main modalities for, and progress in, debt restructuring in four crisis-affected countries are discussed further in box II.1.

The policy focus in Indonesia was on strengthening and consolidating the banking sector. First, a plan for the recapitalization of those private banks that met certain specified conditions was announced in March 1999 to revitalize the "best" private banks and foster cost-sharing between the private and the government sectors. Those banks which had capital adequacy ratios between negative 25 per cent and less than 4 per cent and proposed business plans deemed viable, and whose owners were deemed "fit and proper", would be eligible for government recapitalization funds to bring their ratios up to 4 per cent.

The nine banks (accounting for 10 per cent of the banking sector assets) found qualified according to the criteria would receive 80 per cent of their recapitalization costs from the government through a bond issue. Some 38 banks, with 5 per cent of the banking sector assets, were closed because of their insolvency or dim prospects of financial viability, while seven others, with 2 per cent of the assets, were taken over by the government. Another 73 banks, with 5 per cent of the banking sector assets, did not require such government support because their capital adequacy ratios were then at least 4 per cent. The banking sector has been consolidated significantly since mid-1997, with the number of private domestic banks nearly halved through closures or state takeovers.

Box II.1. Debt restructuring in selected economies affected by the crisis

The economic crisis severely aggravated the problem of NPLs in several countries, including Indonesia, Malaysia, the Republic of Korea and Thailand. The wide-ranging measures introduced by these countries helped to contain the problem and avoid any systemic breakdown. These measures were reinforced from the second quarter of 1999 by the economic recovery, falling interest rates, appreciation of the local currencies and, in several of them, the return of market confidence and external capital. In consequence, there has been a decline in NPLs in Indonesia, Malaysia and Thailand, as detailed in this chapter. In the Republic of Korea, the relative importance of NPLs within the financial system went up from about 9 per cent in March 1998 to 17 per cent in March 1999, but the upward trend in such loans held by commercial banks was much more moderate, their NPLs increasing slightly from 7.7 to 8.9 per cent over the same period.

The NPL problem is being addressed in these four countries through three main mechanisms: initiatives aimed at facilitating voluntary, out-of-court settlement of debt; a strengthening of bankruptcy laws and related frameworks; and the establishment of specialized agencies for the takeover and disposal of bad debt within the financial system. The main features of voluntary arrangements include the setting up of definite timetables for debt settlements, or for reaching specified agreement between debtors and creditors, as well as between the creditors themselves; some penalties may be imposed for non-compliance with agreed provisions. Out-of-court debt workouts frequently involve a rescheduling of financial obligations, reductions in the applicable interest rates, a certain amount of debt forgiveness, and swaps of bank debt for an equity stake in the indebted corporations.

In Indonesia, corporate debt restructuring on a voluntary basis is being promoted and facilitated through the Jakarta Initiative Task Force. The Task Force, established in September 1998, had 251 companies registered for such restructuring as of August 1999; these business entities had incurred foreign debt totalling \$21.4 billion and domestic debt of 13.6 trillion rupiah. The Task Force had arranged for discussions in 122 cases. Although only a handful of major restructuring deals were actually brought to completion, creditors and debtors reached standstill agreements in principle on 13 per cent of debt involved. The Corporate Debt Restructuring Committee was set up in Malaysia to act as an informal debtor or creditor broker on debt restructuring. Applications for assistance were received from 55 companies with a debt

value of 35.5 billion ringgit and the Committee had helped to restructure the financial obligations of 16 companies with a total debt value of 13.1 billion ringgit by the end of 1999. In the Republic of Korea, the Corporate Restructuring Coordinating Committee is responsible for voluntary debt workouts and, out of the 92 cases registered for such restructuring, 46 cases had been finalized by August 1999; the rescheduled debts were about one fifth of the total amount so involved. The Corporate Debt Restructuring Advisory Committee has been handling out-of-court debt restructuring in Thailand; about 167 cases, with 22 per cent of incurred debt, had been resolved out of 825 registered cases by August 1999.

The second modality involved the creation of a legal basis, or its strengthening, for the resolution of debt defaults and the conflicting claims of stakeholders in insolvency cases. An effective bankruptcy system helps to sustain market sentiment and business confidence in two ways. Heavily indebted but potentially viable firms can be quickly restructured as ongoing entities. The system also facilitates the expeditious liquidation of non-viable firms, thus minimizing uncertainties, delays and expenses in the whole restructuring process. Malaysia and the Republic of Korea had had relatively sophisticated bankruptcy codes, while Indonesia and Thailand have strengthened significantly the pertinent legislative framework since the onset of the crisis in July 1997. In August 1998, for example, Indonesia amended its bankruptcy legislation. A specialized commercial court with jurisdiction over all bankruptcy-related matters was set up and an expedited timetable for legal resolution was provided. In Thailand, the Bankruptcy Court, which started operating in June 1999, had received 390 cases for consideration by the end of the year; of these, 367 were bankruptcy cases. Financial institutions had filed a total of 239 bankruptcy suits and 135 bankruptcy cases were completed. Twenty out of a total of 23 cases filed for reorganization were also completed. Given the scale and complexity of the legal problems involved in debt insolvency and restructuring cases, however, bankruptcy courts cannot realistically be expected to resolve a large number of cases quickly; the bulk of NPLs may thus have to be settled out of court.

State-owned, centralized asset management companies were founded in Indonesia, Malaysia and the Republic of Korea to buy NPLs from banks and thus help them to clean up their balance sheets as fast as possible. In Indonesia, a similar mechanism was embodied in the Indonesian Bank Restructuring Agency,

established in January 1998, to manage the large number of insolvent banks and, where feasible, to ensure their proper restructuring. By the middle of 1999, about two thirds of banking-sector NPLs, with an estimated book value of 430 trillion rupiah (or about two fifths of GDP), were held by the Agency although, for a variety of constraints, asset disposal was under 1 per cent of the total value. Danaharta was set up in Malaysia in June 1998 with the power to acquire, and to appoint special administrators for the management of, default loans. This asset management company had purchased about half of all NPLs, worth some \$11 billion by the middle of 1999; no significant sale of these assets took place after one year of operations. The Korea Asset Management Corporation, which had existed long before the crisis, was reconstituted in November 1997. By the middle of 1999, it had acquired problem assets with a total face value of \$37 billion, or about 10 per cent of GDP and 26 per cent of all NPLs, and had managed to dispose of 4.7 per cent of acquired assets. The Corporation had initially purchased only won-denominated loans but, through the successful issue of bonds denominated in United States dollars in late December 1998, it was able to acquire NPLs denominated in foreign currencies as well.

Thailand adopted a slightly different approach in that the financial institutions concerned were encouraged to set up privately funded asset management companies so as to provide maximum flexibility in dealing with their own NPLs. Currently, the legal and tax impediments in the operation of such companies are under review to ensure the availability of adequate incentives while minimizing any undue burden on fiscal discipline and tax-regime neutrality. However, the Financial Sector Restructuring Authority was able to dispose of almost all impaired assets (over \$20 billion) of the 56 non-bank finance companies which had been closed by the government.

A number of measures have been introduced in all these countries to improve the standards of financial and corporate sector governance, to strengthen the monitoring and regulatory apparatus, and to encourage prudent conduct by all corporate entities. The underlying aim is to prevent the recurrence of serious NPL problems in the future. However, notwithstanding these efforts, the backlog of the problem created by the crisis remains huge. It appears inevitable that taxpayers will have to shoulder some of this burden in the interest of preserving systemic stability, although for equity reasons, resort to tax revenue should be as minimal as possible.

Second, four state banks with huge debts (Bank Ekspor Impor Indonesia, Bank Bumi Daya, Bank Dagang Negara and Bank Pembangunan Indonesia) were merged to form Bank Mandiri. Its staff requirements, officially assessed at 14,500 persons, were much lower than the total of 26,500 employees of the four component banks; the redundant staff are expected to leave through a voluntary severance scheme by December 2001. Almost one third of the total number of branches will be closed over a period of two years, and significant downsizing will take place in many remaining branches.

Third, to attract external participation in the financial rehabilitation process, foreign investors have been allowed ownership of up to 99 per cent of a bank's assets. Overseas banks are now permitted to open new branches anywhere in the country if they meet certain requirements. On the other hand, in order to prevent excessive concentration of ownership, bank mergers are prohibited if the merged bank's assets would amount to more than 20 per cent of the assets of the total banking sector.

The NPL ratio of the financial institutions stood at around 50 per cent by the end of 1998. Large sums of bad debts of the financial institutions were transferred to the Indonesian Bank Restructuring Agency in May and June 1999. As a result, the NPL ratio of the financial institutions had decreased to 37 per cent in mid-1999. The state banks and the Agency intensified their loan recovery efforts through, for example, such measures as the publication of the names of their largest debtors (over 50 billion rupiah), the initiation of debt-restructuring negotiations, and the establishment of loan recovery units supplemented by the appointment of international banks or advisers to assist in the process. The extent of progress and of compliance with government guidelines in loan recovery and restructuring programmes is being monitored by the newly established inter-agency restructuring committee.

Interest rates came down significantly, yet the outstanding credit of commercial banks contracted markedly in 1999 owing to the lack of creditworthy customers. For example, the average outstanding credit in the period January-November 1999 was

about 39 per cent lower than in the same period the previous year. Lending rates were higher than deposit rates so that banks could make a profit if they were able to lend. However, state banks were not able to lend their funds and had to end up investing in SBIs (Bank Indonesia Certificates) whose yields were lower than the deposit rate. This added to the losses of the state banks.

A contraction of bank credit was also observable in Malaysia where the value of bank loans fell by 4.6 per cent in the first 10 months of 1999 against a full-year government target of 8 per cent growth in spite of considerably cheaper costs for borrowers. The average base lending rate declined from 8.04 per cent at the end of 1998 to 6.7 per cent in October 1999. Loan approvals and disbursements improved significantly, but higher loans repayments and write-offs, and conversion into bonds and equities resulted in a lower level of aggregate loans outstanding. The sharpest falls were recorded in credit for the purchase of stocks and shares, consumption financing, construction, and insurance and business services.

The large jump in NPLs, from 4 per cent of all loans in 1997 to 15.8 per cent in August 1998, necessitated countermeasures to contain any systemic risks and the credit crunch, including the establishment of three new agencies. Danaharta was set up to purchase NPLs, Danamodal to recapitalize weak financial institutions, and the Corporate Debt Restructuring Committee to assist in the corporate restructuring process. NPLs were down to 7.9 per cent towards the end of 1999. All expenses incurred in debt restructuring are to be tax deductible, as announced in the 2000 budget. About 6,430 million ringgit was injected through Danamodal into 10 banking institutions, with the consequent rise to 12.8 per cent in the capital adequacy ratio of the banking system.

As regards bank restructuring, a plan to consolidate 28 domestic banks and 56 financial institutions into six banking groups, to be led by six identified anchor banks, was indicated by Bank Negara Malaysia in August 1999. Another objective of this measure was to endow these groups with sufficient economies of scale and scope to withstand foreign competition with the WTO-related liberali-

zation of the financial markets in 2003. There were, however, strong local objections concerning the compatibility of partner members in some merged banking groups, as well as the ability of some anchor banks to lead the groups. In the subsequently modified plan, the number of banking groups was not specified, banks were allowed until the end of January 2000 to choose their own partners, and a longer timetable for consolidation was allowed.

In the Philippines, the central bank lowered bank reserve requirements in successive moves and cut its key overnight borrowing and lending rates to ease monetary conditions and spur the recovery process. Pressures on domestic interest rates also abated with the steep increase in the external financing of the budget deficit, by 217 per cent in the first eight months of 1999 from the level of the previous year. Nevertheless, net domestic credit contracted by 1.9 per cent in the first half of the year. Banks were hesitant to lend because of the problem of NPLs, whose total was equivalent to 14.7 per cent of the total credit portfolio as of August 1999. The persistence of NPLs reflects the continued weakness in the corporate sector as well as the fall in the total portfolio of bank loans. The latter was, in turn, attributable to the concerns of banks regarding the repayment capability of their borrowers in the prevailing state of economic activities and the cost of compliance with the stricter provisioning requirements of the central bank.

Bank mergers and acquisitions also took place in the Philippines. The process was largely voluntary, motivated by the quest for competitiveness in response to the increasing pressures from financial globalization. There have been five major bank mergers,¹ but even with these mergers, the biggest (merged) bank in the Philippines will be smaller than their major counterparts in some ASEAN member countries.

¹ For example, the Bank of the Philippine Islands with Far East Bank; the Philippine Commercial and Industrial Bank with Equitable Bank; Metrobank with the Philippine Banking Corporation; ABN-Amro with Great Pacific Bank and Pilipinas Bank; and Westmont Bank with the United Overseas Bank of Singapore.

In May 1999, Singapore announced a financial sector liberalization programme, to be implemented over five years, to attract the participation of more foreign banks and to improve the country's competitiveness as a regional financial centre. Six new full bank licences are to be issued in 1999-2000, the first such move since 1970. The number of restricted banks was increased from 13 to 18 over the same period; a restricted bank is not allowed to operate Singapore dollar savings accounts and to accept individual fixed deposits of less than S\$250,000 from non-bank customers. In addition, the 40 per cent limit on foreign ownership of domestic banks has been lifted and the lending limits of foreign banks raised. Likewise, the insurance sector will be gradually opened up. In a related policy thrust, highly profitable firms with a much shorter track record could be listed on the Stock Exchange of Singapore from September 1999; companies with a market capitalization exceeding S\$80 million that are not yet profitable can also be listed.

The Government of Thailand has played a major role in the process of financial sector and corporate debt restructuring. Policy initiatives included improving the legal and regulatory frameworks, setting up modalities to salvage and revitalize banks and viable corporate debtors (including enforcing bankruptcy laws), raising standards of corporate governance, information disclosure and other benchmarks for greater transparency within both the business and the public sectors, and allowing foreign participation in a wide range of financial activities. Between the beginning of 1998 and July 1999, some 725.3 billion baht was raised from both domestic and foreign sources to finance recapitalization of the core banking system. By September 1999, allocations had been made under the government's capital support scheme to four financial institutions while another 11 requests were under consideration. Full provisions are to be made by banks against NPLs by the end of 2000 and banks have to maintain a capital to risk asset ratio of at least 8.5 per cent. These processes have succeeded in creating confidence in the Thai financial system with a relatively limited use of public sector funds.

The Credit Bureau was established to ensure better credit information, lending disciplines and monitoring processes in Thailand. Another new institution, the Bankruptcy Court, started operating in

June 1999. Other concerted efforts have also been made to improve the Bank of Thailand's independence, transparency and accountability and to strengthen the institutional framework for monitoring and supervising the domestic financial system. In addition, requirements for auditing, accounting and disclosure are to be brought up to international best practice standards. Furthermore, the legislation on commercial bank and finance company will be replaced by a new financial institutions law to facilitate the consolidated supervision of financial institutions and to tighten regulations regarding insider lending, foreign exchange exposure, non-financial activities of financial institutions and disclosure standards. There will also be clearer specifications of penalties for fraud and of corrective action against troubled institutions.

Corporate debt restructuring in Thailand has not occurred as fast as expected and has involved a considerable amount of debt rescheduling. NPLs of the financial sector, held almost in equal proportion by private and public sector institutions, peaked at around 47.7 per cent (or equivalent to 2.7 trillion baht) in May 1999. The ratio, down to 38.5 per cent by the end of 1999, is expected to decline more rapidly because of lower interest rates and improved economic prospects. In addition, banks are being encouraged to set up asset management companies to provide maximum flexibility in dealing with their bad debts; NPLs can be written off against provisions for full loan losses.

In line with developments elsewhere in South-East Asia, the rates of interest were on a downward trend in Viet Nam during 1999. State-owned enterprises receive a large proportion of domestic credit, estimated at 75 per cent of total credit for all economic sectors in 1998; this might have crowded out non-state firms as well as small and medium-sized enterprises. The commercial banking system started to show some vulnerability as state-owned enterprises accounted for a major portion of the rising level of bad debts; the NPL ratio was estimated at 6 per cent in 1994, 12.3 per cent in 1997 and 13 per cent in 1998. Guidelines to write off non-recoverable debts have been issued and commercial banks have been given more independence, and by extension, greater accountability in the provision of credit and in the conduct of their business. The banks have a fairly substantial level

of exposure (40 per cent in 1998) to foreign currency loans extended to enterprises in Viet Nam. Two foreign firms were licensed in June 1999 to operate the country's first life assurance company, which was 100 per cent foreign-invested. Approval had earlier been given to three state-owned enterprises to sell their shares to foreign investors to obtain the needed liquidity and boost their equitization programmes.

Policy issues and responses

The process of recovery in most of the economies in crisis in South-East Asia has been underpinned by virtually the same parameters: fiscal stimulus, eased monetary conditions, relative stability in prices and exchange rates, revived export growth and a gradual, albeit slow, restoration of consumer confidence. Given a relatively benign external environment, the reform and restructuring of the financial and corporate sectors will be a major determinant of the sustainability and acceleration of recovery in the near to medium term. The following discussion focuses on the key common issues of policy concern.

Governments have generally achieved much progress, albeit at a substantial cost in public sector resources, in initiating and sustaining the process of financial sector restructuring and strengthening. Nevertheless, many banks remain inadequately capitalized. The cost of bank recapitalization in Malaysia is estimated at 31 billion ringgit, and about 13 billion had been raised by July 1999. The comparatively more modest resource implication reflected the smaller shock to the country's financial system and higher levels of pre-crisis bank capitalization. In Indonesia, bank recapitalization needs, estimated to be 550 trillion rupiah (around 60 per cent of GDP in 1999), are the highest in the region and, given the wide-ranging problems and uncertainties faced by the country, the capital-replenishing process has been relatively slow.

In Thailand, some 800 billion baht in new capital was mobilized by local financial institutions towards the end of 1999. About 100 billion baht in new capital will be needed by local banks to meet full provisioning requirements. Assuming a stable level of bad loans, actual loan loss provisions

throughout the sector stood at 70–80 per cent of the required level by the end of 1999. The pressure on fiscal resources has been considerably mitigated through private efforts to raise such capital. Government funding is tied to management changes and, of the 300 billion baht set aside in a government scheme to provide matching funds for privately raised capital, only 32.5 billion baht was used by private banks largely because of such conditionality. The revived inflow of foreign resources into the financial sector indicates the successful efforts of a large number of Thai banks and finance companies to find strategic external partners and thus acquire better technology, management expertise and professional skills.

Corporate sector reform and restructuring constitute the flip side of the process of financial sector revitalization. The substantial overhang of NPLs was largely a consequence of weak performance of the corporate sector entities. These are being encouraged to take the lead in the restructuring of their own assets and liabilities. The restoration of the financial viability of the corporate sector is crucial because a large proportion of debt restructuring has taken the form of debt rescheduling which temporarily allows NPLs to be reclassified as performing and thus lowers requirements of loan loss provisions and capital replenishment for banks. If the corporate sector does not quickly regain the strength to service rescheduled debt, the problems faced by the financial sector may re-emerge. The problem of the so-called strategic debt also exists, where debtors are reluctant to service their debt obligations despite their inherent financial capabilities. In Thailand, up to one third of the banking sector NPLs are estimated to belong in this category.

Indonesia and Thailand have implemented significant legislative changes for the settlement of corporate debt while Malaysia already had a relatively sophisticated bankruptcy code. At the same time, out-of-court mechanisms have been developed to encourage the process through, for example, the Jakarta Initiative in Indonesia, the Corporate Debt Restructuring Committee in Malaysia, and the Corporate Debt Restructuring Advisory Committee in Thailand. Once financial obligations and property rights have been clarified and agreed upon by both creditors and debtors, market-driven mechanisms should facilitate the required discounting and

reallocation of productive assets. However, governments can play an important role in promoting greater asset mobility, especially in encouraging corporate mergers and acquisitions, FDI and debt-equity conversions and swaps.

In the wake of the crisis, governments have acquired, through asset management companies, the assets of failed finance companies and the bad assets of commercial banks. The state has thus become an important holder of corporate assets in Indonesia, Malaysia and Thailand and could be the agent for restructuring. In Indonesia and Malaysia, asset management companies have not yet disposed of many assets. In Thailand, the Financial Sector Restructuring Authority has sold almost all the assets of the closed non-bank finance companies. The realization rate of around 28 per cent was low, but there is no evidence that waiting would have increased it. In Thailand, the government has not acquired the non-performing assets of commercial banks and has allowed the commercial banks to take the lead in restructuring.

An expansionary fiscal policy stance, a common factor behind the subregional process of economic upturn, has led to larger fiscal deficits and growing public debt in Indonesia, Malaysia and Thailand. The consequent increases in debt-service burden have moderated somewhat through lower interest rates. However, difficulties may arise in the future and interest rates may rise. If all financial restructuring costs fall on the public sector, public debt will rise sharply in all crisis economies and could reach close to 100 per cent of GDP in Indonesia. With some of the difficult problems still ahead, including provision for expanded social safety nets, governments face the complex task of managing their fiscal costs. There is also the dilemma that withdrawing stimulus too quickly can slow down the fledgling recovery process.

The social impact of the economic crisis has been both severe and wide-ranging, and the cumulative costs of socio-economic dislocations are still to emerge fully. Unemployment, both open and disguised, and poverty increased sharply in 1998 and the unemployment rate has remained high in most countries despite the recent economic upturn. Governments have been implementing various programmes to boost gainful employment and to mitigate the adverse social impact of the crisis.

East and North-East Asia

This subregion contains four disparate economies (China; Hong Kong, China; Mongolia; Republic of Korea). Two of them, namely Hong Kong, China and the Republic of Korea, suffered a major contraction of output in 1998. Both of them recorded positive growth in 1999, with the Republic of Korea recording a stunning 9 per cent growth. The other two economies more or less maintained their recent performance. Another significant feature of developments in the subregion was that inflation remained muted. In fact, in 1999, two of the economies (China and Hong Kong, China) experienced the rare incidence of deflation, reflecting a widespread feeling of uncertainty and insecurity among households in the aftermath of the crisis. It is also noteworthy that there was an increase in the budget deficit as governments were constrained to resort to fiscal stimulus as a major means to revive or maintain economic growth.

Subregional economic prospects are much brighter than they were as recently as in mid-1999, but growth in the near and medium term will be strongly influenced by the degree of success in restoring household and business confidence, in achieving reform and restructuring of the financial and enterprise sectors, and more generally, in regenerating sources of stimulus other than fiscal deficits.

Growth performance

GDP growth in China slowed marginally to reach 7.0 per cent by the third quarter of 1999 on a year-to-year basis; overall economic expansion, estimated at 7.2 per cent for the year as a whole, was among the highest inside and outside the ESCAP region (table II.16). The Republic of Korea rebounded with striking vigour, growing by 12.3 per cent over the 12 months to the third quarter of 1999, compared to a contraction of 5.8 per cent in 1998. Full-year GDP growth is expected to be 9 per cent. Recovery had been rather muted in Hong Kong, China, but it gathered pace and economic activities had increased by 4.5 per cent by the third quarter of 1999, compared to the previous 12 months. GDP was forecast to be 0.5 per cent higher in 1999, compared with a contraction of over 5 per cent the

Table II.16. Selected East and North-East Asian economies: growth rates, 1996-1999

(Percentage)

		Rate of growth			
		GDP	Agriculture	Industry	Services
China	1996	9.6	5.1	12.1	7.8
	1997	8.8	3.5	10.8	8.2
	1998	7.8	3.5	9.2	7.6
	1999	7.2	3.3	8.9	7.0
Hong Kong, China	1996	4.5	..	..	..
	1997	5.3	..	..	..
	1998	-5.1	..	..	..
	1999	0.5	..	..	..
Mongolia	1996	2.4	10.0	0.5	-4.1
	1997	4.0	4.8	3.9	3.3
	1998	3.5	3.1	2.9	4.7
	1999	3.5	..	..	..
Republic of Korea	1996	6.8	3.3	7.0	7.0
	1997	5.0	4.6	5.4	4.7
	1998	-5.8	-6.3	-7.5	-4.4
	1999	9.0	1.5 ^a	15.4 ^{a,b}	8.5 ^a

Sources: ESCAP secretariat calculations based on IMF, *International Financial Statistics*, October 1999; ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999) and *Asian Development Outlook 1999* (Oxford University Press, 1999); and national sources.

Notes: Data for 1999 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

^a January-June.

^b Rate of growth of manufacturing only.

year before. Similar data for Mongolia are not available. However, given the strong industrial recovery in the Russian Federation and generally firmer commodity prices discussed earlier, GDP was expected to grow at about the same rate in 1999 as in 1998, 3.5 per cent.

China remains one of the fastest-growing economies in the region, and in the world as well. The country's external position has been strong despite a somewhat poorer export performance, especially in the first half of 1999, attributable to a crisis-induced reduction in intraregional demand for exports. The marginal economic slippage was also partly a result of domestic factors, including weak consumer demand, deflationary pressures and an increase in unemployment consequent upon the restructuring of state-owned enterprises. In 1998 and much of 1999, the main stimulus to domestic

growth was through larger government spending on investment. There was, however, an easing of investment expenditure in the latter part of 1999; FDI inflows, though large at around \$38 billion, also appeared to taper off somewhat.

The markedly higher propensity to save displayed by households was a reflection of the observed weakness of domestic consumption demand in China. Indeed, savings had risen faster than incomes and consumption with the consequent decline in prices going back over two years. The purchase of discretionary items, such as big-ticket consumer durables, was postponed to meet the rising costs of health and education, and to provide for contingencies such as unemployment. Attempts by the government to stimulate consumer spending by encouraging consumption-based borrowings did not produce the desired results; the real cost of

borrowing has been high despite seven cuts in interest rates since late 1996. Besides, consumer credit was still an unfamiliar method of financing purchases for the majority of Chinese consumers. Furthermore, there was some diversion of surplus household incomes into the stock markets.

Higher public sector outlays on investment fuelled a fairly robust expansion in industrial activities, especially in the capital and intermediate-goods sectors in which state-owned enterprises predominated. The growth rate of industrial value added from the state sector remained vigorous in 1999 resulting from the combined effects of lower interest rates, which had been instrumental in lowering the cost of working capital, and the ongoing rationalization in state-owned enterprises. Such expansion was, however, lower than that of foreign-invested firms or township enterprises, but the performance gap among the categories of enterprises narrowed significantly during the year. The rationalization process of state-owned enterprises, which has been overseen by the State Economic and Trade Commission, involved steps initially intended to reduce overcapacity in the textile, coal and oil industries; it has so far resulted in the shedding of a substantial number of jobs in these industries.

Agriculture was adversely affected by serious flooding of the Yangtze River during 1998. In 1999, the growth of agricultural output was somewhat lower than that of the previous year owing to a reduction in the cultivated area. But, as was the case of industry, overproduction of several agricultural commodities was a problem after several years of above-average growth. The glut was especially acute for cotton, although both wheat and rice were also in modest oversupply. China has been the world's largest producer and consumer of cotton; a substantial stockpile of this commodity was normally maintained to supply its large textile industry which, in turn, was one of the major sources of export earnings for the country. Large cuts in production will be required to bring demand and supply into a better balance but farmers as yet have had few viable alternative crops for cultivation. Weak cotton prices might have provided a competitive boost to China on the export side but this also undermined a sizeable segment of domestic consumer demand. With regard to food grains, China became a substantial exporter with 9.1 million tons of grain exports in 1998; of this amount, rice accounted for

3.8 million tons, or some 74 per cent more than the exported volume in 1997. Whether such a large surplus can be maintained will depend upon the exact size of the harvest in 1999.

Services accounted for approximately 30 per cent of GDP; a significant growth of some 7 per cent was recorded by this sector during 1999, although this was marginally slower than in the previous year. Much of the buoyancy originated in housing, retail trade and transport services that have been developing rapidly in urban areas in recent years. The contribution of financial services was also higher; according to one estimate, some 40 million Chinese were said to own shares of listed companies. Furthermore, services normally associated with relatively more advanced economies such as accountancy, legal rights, advertising, and the private provision of health care and education have also made their mark in the larger cities of the country over the last two or three years.

In Hong Kong, China, the economic downturn that began in October 1997 ended in the second quarter of 1999 and, by the third quarter of 1999, the economy had grown noticeably on a year-on-year basis. The fall in domestic demand, as well as exports, came to a halt from the middle of 1999. Domestic exports then started to recover. Largely as a result, pressure on the exchange rate parity subsided permitting a rapid decline in interest rates. The inter-bank overnight rate, for instance, fell from a peak of 17.7 per cent in August 1998 to 5.9 per cent in July 1999. The unemployment rate has stabilized, some sectors actually recording higher levels of employment in the second half of 1999.

In response to these positive developments, property prices began to firm up and the stock market surged, registering a rise of over 59 per cent between the end of December 1998 and early December 1999. The negative wealth effect, which had undermined consumer confidence during 1998 and a considerable part of 1999, was thus much weakened. However, deflationary pressures have not been totally eradicated. The real interest rate did not decline as much as nominal interest rates owing to falling prices for almost two years. This exerted a dampening effect on local demand for credit, especially housing mortgages.

GDP growth rebounded strongly in 1999 in the Republic of Korea after the large contraction in the previous year. The recovery of manufacturing output dominated growth on the supply side; on a year-on-year basis, industrial expansion amounted to an astonishing 30.6 per cent by the third quarter of 1999. Agriculture, boosted by good weather, was estimated to have grown by 2.5 per cent in 1999, compared to a major contraction of 6.3 per cent in 1998. Sharp increases in the levels of value added in utilities and services were a response to the resurgent manufacturing sector. However, construction activities continued to decline. While the recovery of manufacturing was broad-based, such traditional industries as clothing, textiles and metals were outperformed by the information technology, microprocessor, office machinery and motor vehicle subsectors. On the demand side, strong export demand for IT components, particularly from the United States, provided a major stimulus to output. However, private domestic demand also exhibited considerable buoyancy, rising by over 6 per cent in the first half of 1999, this being the first growth in private consumption since the third quarter of 1997.

Easier fiscal and monetary conditions combined with concerted efforts made in support of banking and corporate sector restructuring to underpin the economic recovery process in the Republic of Korea. The fiscal deficit, estimated at 4.2 per cent of GDP in 1998, was expected to decline to 3.9 per cent in 1999 as tax revenues increased as a result of strong growth. The rapid decline in inflationary pressures, from 7.5 per cent in 1998 to 0.9 per cent in 1999, had allowed interest rates to fall steeply; short-term rates of 13 per cent in mid-1998 had come down to under 7 per cent by the end of 1999. Lower interest rates have aided the process of corporate sector restructuring and they have boosted business confidence as well.

GDP in Mongolia was estimated to grow by 3.5 per cent in 1999, or about the same rate as in 1998. Industrial production had increased by 2.8 per cent year-on-year by the middle of 1999. The slowing agricultural sector, which consisted largely of animal herding, showed signs of revival despite a persistent drought. Exports and industrial activities were far below the levels reached in 1995 but showed a significant recovery over their performance

in 1998. A disruption in oil and gas supplies from the Russian Federation in the summer of 1999 had a negative impact on industrial output in Mongolia. Aid donors took a positive view of the government's management of the economy in 1998 and in June 1999, pledged more funds than the government had requested. The bulk of the aid funds is earmarked for investment in infrastructure, which has long been a major impediment to improving economic growth and market integration in the country. Against this backdrop, better economic performance would appear to be sustainable, aided by firmer prices for many of Mongolia's exports, such as copper and cashmere and a recovery in the numbers of animal herds, especially sheep and cashmere-producing goats. The process could be further reinforced through the recovery of industrial production in, and essential supplies from, the Russian Federation.

Inflation

As mentioned previously, retail prices remained stable or declined in East and North-East Asia, despite a substantial increase in fiscal deficits across the subregion in 1999 (table II. 17). It was thus not inflation but the persistence of weak or falling prices that was an issue of policy concern among the three main subregional economies in the past year. The deflationary process was associated, on the supply side, with lower agricultural commodity prices and excess capacity in a wide range of manufacturing activities. On the demand side, low confidence generated a high preference for saving; consumers have been reluctant to purchase items other than essentials. Household expectations have improved along with the onset of economic recovery in the Republic of Korea and Hong Kong, China; in China, however, such confidence was still dampened by an overall feeling of economic insecurity.

Consumer prices are estimated to have declined by 1.4 per cent in China in 1999 relative to a drop of 0.8 per cent in the previous year. A similar trend was observable in Hong Kong, China, where consumer prices fell by 3 per cent in 1999 compared to a modest 2.8 per cent increase in the previous year. There was a marginal price increase of 0.9 per cent in the Republic of Korea in

Table II.17. Selected East and North-East Asian economies: summary of macroeconomic indicators, 1996-1999

(Percentage)

		1996	1997	1998	1999
China	Savings/GDP	39.5	40.1	41.5	41.0
	Investment/GDP	39.6	38.2	39.0	40.0
	Budget balance/GDP ^a	-0.8	-0.8	-1.2	-2.1
	Trade balance/GDP	2.4	5.1	4.8	3.3
	Current account balance/GDP	0.9	3.3	3.0	0.5
	Money supply growth (M2)	25.3	20.7	14.9	16.3 ^b
	Inflation rate ^c	8.3	2.8	-0.8	-1.4
Hong Kong, China	Savings/GDP	30.7	31.9	30.7	31.0
	Investment/GDP	32.1	35.4	30.3	30.5
	Budget balance/GDP ^a	2.2	6.5	-2.5	-2.8
	Money supply growth (M2)	10.9	8.3	11.8	8.5
	Inflation rate ^c	6.3	5.8	2.8	-3.0
Mongolia	Savings/GDP	19.9	21.9	27.0	..
	Investment/GDP	25.2	26.0	25.8	..
	Budget balance/GDP	-2.6	-9.3	-11.1	..
	Trade balance/GDP	-3.4	12.4	-5.9	-6.1
	Current account balance/GDP	-9.4	5.9	-12.3	-7.6
	Money supply growth (M2)	25.8	32.5	-1.7	20.0 ^d
	Inflation rate ^c	49.3	36.7	9.5	12.0
Republic of Korea	Savings/GDP	34.0	33.7	33.4	34.1
	Investment/GDP	37.9	34.2	20.9	27.3
	Budget balance/GDP ^a	0.1	-1.3	-4.2	-3.9
	Trade balance/GDP	-2.9	-0.7	13.0	8.2
	Current account balance/GDP	-4.4	-1.7	12.5	6.1
	Money supply growth (M2)	15.8	14.1	27.0	20.0
	Inflation rate ^c	4.9	4.4	7.5	0.9

Sources: ESCAP secretariat calculations based on ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999) and *Asian Development Outlook 1999* (Oxford University Press, 1999); IMF, *International Financial Statistics*, October 1999 and December 1999; The Economist Intelligence Unit, *Country Report: South Korea and North Korea*, fourth quarter 1999; and national sources.

Notes: Data for 1999 are estimates. Savings/GDP refers to gross domestic savings/GDP; investment/GDP refers to gross domestic investment/GDP.

^a Excluding grants.

^b January-March.

^c Referring to changes in the consumer price index.

^d January-September.

1999. In comparison, inflation had reached 7.5 per cent in 1998, a reflection of the sharp depreciation of the won during the first half of the year, although prices had been on a downward trend since the middle of 1998. In Mongolia, after four years of declining inflation, the recent rise in oil prices caused an upturn of domestic prices during 1999.

The benign state of inflation in most parts of East and North-East Asia embodied weak consumer demand which was, in turn, a crisis-induced feature. Such weakness had been occasioned by business uncertainty and job insecurity following the sharp downturn in economic activities in 1998. In China, lower household expectations were reflected in the rapid growth of private savings and hence in the

faster growth of M2 (M1 plus savings deposits, corporate deposits and household savings) between June 1998 and June 1999 than in the 12 months to June 1998. To reverse this trend and encourage spending, the People's Bank of China cut deposit rates seven times from May 1996; but consumers tended to divert their savings into the stock markets rather than into consumer goods. Government authorities were not totally averse to this reallocation of private sector surpluses because rising stock market prices could also stimulate consumption through the wealth effect. Stock markets in China rose by over 24 per cent between the end of December 1998 and early December 1999. However, these gains have not yet translated into higher consumer spending and thus deflationary pressures continued to persist.

The pace of deflation in consumer prices actually quickened in Hong Kong, China during 1999. Among other causal factors, there were lower import prices owing to the appreciation of the local currency (which is tied to the United States dollar) in relation to other currencies, declining prices in China, heavy discounting of consumer goods prices as producers and retailers tried to generate cash flow, and a freeze on government fees and utility charges. The demand for housing mortgages was constrained by the impact of falling prices on real rates of interest.

The lower exchange value of the won and the consequent higher import prices had pushed inflation upward in the Republic of Korea during the first half of 1998. The stabilization of the won from the middle of 1998 onwards and through 1999 implied the absence of import price inflation for more than a year. Private consumption, which had fallen sharply in 1998, started to recover slowly, although this has not lifted retail prices, given the large excess capacity in manufacturing. Higher oil prices and some increase in utility charges in the latter part of 1999 might, however, generate modest pressures from the cost side. Another complication could emanate from the recent appreciation of the yen; the Republic of Korea sources many components and parts for manufacturing activities from Japan. All in all, however, inflationary pressures are unlikely to become a major issue in the Republic of Korea in the near term.

In Mongolia, inflation slowed markedly in the first half of 1999 and single digit inflation seemed

probable for the first time since the country moved to a market-based economic system. However, a break in supplies from the Russian Federation created shortages of consumer goods, particularly imported goods and fuels, which had a strong upward pull on the overall price level. This was then aggravated by a doubling of oil prices. As a consequence, inflation for the full year could be in the neighbourhood of 12 per cent. Inflation in Mongolia was essentially in the nature of cost-push and, as such, it could be moderated to some extent by better management of stocks. However, domestic prices could not be totally shielded from external shocks and it was for this reason that the disruption in oil supplies from the Russian Federation impacted so unfavourably on prices in Mongolia during the latter part of 1999.

Trade and exchange rates

The dollar value of exports from China had risen by 6.9 per cent while imports had expanded by 20.9 per cent by November 1999 (table II.18); the merchandise trade surplus fell from over \$43.2 billion in 1998 to just under \$26.6 billion during the same period. To begin with, there was a sharp fall in trade earnings from China's second largest export market, Hong Kong, China. There were also small declines in the value of exports going to Taiwan Province of China, the United Kingdom and Latin America. Although exports to Japan, the Republic of Korea and the United States increased, these increases could not prevent an overall decline. Garments, textiles and footwear did not perform well compared to the exports of computer-related and electronic goods. On the import side, the increases were concentrated mostly in raw materials and intermediate inputs, rather than in investment or consumer goods.

To boost flagging exports, the State Council raised the rate of export rebate on garments, textiles, selected machinery, electrical products and a number of other items from July 1999. The export momentum was then regained and, as a result, the merchandise trade surplus rose significantly to over \$29 billion in the 12 months to December 1999. However, the current account surplus was expected to drop sharply from 3 per cent of GDP in 1998 to 0.5 per cent in 1999. The poor export performance in the first half of 1999 had fuelled arguments

Table II.18. Selected East and North-East Asian economies: merchandise exports and imports in United States dollar value and their rates of growth, 1996-1999

	Value (millions of US dollars)	Exports (f.o.b.)					Value (millions of US dollars)	Imports (c.i.f.)				
		Annual rates of growth (percentage)						Annual rates of growth (percentage)				
		1998	1996	1997	1998	1999		1998	1996	1997	1998	1999
China	183 589	1.6	21.0	0.4	6.9 ^a	140 305	7.6	2.3	-1.3	20.9 ^a		
Hong Kong, China	173 990	4.0	4.0	-7.5	-0.4 ^a	184 503	3.0	5.1	-11.6	-4.4 ^a		
Mongolia	317	-10.4	-1.4	-24.2	4.2 ^b	472	8.7	-1.8	6.5	-11.7 ^b		
Republic of Korea	132 313	3.7	5.0	-2.8	9.0	93 282	11.3	-3.8	-35.5	28.3		

Sources: United Nations, *Monthly Bulletin of Statistics*, September and October 1999; IMF, *International Financial Statistics*, November 1998, November 1999 and February 2000; and ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999); and national sources.

^a January–November.

^b January–October.

concerning the desirability of an exchange rate devaluation. The subsequent recovery in exports noticeably lessened the need for such a policy response, at least in the immediate future. At the same time, the recent agreement with the United States over the terms of China's entry to WTO provided a major boost to the country's longer-term export prospects and its role as a major trading nation

The value of exports contracted by 7.4 per cent in Hong Kong, China during the first half of 1999 and re-exports were also down, though by a lesser magnitude. The value of imports declined at a much faster rate. The trade deficit fell, on a year-to-year basis, from \$12.4 billion as of October 1998 to \$5.2 billion up to October 1999. On the export front, the biggest fall was in earnings from the largest market, China. Exports to the United States and other developed country markets were also lower, although the value of shipments to the Republic of Korea jumped significantly. Of the 10 most important categories of exports, the only rise in earnings was from non-ferrous metals during 1999. Trade receipts on apparel and clothing, the largest single export category, remained largely unaffected; the decline was marginal at only 0.1 per cent. In the second half of 1999 there was a marked recovery in both exports and imports.

The apparent loss of competitiveness in Hong Kong, China was partly a result of the fixed exchange parity with the United States dollar, although a moderating influence in this regard came from the deflationary trends in the economy over the past 18 months. However, subdued domestic demand seems to have contributed to falling imports and a narrowing of the trade deficit. In fact, the overall current account could actually show a small surplus for 1999 as a whole. In view of such multi-sided interaction, the exchange parity and associated loss of competitiveness might arguably not be a major policy issue, at least in the short term. Besides, Hong Kong, China is now predominantly a service-oriented economy. The exchange rate does not have a major implication for competitiveness in many service activities. Furthermore, the long-established parity has been a major factor in minimizing business and financial uncertainties.

In the Republic of Korea, the performance of merchandise exports in dollar value strengthened considerably as the year progressed. Export figures were marginally down by June 1999 compared to the same period in 1998; by October 1999, however, exports were nearly 15 per cent higher year-on-year. Full-year growth in export receipts for 1999 was expected to be in the region of 9 per cent on a year-on-year basis. This steep upturn was led by

semiconductors, liquid crystal display panels, personal computers, motor cars and precision instruments. The trade surplus had reached \$25.8 billion in the 12 months to October 1999 compared to over \$38 billion for the comparable period to October of the previous year. Imports had been severely compressed in 1997 and 1998 but rebounded by over 40 per cent in the first three quarters of 1999. The imports mainly consisted of capital goods and other vital inputs such as semiconductors (in specifications not manufactured in the Republic of Korea), chemicals and metallic ores.

The sharp turnaround in export performance was largely driven by the strong expansion in the United States economy, a destination of just under a fifth of exports from the Republic of Korea. There had also been some improvement on the supply side through a mitigation of the severe credit crunch of 1998. Other helpful factors included the gradual recovery in Japan as well as the continued demand in such large regional markets as China and Taiwan Province of China. The medium-term prospects for exports from the Republic of Korea are encouraging, given the likelihood of sustained growth in these economies. This optimism, of course, has to be tempered by possible economic slippage in the United States. Imports will also rise, perhaps faster than exports for some months to come. The deficit in the external account for services, too, will widen owing to a rising outflow of interest, profits and dividends from the increasing stock of foreign-owned assets. By and large, therefore, the current account surplus in 2000 could be lower than 6.1 per cent of GDP recorded for 1999.

In Mongolia, the dollar value of exports went up by 4.2 per cent while imports fell by 11.7 per cent in the first ten months of 1999. The merchandise trade deficit narrowed to \$72.4 million, from \$128.4 million. Textile exports more than doubled during this period. However, earnings on mineral exports were down, largely on account of production difficulties. China has now become Mongolia's largest export market; trade with the Russian Federation, however, continued to be of critical importance as Mongolia has been completely reliant on this trading partner for energy supplies. A problem with fuel exports from the Russian Federation in July and August 1999 left parts of Mongolia without petrol and had a major negative impact on domestic prices and industrial production.

Capital inflows and outflows

All economies in this subregion, excluding Mongolia, have become closely integrated with the world economy not only through trade but also through capital flows. China remained the largest recipient of FDI in the world, although the country's external current account consistently registered annual surpluses of just under 1 per cent of GDP between 1991 and 1996, and over 3 per cent in 1997-1998. In addition, China has been a destination of significant amounts of portfolio investment in recent years, the figure rising rapidly from \$650 million in 1991 to \$8.5 billion in 1997. Partly in consequence, the foreign exchange reserve position of nearly \$155 billion comfortably exceeds the annual import bill of China.

The external current account was in a surplus of just under 2 per cent of annual GDP in Hong Kong, China during the early 1990s. This was converted into a deficit of 3.5 per cent in 1997 followed by a small surplus a year later. The amount of foreign exchange reserves, too, was substantial at \$90 billion in September 1999, the equivalent of about six months of import spending by Hong Kong, China. The economy has been a major regional and international financial centre and, as such, it was managing substantial inflows and outflows of funds for a variety of purposes, including for portfolio investments and currency trading in the region as a whole. The value of foreign assets of banks based in Hong Kong, China amounted to a huge \$445 billion in June 1999.

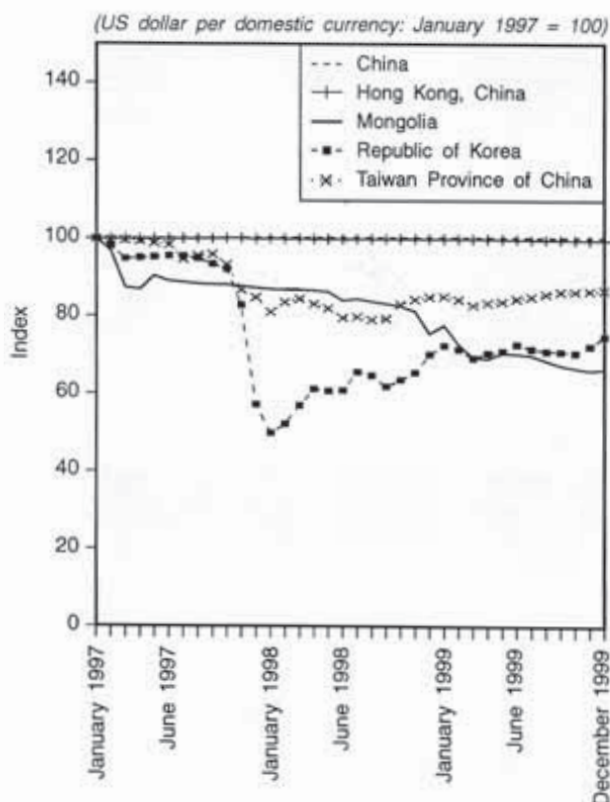
The Republic of Korea experienced a current account deficit of about 2 per cent of annual GDP in the early 1990s. As imports collapsed in the wake of the economic crisis, a surplus of 12.6 per cent was recorded in 1998. This enormous turnaround was also accompanied by large FDI inflows so that external reserves were boosted from \$31 billion in December 1997 to \$47 billion in September 1998, and further to \$65 billion in September 1999; this latter figure translated into approximately eight months of import coverage.

Mongolia has run a substantial current account deficit on and off over the recent period, and the country depends primarily on ODA for financing this deficit to the tune of \$65 million a year, which is equal to approximately half the current account deficit.

There were sharp falls of varying magnitude in equity prices as well as unfavourable conditions for external financial inflows, whether in portfolio investment, FDI or international bond issues, in the wake of the crisis and up to early 1998 (figures II.8 and II.9). Bank credits tended to dry up almost completely while the higher level of official inflows reflected the operation of the IMF-led rescue packages for the economies in the region affected by the crisis, including the Republic of Korea. The sharp decline in private financial flows began to ease from about mid-1999. The resurgence and sustainability of these will, of course, be conditioned by a variety of considerations, including macroeconomic fundamentals and the state of development in various recipient countries, as well as developments in the global financial markets.

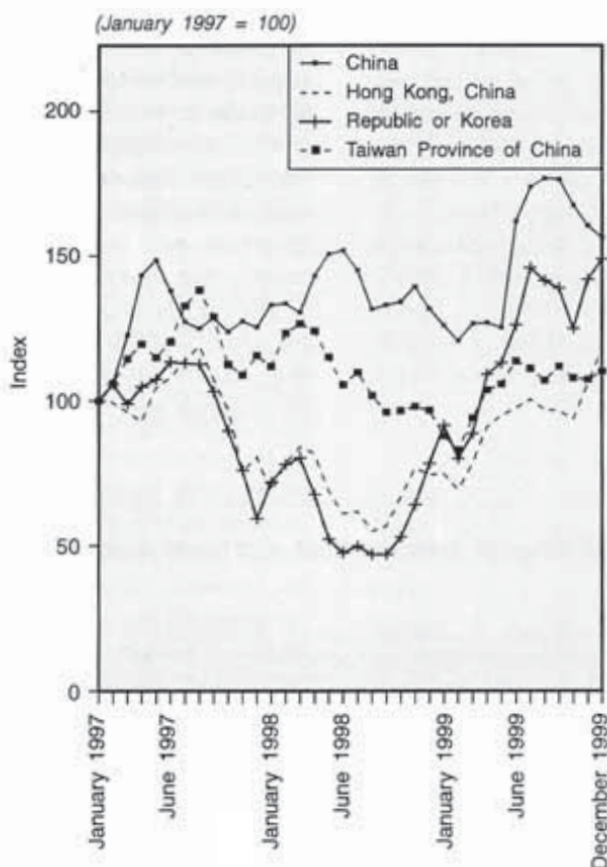
China, the Republic of Korea and Hong Kong, China have usually enjoyed a relatively strong balance of payments position. Nevertheless, these economies have been significant recipients of foreign capital. All three economies have been simultaneously exporters of capital, a characteristic which is atypical of most other developing countries. China, for example, has successfully attracted huge inflows of FDI, especially to its special economic zones in the coastal regions; in the process, it has acquired new technologies, management expertise, marketing know-how and market access. Simultaneously, the country has invested, directly and heavily, in other economies, particularly Hong Kong, China. In 1998, the latest year for which full-year figures are available, FDI in China amounted to \$45.5 billion while the outflows were \$1.6 billion, the latter representing

Figure II.8. Index of exchange rates of selected East and North-East Asian economies, 1997-1999



Sources: IMF, *International Financial Statistics*, various issues; and *Far Eastern Economic Review*, various issues.

Figure II.9. Index of stock markets of selected East and North-East Asian economies, 1997-1999



Source: *The Economist*, various issues.

a considerable decline from an annual average of about \$2.5 billion since 1993. Indications for 1999 suggest a fall in inflows to around \$38 billion.

One of the facilitating factors for capital flows into and out of China has been the maintenance of exchange rate stability. FDI inflows appeared to level off in 1998 and 1999 as a negative ripple effect of the crisis and possibly for fear of a devaluation of the yuan renminbi. In order to dispel such fears, China repeatedly announced its firm commitment to the exchange parity of the yuan renminbi and at the same time took several supportive measures to boost exports and relieve pressure on the exchange

front. Such responses included higher rebates of export taxes, allowing private companies to export directly rather than through foreign trade enterprises and ensuring access to export credits by joint venture enterprises. As a result of these measures and aided by the economic recovery in the region and elsewhere, merchandise exports expanded significantly in the latter part of 1999 and pressure on the exchange rate of the yuan renminbi has subsequently abated.

In contrast to China, FDI outflows from Hong Kong, China, have tended to be several times larger than the inflows: for instance, \$1.6 billion of inflows relative to an outflow of \$18.8 billion in 1998. Such

a pattern is likely to have continued in 1999. In 1998, Hong Kong, China, also faced pressure on the exchange parity, which persisted until early 1999, in spite of the ample reserves available for defensive purposes. Substantial amounts of short sales of stocks in the futures market were made along with the forward purchase of foreign currencies, particularly the United States dollar, against the local currency. Under the currency board system in Hong Kong, China, this process reduced domestic liquidity, thus forcing up interest rates. These rates had risen to very high levels by mid-1998; the increased cost of financing and, on the other hand, the enhanced attractiveness of bank deposits automatically generated a strong downward pull on share prices. The domestic stock market thus remained weak throughout 1998 with the Hang Seng index declining by 6 per cent during the year. Partly to counter this pressure, a significant volume of shares, estimated at \$15 billion, was directly purchased by the government authorities. This move proved highly successful; both the pressure on short selling of stocks and the pressure for a devaluation abated as the stock market began to strengthen. Interest rates declined rapidly afterwards. The stock market in Hong Kong, China, went up by nearly 60 per cent during 1999, thus giving the authorities an opportunity to offload their investments at a considerable profit. The first sales took place in November 1999.

FDI in the Republic of Korea went up from \$2.8 billion in 1997 to \$5.1 billion a year later as foreign investors bought up financially distressed enterprises at heavily discounted prices. At the same time, FDI outflows also went up, though much more slowly, from \$4.4 billion to \$4.8 billion respectively over the same period. Such outflows might have reflected the needs of various chaebol to protect their overseas investments. From the available data for 1999, inflows were broadly of the same order of magnitude but outflows appear to have declined in response to the restructuring of chaebol balance sheets. With rising exports and lower outflows of FDI, the won/dollar exchange rate remained stable for more than a year, providing an anchor for longer-term business decisions and for sustaining market confidence. External debt displayed a stable picture at the end of July 1999. All \$13.2 billion of short-term loans from IMF were to have been repaid in September 1999. Long-term loans of \$7.5 billion,

including \$1.5 billion to be drawn down in 2000, were still owed by the government to IMF. There has been a modest rise in short-term debts, an incidence attributable mostly to the higher volumes of international trading activities during 1999. By and large, the total foreign assets of the Republic of Korea were forecast to exceed its total liabilities by the end of 2000, a remarkable turnaround in the short space of three years. Nevertheless, such an improvement in the debt profile had not led to an upgrade by the international rating agencies as of the third quarter of 1999.

Financial sector developments

Major weaknesses in the financial sector in East and North-East Asia, brought to light by the financial and economic crisis, were analysed in the *Survey 1999*. The persistent credit crunch was posited as a major constraint on post-crisis recovery. The credit crunch partly reflected the limited ability of banks to extend new credit facilities on account of the huge volume of NPLs on their books and the gross deficiency in their capitalization. These problems had arisen as a result of weak capacities in risk management among the financial institutions concerned as well as inadequate regulatory and oversight capabilities of the financial supervisory bodies. An initial framework for the reform and restructuring of the financial and corporate sectors had been put in place in the course of 1998, and the following year witnessed further progress in that direction. The improved market confidence, the notable appreciation and stabilization of exchange rates, and low consumer prices facilitated large reductions in interest rates which, in turn, considerably eased the credit crunch problem. Pertinent developments in the financial sectors in East and North-East Asia in 1999 are briefly reviewed below.

A pressing problem in China was the persistence of low consumer confidence and spending. As a stimulus measure, interest rates were cut seven times from May 1996, taking the rate on one-year deposits to a historical low of 2.2 per cent in June 1999. The falling interest rates led initially to a considerable surge of investment in the stock markets, although share prices in China were affected by the volatile declines in most of the major

stock markets in the world in the middle part of 1999. By December 1999, however, the Chinese stock market for B-shares averaged 24 per cent above its level at the end of the previous year. There is a general consensus that buoyant stock markets boost consumer confidence and thus household spending. A prerequisite for this to happen is strengthened confidence in the sustainability of upward movement in stock markets and greater share ownership in the country. To these ends, brokerage houses have been encouraged to expand their activities, stamp duties on share trading have been reduced, and private firms have been allowed to list on the B-share market in Shanghai.

The People's Bank of China announced plans to set up asset management companies to take over NPLs of the four principal state banks (China Construction Bank, China Agricultural Bank, China Industrial and Commercial Bank, and Bank of China) in May 1999. A favoured method for dealing with NPLs appeared to be debt-for-equity swaps. It was then announced in July 1999 that 1.2 trillion yuan renminbi (equivalent to some \$145 billion) owed to these banks by state-owned enterprises would be converted into equity; such an amount was equivalent to about 14 per cent of GDP. A sizeable proportion of these loans, perhaps around 30 per cent, was deemed recoverable given time and an upturn in consumer spending. The remaining volume of NPLs could still be quite large on the basis of internationally defined criteria. Given the low ratio of public debt to GDP in China, even a higher estimate of the NPL volume would not pose an unmanageable burden on the budget.

On the supervisory front, local banks were coming under closer and more regular scrutiny. Some mergers have occurred among city credit cooperatives and commercial banks, and a deposit insurance scheme has been under consideration, the latter being a direct consequence of the closure of Guangdong International Trust and Investment Corporation with debts of 36.2 trillion yuan renminbi (\$4.4 billion). In addition, the People's Bank of China has been undertaking a major restructuring of trust and investment corporations. Furthermore, banks have been encouraged to operate along commercial lines and foreign institutions are being

gradually allowed to enter the domestic market to provide a competitive spur for greater efficiency in the domestic financial sector.

The trend of declining interest rates, also in evidence in Hong Kong, China, was partially reversed after mid-1999. The local currency is tied to the United States dollar and the inter-bank rates of nominal interest were hiked upward in response to the announced monetary tightening by the Federal Open Market Committee of the United States Federal Reserve System in June 1999. Real interest rates, however, went up more significantly as a result of the somewhat accelerated rate of deflation in 1999, further dampening the prices of real assets and consumer demand. This process was particularly visible in the housing market where local demand for mortgages, already low on account of the recession, was further eroded.

Another problem area for financial institutions based in Hong Kong, China, has been their exposure to enterprises in China. Efforts were made by these institutions to redress or limit such exposure after the collapse of the Guangdong International Trust and Investment Corporation, the financial difficulties in other investment trusts in China, and the debt problem of state-owned enterprises. In mid-1999, for example, the level of exposure of financial institutions of Hong Kong, China, in the form of outstanding loans and credit facilities to China amounted to HK\$280.4 billion compared to HK\$ 297.5 billion in December 1998. More meaningfully, such exposure was equivalent to only 4.1 per cent of total banking assets. At the same time, overall NPLs in Hong Kong, China, at around 5 per cent of total loans, remained negligible by the prevailing standards in the region. They would probably reach a peak at 7 per cent in late 1999, a reflection of the quality of both bank management and banking supervision in the economy.

In the Republic of Korea, priority has been placed on keeping interest rates low despite the striking pace of GDP growth. However, there was no immediate danger of inflation emerging in the economy, given the existence of relatively high levels of excess capacity and available labour supplies. Low interest rates, on the other hand, became critical for the corporate restructuring process which, in turn, has been generally regarded as

the linchpin for the sustained strength of economic recovery over the medium term. According to the Financial Supervisory Commission, a total of 63.4 trillion won (approximately \$53 billion) in NPLs was held by domestic financial institutions as of September 1999, this amount being equivalent to about 14 per cent of GDP. Some 37.9 trillion won had already been injected by the government since 1997 to recapitalize the banking system, with a further 13 trillion won earmarked for this purpose in the latest budget.

Despite these supportive measures, the financial sector remains acutely vulnerable to negative developments within the corporate sector. For example, the problems encountered in the restructuring of Daewoo, the second biggest chaebol, reverberated throughout the financial sector; market fears of a default by Daewoo lifted long-term yields on corporate bonds to 10.5 per cent. The prices and rates of treasury bonds came under great pressure, with unfavourable implications for the government's ability to raise debt for funding a larger budget deficit. Access to credit remained tight, especially for small and medium-sized enterprises. Many enterprises were forced to turn to the banks for working capital and in this process, the smaller enterprises tended to be crowded out by the bigger companies.

A bond stabilization fund was created in October 1999 to buy lower grade bonds that might be offloaded by the investment trust companies. The Financial Supervisory Commission has also provided additional funding for the Seoul Guarantee Insurance Company, the bond underwriting and guarantee company. Another response was to ease the requirement that, by the end of 1999, all banks had to meet the capital adequacy ratio set by the Bank for International Settlements. A positive achievement of note was that leading chaebols had managed to reduce their combined debt-equity ratio to 300 per cent by June 1999 from 386 per cent in December 1998; they appear to be on track in their target of cutting the ratio further to 200 per cent by the end of 2000. The robust performance of the stock market has been of particular help in the above process. By early December 1999, the Korea Composite Stock Price Index stood at 78 per cent above its level of the end of December 1998.

Policy issues and responses

The overall economic situation and, by implication, the prospects of East and North-East Asia are more favourable than they were as recently as mid-1999. A common concern for the subregional economies is the evolving direction of the international economy and, closer to home, the economic strength and financial stability in Japan, South-East Asia and the Russian Federation.

China has weathered the effects of the crisis rather well. GDP growth remained very strong, albeit marginally lower in 1999; pressure on the exchange rate has also been muted as exports were on an upward trend in the second half of 1999. However, the modest slowdown in economic performance has combined with the ongoing restructuring of state-owned enterprises to cause an adverse effect on the growth of jobs and employment, a phenomenon with potentially serious social implications. Moreover, China's success in keeping itself insulated from the crisis has been underpinned by a relatively closed capital account and the huge level of foreign exchange reserves. As has been the case elsewhere in East Asia, the crisis has subjected the Chinese economy to closer scrutiny, both by external analysts and investors and by domestic policy makers. A substantial agenda for reform has been drawn up partly in response to the marginal slowdown in economic growth in China and partly in response to the regional economic crisis itself.

The fiscal stimulus associated with large government outlays on infrastructure was a major force behind China's strong growth in 1999. Its positive effects are expected to abate gradually so that growth will have to become more dependent on higher private consumption and enterprise investment during the coming years. Poor consumer confidence remains a crucial problem in the short term; domestic consumption constitutes some 60 per cent of GDP. Efforts have been made to stimulate consumer demand through both fiscal stimulus and interest rate reductions; banks are also encouraged to provide individuals with credit for housing and durable goods. However, the fear of job losses has had a dampening impact which has not been substantially reversed through these stimulus measures.

FDI has played an important role in strong economic growth in China over most of the 1990s. However, the prospects for increased FDI inflows are poor, owing to the economic weakness in the rest of Asia, concerns over the health of the country's financial sector, and competition from other countries as attractive alternate locations for investment by transnational corporations.

The levels of the budget deficit and public debt are low by international standards, but the overall financial position could worsen because of the size of off-budget operations, including the magnitude of NPLs commonly accepted as an implicit government obligation. An issue in this regard is the frequent use of bank credit to cover the cash shortfalls of state-owned enterprises. Moreover, the need for greater fiscal receipts will be increasingly felt as the government undertakes reforms of pensions, health and other social expenditure currently borne by the enterprises. Measures to widen and deepen the revenue base thus need strengthening.

There has already been considerable reform in the financial sector, as discussed in some detail earlier. Likewise, reform of state-owned enterprises has been gaining momentum. Extensive restructuring of the textile and coal industries has taken place. Merger and acquisition activities to restructure and consolidate medium-sized enterprises have been widely encouraged and a large proportion of the smaller state-owned enterprises have been separated from direct state control. However, the extent, pace, durability and overall progress in such reforms is difficult to gauge. As government authorities have themselves indicated, the reform of state-owned enterprises might need to be slowed down if unemployment grows too fast. Furthermore, the competitive strength of restructured state-owned enterprises remains to be tested. Practices such as management accountability are still in their infancy. Above all, it would appear difficult to contain the problem of NPLs or to establish commercial yardsticks as the basis for bank lending without a durable improvement in the financial position of state-owned enterprises, which have customarily relied on state bank credits to cover shortfalls in receipts.

The economic difficulties experienced by Hong Kong, China, since October 1997 appear to be at an end. Growth resumed from the latter part of 1999

and, on current indications, is expected to be between 0.6 and 1 per cent in 2000. Among the short-term risks is the falling price level, which serves to lift real interest rates and to undermine business confidence. On the plus side, however, the financial sector remains strong, despite some recent, albeit modest, rises in NPLs and the exposure of some institutions to the investment trust companies in financial difficulties in China, such as the Guangdong International Trust and Investment Corporation. There was a pronounced recovery of the stock market from the second half of 1999. Given these continuing trends, output expansion near or even above the upper range of forecasts noted above could be attained by Hong Kong, China, in 2000.

A medium-term issue concerns the role of Hong Kong, China, as a regional and international financial centre. Broadly speaking, this role has remained unaffected by the crisis, and the volume of financial market transactions, such as those embodied in the level of foreign banking sector assets remains high. The maintenance of the fixed exchange parity, while sustaining business and market confidence, imposed heavy costs in 1998. The Cross Market Surveillance Committee was created to reduce future vulnerability to sharp or unexpected market turbulence and swings, by facilitating better and more timely communication among market regulators and more sharing of regular up-to-date market information and developments. Another issue relates to the close economic linkages with China. The upward trends in output and employment recently experienced by Hong Kong, China, could dip with an economic slippage in China. On current indications, however, the likelihood of a significant or prolonged slowdown in China is small.

The Republic of Korea recorded the highest growth rate in the region less than two years after the crisis. One of the principal factors in the sharp recovery has been an expansionary stance in fiscal policies. The other facilitating factors were the rapid decline in interest rates, the relative stability of the exchange rate and the stabilization of domestic prices. Consumer and investor confidence and expenditure were boosted in consequence, while buoyant exports from the second half of 1999 provided an added stimulus. It is the fast pace of the economic recovery itself that has raised questions

concerning its sustainability. Recovery is expected to slow down to around 7.8 per cent in 2000 as the effects of fiscal expansion wind down and excess capacity becomes exhausted.

The continuing need for comprehensive reform and restructuring of the financial and corporate sectors certainly has not been lessened by the strong recovery. Wide-ranging actions have been taken to grapple with the problems of the banking sector and large chaebols over the past two years. A focused effort may now be needed for the non-bank financial institutions, and for the medium-sized companies to reduce their debt-equity levels to more manageable levels. The risks to sustained growth in the medium term will vary inversely with the degree of success in tackling these two problem areas. Another recurrence of uncertainty in the financial sector would not only choke off liquidity to the medium-sized companies but also more seriously, undermine consumer confidence.

Another area that will require the attention of policy makers is the accumulation of fiscal deficits in the Republic of Korea, as elsewhere in East and South-East Asia. Public sector borrowings have ballooned, along with the implementation of wide-ranging, publicly funded measures aimed at restructuring the financial sector and extending social safety nets. Central government debt went up from 13.6 per cent of GDP in 1997 to 31 per cent in 1998 in the Republic of Korea. These figures, however, do not take full account of off-budget expenditure, a common situation in many other economies in the subregion. Such pump-priming was undoubtedly necessary to revive growth in those economies hit by the crisis that were laden with large excess capacity. Conceivably, fast and broad-based growth could substantially increase government revenue and reduce the budget deficit. Nevertheless, governments will have to deal with the challenge of sustaining growth in 2000 and beyond without significantly adding to the fiscal burden.

Mongolia has been facing a financial sector crisis of sorts and rising fiscal deficits after a reasonable period of moderate growth. A sharp decline in the price of exports from the country, coupled with lower FDI and ODA flows, caused a major cash crisis during 1999. A drawdown of bank deposits plus a simultaneous increase in NPLs considerably weakened the banking system. The

economic prospects of Mongolia in the near to medium term are thus closely linked to the resolution of the problems in the banking sector and an improvement in export earnings. The recent upturn in world prices of its commodity exports has been counterbalanced by an even steeper rise in the price of its import of oil products. Pledges of assistance worth some \$320 million for the next fiscal year, the highest sum ever on offer, were made at the Mongolia Assistance Group meeting organized by the Government of Mongolia and the World Bank in June 1999. The extent of progress in improving fiscal management and in financial sector reforms will greatly influence the timely disbursement and effective utilization of such resources and, by extension, Mongolia's economic performance over the period 2000-2001.

DEVELOPED COUNTRIES OF THE REGION

Australia, Japan and New Zealand

The economies of the three developed countries in the region (Australia, Japan and New Zealand) displayed contrasting performances in terms of practically all major economic indicators. Australia achieved the highest growth rate among these economies in 1997 and 1998. This record was maintained in 1999 as well, albeit at a lower rate than in the previous year. New Zealand appears to have staged a strong recovery following a mild recession. Of particular significance is the return of positive growth in Japan after a fairly deep contraction in 1998. The recovery of Japan assumes significance not merely because of the sheer size of its economy, but more importantly because of its close interlinkages with the developing countries of the region through trade, FDI and other forms of capital flows. The contrasting performance of the three economies is also visible in terms of many other indicators such as domestic interest rates, growth of money supply, current account balance and fiscal balance. One strikingly common feature is that all these economies have built up a strong tradition of price stability; during the past four years, the highest inflation recorded in any of them was a modest rate of 2.6 per cent in Australia in 1996. This tradition was preserved in 1999. In fact, Japan experienced a mild deflation.

Growth performance

Buoyant consumption expenditure and the spread effects of high rates of annual export growth, averaging 9 per cent during the period 1995-1997, were behind the continuing strength of the Australian economy in 1998 and 1999. Export performance moderated significantly in 1998. However, domestic consumer expenditure remained buoyant, underpinned by the wealth effects of stock market gains. The impressive performance of the Australian economy, despite the adverse ripple effects from the East Asian crisis, can also be attributed to sound macroeconomic policies and an ongoing programme of export diversification and microeconomic reform. The easing of monetary policy in the wake of the crisis and the associated financial market turmoil served to stimulate domestic demand, in particular

for residential construction. In turn, this sustained consumer confidence, while a gentle depreciation of the exchange rate since 1997 has helped to improve export competitiveness. Competitive pressures arising from the deregulation of retail and wholesale trade have forced importers to absorb, rather than pass on, the costs of depreciation. The pressures on retail prices have thus remained minimal, despite a weaker exchange rate.

The robust economic performance has been achieved in an environment of low interest rates and low inflation in Australia, while unemployment has also tended to decline, though somewhat slowly. By developed country standards, the economy expanded by a highly respectable rate during 1999, propelled by the continuing, rapid growth in private consumption, as well as by the ongoing high levels of investment (table II.19). Several one-off factors that have

Table II.19. Developed countries of the ESCAP region: major macroeconomic indicators, 1996-1999

(Percentage)

		1996	1997	1998	1999 ^a
Australia	GDP growth	3.9	3.8	4.8	3.4
	Inflation ^b	2.6	0.3	0.8	1.5
	Consumption/GDP	84.5	84.2	84.0	84.5
	Investment/GDP	22.5	25.3	26.6	26.3
	Budget balance/GDP ^{c,d}	-1.1	-0.2	0.2	0.6
	Short-term interest rates	7.2	5.4	5.0	4.9
	Money supply growth (M2)	10.6	7.3	8.4	9.4 ^e
	Current account balance/GDP	-3.9	-3.1	-5.0	-5.7
Japan	GDP growth	5.1	1.4	-2.8	0.9
	Inflation ^b	0.1	1.7	0.7	-0.2
	Consumption/GDP	69.6	70.3	71.2	71.9
	Investment/GDP	29.8	28.4	26.7	25.5
	Budget balance/GDP ^d	-4.2	-3.4	-5.3	-7.3
	Short-term interest rates	0.6	0.6	0.7	0.3
	Money supply growth (M2)	2.3	3.1	4.2	4.0 ^e
	Current account balance/GDP	1.4	2.2	3.2	2.7
New Zealand	GDP growth	2.5	3.1	-0.8	2.2
	Inflation ^b	2.3	1.2	1.3	2.0
	Consumption/GDP	81.5	81.8	82.1	82.0
	Investment/GDP	18.0	19.4	19.7	19.9
	Budget balance/GDP ^d	2.8	2.3	2.4	1.1
	Short-term interest rates	9.3	7.7	7.4	4.8
	Money supply growth (M2)	2.5	1.2	14.6	19.3 ^e
	Current account balance/GDP	-6.1	-7.3	-6.1	-7.2

Sources: United Nations, "Project LINK World Outlook", various issues; IMF, *International Financial Statistics*, January 2000, and *World Economic Outlook*, October 1999; and *OECD Economic Outlook*, December 1999.

^a Estimate.

^b Referring to percentage changes in the consumer price index.

^c Excluding net advances (primarily privatization receipts and net policy-related lending).

^d Referring to the general government fiscal balance.

^e January-September.

also stimulated growth include spending on equipment to prevent the anticipated Y2K computer problems and investments in connection with the hosting of the Olympic Games in 2000. In addition, spending on residential property increased in response to the planned introduction of the goods and services tax in 2000.

The sectors engaged in exporting to Asia or exposed to strong import competition faced some difficulties during 1999, but the strong recovery of most economies in East Asia and the upturn in commodity prices in 1999 augur well for the performance and prospects of the various export sectors in Australia. GDP expansion could well exceed the current estimate of 3.4 per cent for 1999, given the growth rate of 4.5 per cent recorded in the third quarter of the year.

The wealth effects of a rising stock market, the diversification of financial investment products and high levels of consumer confidence have led to the rapid growth of household borrowings in Australia. The ratio of household debt to household disposable income (excluding unincorporated enterprises) went up by 12 percentage points, to 94 per cent, over the past two years (to September 1999) to support rapid growth in private consumption. On the other hand, the trends in business investment were rather mixed in 1999. The sharp fall in investment by the mining industry, comprising around 12 per cent of domestic capital formation, reflected the sector's weakness in the face of strong competition in the international markets. Mining investment fell by almost 40 per cent between its peak in early 1998 and the second quarter of 1999. Investment by the manufacturing sector dropped considerably in the second quarter, but recovered markedly in the third quarter and is expected to grow strongly over the next year, with current capacity utilization at a five-year high and positive prospects for sustained domestic demand and export growth. Other components of business investment (in livestock, in intangible fixed assets such as computer software and in mineral exploration) have also grown strongly over the past two or three years, with the fastest growth occurring in investment in computer software. Spending on gross fixed investment in Australia has accounted for about a quarter of GDP, a ratio broadly in line with the average for the developed economies. However, the speedier growth of consumption in 1997 and

1998 has caused some concern, especially in the light of the need to improve competitiveness in the years ahead.

In Japan, signs of recovery in GDP appeared in the first quarter of 1999, after five consecutive quarters of output decline. The turnaround came in the wake of several large fiscal stimuli packages injected into the economy during 1998. Although the rate of growth decelerated in the second and third quarters of 1999, the worst of the recession appears finally to be over. A recovery in export growth, especially in Asia, the stabilization in domestic demand, and continued fiscal stimuli are expected to lead to a modest GDP expansion of just under 1 per cent in 1999, after a decline of 2.8 per cent in 1998.

However, the sustainability of the overall recovery remains ambiguous as household confidence shows few solid signs of revival, owing, in part, to the high levels of unemployment by historical standards and the business sector's need to cut excess labour. Likewise, corporate confidence is far from robust as many corporations are still suffering from large debt burdens and from the excess capacity built up during the boom period of the late 1980s. A problem of credit crunch has particularly affected SMEs. However, there has also been an easing of access to credit in recent months owing to the government's recapitalization programme for the banking system. The Bank of Japan's quarterly survey of business confidence (the *tankan* survey), released in December 1999, indicated a marginally better but still low level of business confidence. Indeed, the survey results indicated planned cuts in capital spending, by as much as 10.8 per cent in 2000, by large Japanese corporations, thus dimming the prospect of such corporations playing a leading role in the economic recovery through a surge in capital spending in the near future.

The process of economic growth continues to be strongly dependent on government expenditure in Japan. The need for such growth-promoting public spending cannot be questioned, although a trade-off for successive public spending packages may well be an unsustainable burden on the already large official debt, with various financial sector implications, as will be discussed later in this section.

Several sectors have witnessed increasing participation and penetration by foreign firms in consequence of deregulation policies and the increasing pressure for corporate restructuring under the lingering recession. A large inflow of foreign capital was recorded in 1999 by the telecommunications sector, and by some activities in manufacturing and finance. A law barring foreign ownership of more than 20 per cent of Japanese telecommunications firms, lifted in 1998, has greatly increased opportunities for foreign firms to operate in the fast-growing and highly competitive telecommunications market in Japan. At the same time, the severe credit crunch has forced Japanese firms to look for alternative sources of funds through, for example, the disposal of their own business divisions or various forms of foreign investment. Car manufacturing, a long-time symbol of competitive success of Japanese industry, has not been an exception to these trends. In addition, the banking sector itself has become a possible target for acquisition by foreign investors in response to the implementation of financial sector reform.

Such developments have generated additional pressures for a radical restructuring of Japanese firms for their own survival. In the past, emphasis on lifetime employment tended to prevent corporations from making significant cuts in employment, even in recession. This served to depress corporate profitability. Many corporations are now under pressure to bring capital expenses, as well as labour wage costs, into a more sustainable, competitive balance through significant cost reductions, as well as a downsizing of operations. While this would be rational behaviour on the part of the affected firms, it inevitably generates a heightened sense of insecurity among employees, while any reductions in labour income would further lower household spending and confidence.

The New Zealand economy moved out of recession in the second half of 1998, with various indications of a broad-based recovery during 1999. Following GDP growth of 3.1 per cent in 1997, a sharp and sudden contraction of almost 1 per cent in aggregate production was recorded in 1998. This setback was essentially due to the East Asian crisis, a severe drought, weaker domestic demand and low international prices for farm commodities. With the recovery of domestic demand of some commodity prices, the economy bounced back in 1999. The strong growth in the second half of 1999 gave rise

to some concerns for a possible build-up of inflationary pressures and led the central bank to initiate a modest degree of monetary tightening in November 1999.

A major domestic factor behind the rapid turnaround from the 1998 recession has been the growth in investment spending. Housing investment, in particular, showed a notable upturn in the last quarter of 1998 after four consecutive quarters of decline. Such investment registered continued growth at the beginning of 1999, aided greatly by the fact that mortgage interest rates were at their lowest level in two decades. Business investment on fixed assets showed a modest increase of 0.7 per cent in the second quarter of 1999, after rising by 4.8 per cent in the first quarter of the year. Most of this higher expenditure was concentrated in plant, machinery and equipment and, as such, it is generally viewed as a good sign for future economic growth.

Exports remain a key factor in the economic performance of New Zealand, given their large relative share of some 30 per cent in aggregate output. This sector did not perform very well in 1999, largely because of weak earnings from such major items as dairy products, meat, logs and wool. At the same time, with the appreciable economic recovery, imports kept rising. In consequence, the current account deficit expanded.

The process of economic recovery in New Zealand thus far has been essentially domestically driven. Rising business and consumer confidence underpinned a higher level of economic activities in 1999. The revival of domestic demand, consequent upon an easier monetary stance, has resulted in a turnaround in both fixed and residential investment.² Given New Zealand's already large current account deficit, a potential worry on the horizon is the degree to which domestic demand, and economic recovery more generally, might lead to still higher imports and warrant a degree of policy tightening. However, on the positive side, the recovery of demand in most of New Zealand's trading partners promises improved prospects for export growth.

² IMF, *World Economic Outlook*, October 1999, box 1.1. "Australia and New Zealand: divergence, prospects, and vulnerabilities".

Inflation

Consumer prices in both the relatively fast-growing Australian economy and the recovering New Zealand economy remained subdued in 1999. Given the gentle but upward edging, both economies are cautiously looking at the potential inflationary pressures arising from strong domestic demand, some exchange rate weakness and a rapid recovery in most of the Asian economies hit by the crisis. In strong contrast, the Japanese economy remains mired in a deflationary situation, with added downward pressure on prices coming from the recent appreciation in the yen exchange rate.

Retail prices in Australia increased only marginally, by 0.3 per cent in 1997 and by 0.8 per cent in 1998. Inflation rose slightly to 1.5 per cent in 1999, although the rate was well within the range of the Reserve Bank's inflation target of between 2 and 3 per cent. As was the case in 1998, higher import prices were not passed on to consumers as a result of strong competition in the domestic market following deregulation. With the firmer Australian dollar in 1999, importers were expected to recover some of the margins foregone so as to remain competitive without adding to inflationary pressures. In addition, falling interest rates on mortgages reduced housing costs.

Nevertheless, the stronger pace of economic growth coupled with an improvement in the international economic environment led to a modification of the expansionary monetary policy stance of the past couple of years. The Reserve Bank of Australia increased the discount rate, by 25 basis points, to 5 per cent in November 1999 in order to pre-empt any inflationary pressures at an early stage and to maintain inflation within the targeted range of 2 to 3 per cent over the medium term. Given the surplus fiscal situation, macroeconomic management is likely to be preponderantly based upon changes in the monetary policy stance with the inflation rate as the principal policy target.

In Japan, inflation stood at 0.7 per cent in 1998 and then fell to minus 1.2 per cent by November 1999 on a year-on-year basis, despite an easy stance of monetary policies. In the so-called deflationary spiral, both the household and the business sectors delay their purchases in the expectation of a further fall in prices. This leads to an increase in inventories, thus forcing domestic firms to cut prices in order to reduce inventories and excess

capacity; the action reinforces consumers' expectation of deflation, creating a vicious self-sustaining downward movement in prices. Although the inflation rate in Japan is still estimated at minus 0.2 per cent for 1999 as a whole, the fear of a deflationary spiral was reduced as a result of the ongoing easier monetary policies reinforced by a series of substantial fiscal stimulus packages.

The Bank of Japan's stated policy commitment is to maintain a loose policy stance until the threat of deflation disappears. Although real interest rates are relatively high given the deflationary tendencies, the very low nominal interest rates have imposed a limit on further easing of monetary policies. On the other hand, the amount of public debt has expanded rapidly so as to cause some concern in the financial markets, including through upward pressure on long-term interest rates, about the sustainability of a loose monetary policy. This is in addition to the "Japan premium" that financial sector companies have had to pay for external financial support on account of the impaired position of their balance sheets. A possible policy option in this context might be to monetize the government debt, with the Bank of Japan buying government bonds directly, together with setting a target growth rate for money supply or targeting a positive inflation rate. Thus far, the Bank of Japan has not embarked on this approach.

The inflation rate in New Zealand, which had averaged at around 2 per cent a year for most of the 1990s, fell to 1.3 per cent in 1998, despite a substantial decline in the New Zealand dollar exchange rate. Changes in consumer prices, standing at 2 per cent in 1999, were still within the target range of 0-3 per cent for inflation pursued by the Reserve Bank of New Zealand. Lower inflationary pressures from external sources, including some of the country's major trade partners, and weak domestic demand at the beginning of the year contributed to the maintenance of a low inflationary environment. Nevertheless, upward pressure was becoming more apparent from the second half of 1999, emanating largely from firmer prices for both commodities and oil products, and for such manufactured goods as information technology components.

Domestic sources of cost-push pressures remain benign, with wage rates (including overtime) growing at an annualized rate of only 1.5 per cent in the third quarter of 1999, while the rate of unemployment was at 6.8 per cent during the same period, the lowest level since the fourth quarter of 1997. However, there has been some upward pressure on

New Zealand's inflation in consequence of the steep rise in petrol prices in line with a sharp increase in world crude oil prices. While part of the impact was absorbed by the domestic petrol retailing industry, which is facing increasingly fierce competition, some "flow-through" effects on producer input prices remain, thus contributing to an increase in wholesale prices. The overall effects are as yet modest but some monetary tightening was nevertheless initiated in late 1999.

Between 1980 and 1989, New Zealand had experienced relatively high rates of inflation, averaging 9.9 per cent a year. However, the rate dropped to an annual average of 2.1 per cent between 1990 and 1998 after the Reserve Bank of New Zealand Act of 1989 established the legislative framework for inflation targeting, provided the Reserve Bank with a high degree of independence and specified price stability as its sole policy objective. The Bank then took a very strict approach to demonstrate its commitment to price stability and set the inflation target band for consumer price inflation at 0-2 per cent a year in the first half of the 1990s. Inflation fell to around 2 per cent in the early 1990s and has remained around that level since. However, a more flexible approach with a longer time horizon has been adopted since the mid-1990s, reflecting the increased credibility of the Reserve Bank's ability to control domestic prices and, at the same time, a concern over the impact of a strict monetary approach on the real economy and on other macroeconomic variables. The inflation target band was consequently widened from 0-2 per cent to 0-3 per cent in late 1996, and the policy horizon was extended from a strict one-year period to between six and eight quarters.

On the fiscal front, while a small surplus, the sixth in succession, is expected in the fiscal year ending in June 1999, a deficit is likely to emerge in the next two fiscal years; net public debt is also projected to rise temporarily. To limit the size of the fiscal deficit, the government has scaled back its three-year expenditure package announced in late 1996. Given a relatively high current account deficit and external debt, New Zealand has to be particularly concerned about inflation as even a mild upturn is likely to affect adversely the financial market's assessment of the sustainability of the macroeconomic balance. This, in turn, may cause volatility in both exchange and interest rates.

Trade and exchange rates

A higher deficit in the current account, from 5 per cent of GDP in 1998 to 5.7 per cent in the following year, is a major concern for the Australian economy. Such a deterioration was largely due to strong economic performance coupled with weak commodity prices in the first half of 1999, and generally lower export demand from Asia. Trade earnings declined by some 11 per cent, from \$62.9 billion in 1997 to \$55.9 billion in 1998, while imports showed only a slight decrease, from \$65.9 billion to \$64.6 billion during the same years (table II.20). Any improvement in the current account balance will very much depend on an increase in export growth, given the continued strong growth in domestic demand. The prospects of higher trade earnings are reasonably bright in the aftermath of the upturn in commodity and oil prices, and the economic recovery in most of Australia's major trade partners in Asia. In fact, the second half of 1999 saw an increase in Australian exports, reflecting mostly the

Table II.20. Developed economies of the ESCAP region: merchandise exports and imports in United States dollar value and their rates of growth, 1996-1999

	Value (millions of US dollars)	Exports (f.o.b.)					Value (millions of US dollars)	Imports (c.i.f.)				
		Annual rates of growth (percentage)						Annual rates of growth (percentage)				
		1998	1996	1997	1998	1999 ^a		1998	1996	1997	1998	1999 ^a
Australia	55 900	13.6	4.3	-11.1	-3.5	64 630	8.5	0.7	-1.9	3.8		
Japan	388 117	-7.3	2.5	-7.8	5.4	280 618	3.9	-3.0	-17.2	5.7		
New Zealand	12 071	5.3	-1.1	-15.0	2.4	12 495	5.5	-1.4	-13.9	10.9		

Source: United Nations, *Monthly Bulletin of Statistics*, January 2000.

^a January-September.

higher prices for non-rural exports, but the contribution to such trade gains from Asian economies remained weak. Earnings from resource-based exports rose by around 7.2 per cent in the third quarter of 1999 on account of both higher prices and volume, while those from service exports for the same quarter were around 5 per cent higher than in the previous year. Travel revenue showed strong recovery, growing at around 6.5 per cent on a quarterly basis, with the number of short-term arrivals fully recovered after an earlier fall. Visitor arrivals from the economies in crisis have improved somewhat but are still below the levels prior to the crisis; at the same time, a significant increase in arrivals from Europe and the United States has compensated for this shortfall.

Japan's overall current account surplus surged to \$120.7 billion (or 3.2 per cent of GDP) during 1998, compared to \$94.4 billion (2.2 per cent) the year before. The improvement was largely due to a sharp drop of 17.2 per cent in import spending as there was a decline in exports attributable to a striking fall in such demand, amounting to some 20 per cent, from ASEAN and the Republic of Korea. A needed impetus for the recovery of Japanese exports has come from the gradual recovery of the economies hit by the crisis in Asia, but the yen's appreciation against the American dollar significantly eroded such export competitiveness in 1999. There was a moderate expansion in exports to the United States, although trade earnings from EU and other regions declined. The steep decline in the merchandise trade surplus resulted in a lower current account surplus, which was estimated to fall by about 8 per cent to \$111 billion in 1999 from \$121 billion in 1998. The current account surplus in yen terms, however, fell by 16.5 per cent (to 8.3 trillion yen) on a year-on-year basis for the period January-August 1999. Another contributing factor to this lower surplus was a contraction, again in yen terms, in investment income from overseas because of the appreciation of the yen.

The widening current account deficit in New Zealand continues to be the major concern in an otherwise positive economic outlook. The deficit rose to \$NZ6.3 billion (or 6.3 per cent of GDP) for the year ending in the second quarter of 1999; it is estimated to reach 7.2 per cent of GDP for the whole year. On the trade front, a deficit was recorded in June, the first time in 13 years. Heightened concerns over the patterns of merchandise trade and the current account deficit contributed to a fall in the exchange value of the New Zealand dollar.

Apart from a fall in exports to Asia, the worsening deficit can be attributed to a higher expansion of imports than exports, reflecting strong domestic demand, including Y2K-related demand for computer equipment and higher oil prices. For instance, a surge in import spending in the third quarter of 1999 more than offset the increase in export earnings, despite the recovery in the volume and price of some exports in the same period.

At the same time, the higher receipts from increased tourist arrivals from Europe and North America were outweighed by a larger income outflow, including the repatriation of profits by foreign firms and the servicing of higher levels of private sector debt by domestic firms. The deterioration of the current account deficit also reflected the large profits made by foreign companies operating in New Zealand. These disparate income trends are expected to continue over the medium term.

Capital inflows and outflows

A chronic current account deficit, which can be attributed to a substantial outflow of net income payments associated with a high level of net foreign investment and loans, developed in Australia over the past decade. Coupled with a relatively low domestic savings rate, this trend constitutes one of the major areas of policy concern for the country, which otherwise has been enjoying a sustained period of strong economic growth. Australia's net foreign debt in national currency terms fell in the second quarter of 1999 to 38.4 per cent of GDP, from just under 40 per cent in the previous quarter, owing to the firming of the exchange rate and a slight decline in borrowings. However, the net foreign debt jumped by nearly \$A10 billion in the third quarter of 1999. This debt surge was caused by additional borrowings, as well as a slight deterioration in the exchange rate of the Australian dollar.

Foreign investment by Japanese companies more than doubled to 5,452.6 billion yen (\$46 billion) during the six months from April to September 1999, compared with the level of the corresponding period in the previous year. The largest single share (34.9 per cent of the total, or 1,902.3 billion yen) went to the United States, and European countries as a group attracted 39.7 per cent (2,163.9 billion yen). The relative share of Asia in Japanese FDI stood at 9.1 per cent (or 498 billion yen), with Singapore, Indonesia and Thailand being the top recipients of such resources.

The latest trends underline the prolonged economic recession, the difficulties encountered by Japanese-affiliated manufacturing companies in Asian countries hit by the crisis, and recent problems within the financial industry. These have triggered a radical restructuring of Japanese firms and have consequently led to a significant increase of investment in Japanese affiliates overseas. At the same time, during 1999 Japan experienced a surge of inward overseas investment in response to the ongoing restructuring of the corporate sector and policy deregulation, particularly in the automotive, financial services and telecommunications sectors. From April to September 1999, for example, FDI inflows soared to a record 1,330 billion yen (\$13.2 billion), an amount nearly equal to the full-year record of 1,340 billion yen registered in the year to March 1999. The bulk of such capital (89 per cent) was for acquisition purposes.

In 1998, the Government of Japan announced a \$30 billion aid package (the "New Miyazawa Initiative") for Asian countries hit by the crisis; this took the form of short-term financial support, bond guarantees and currency support designed to ease the credit crunch affecting the entire region. A second stage of this initiative, announced in Japan in May 1999, includes a guarantee scheme to mobilize up to 2 trillion yen of domestic and foreign private sector funds for Asia; this further underlined the government's firm commitment to take a leading role in the stabilization of Asian economies.

New Zealand's chronic current account deficit remains a major focus of policy attention. The deficit stood at \$3.2 billion in 1998 (6.1 per cent of GDP), though this was an improvement compared with the deficit of \$4.7 billion (7.3 per cent of GDP) in 1997; it was still very high. This led to a large accumulation of overseas debt, to over 100 per cent of GDP in 1998 and to an estimated 103 per cent of GDP in 1999. The latter figure, however, embodies a degree of stabilization of the external debt after a 25 per cent increase in its volume between March 1997 and March 1999. The increase in total debt was primarily on account of higher corporate sector debt, which more than negated a slight decrease in public sector debt, thanks to an operating budget surplus during the last few years. The rising level of private sector indebtedness, in turn, reflected the inadequacy of domestic savings in relation to domestic demand for financing. This large external imbalance carries with it a potential risk of shifting market sentiment,

leading to an increase in the risk premium of foreign debt and downward pressure on the exchange rate. However, such risks remain small on current indications.

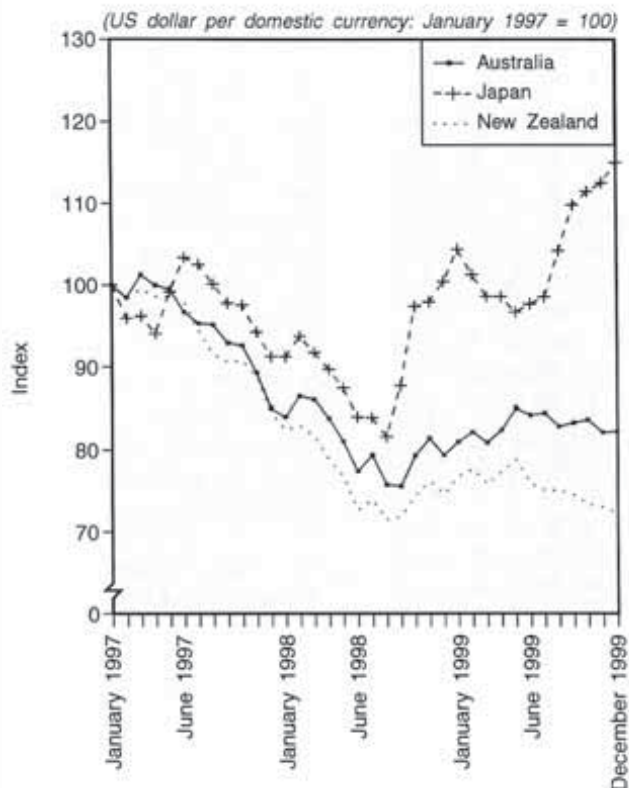
The country had experienced a relatively steady volume of inward FDI, totalling around \$2.5 billion a year during the 1980s and early 1990s; such inflows declined sharply to \$1,160 million in 1998. It is currently not certain whether this fall was a one-time phenomenon associated with recent developments in the international financial markets, or whether it represents a more long-term unfavourable trend in an increasingly competitive global environment for external capital resources.

Financial sector developments

In Australia, corporate lending rates remained at historically low levels in 1999; the Reserve Bank had reduced the base lending rate to 4.75 per cent in December 1998, the sixth successive cut since July 1996. Intense, speculative selling of the local currency against the United States dollar had been evident in 1998; several other countries experiencing similar pressures were forced to raise interest rates in response. The Reserve Bank, however, chose to intervene in the foreign exchange market, while maintaining a low interest rate regime throughout to sustain the domestic growth momentum in the wake of the Asian crisis. With increasing signs of recovery in most of the economies hit by the crisis and an upturn in commodity and oil prices, the exchange rate recovered from a low of \$A1.78 against the United States dollar in late August 1998 to around \$A1.49 in early July 1999 (see figure II.10). The Reserve Bank subsequently reversed its expansionary monetary stance and increased the discount rate in November 1999 to pre-empt any incipient inflationary pressures and, at the same time, to ensure some parity following the trend of monetary tightening in the United States.

In the banking sector, there has been heavy pressure from banks to relax the official ban on a merger involving the largest four banks in Australia. In December 1998, the government ruled out any relaxation of policy on the grounds of inadequate competition in the small business loan market. Besides, the ban reflects public opposition and fears that banking mergers would lead to a decline in the quality of services and possibly to higher costs. On the other hand, the ongoing international trend

Figure II.10. Index of exchange rates of developed economies in the ESCAP region, 1997-1999



Source: IMF, *International Financial Statistics*, various issues.

towards consolidation in the financial services industry poses a formidable challenge that will need to be addressed in the future. Australian banks are not major players in the international or regional markets for financial services; the merger ban could further constrain their ability to become active participants in a crucial industry.

Following the financial sector reforms announced in Australia during 1997, a new regulatory structure has been in operation consisting of three agencies: the Reserve Bank, the Australian Prudential Regulation Authority, and the Australian Securities and Investments Commission. These agencies are responsible for safety, stability and the settlement of payments, and for conduct and disclosure across the financial system. The new institutional framework was put in place because the boundaries between financial instruments and institutions were becoming blurred owing to rapid

changes in the nature and scope of financial sector instruments and activities. The Australian Prudential Regulation Authority, for example, has conducted prudential supervision of banks, as well as other financial institutions, since July 1998, and its board has wide authority to set rules for the financial sector. The integration of the state-based agencies is expected to provide a better environment for more timely review and reorganization of various aspects of prudential supervision and perhaps for even more active pursuit of financial sector reforms.

In Japan, the serious problems of bad debts have continued to have a negative impact on activities in the real economy through a tightening of loans and credit to companies, in particular SMEs, for which banks have traditionally served as a major source of finance. Thus, financial sector policy has focused largely on strengthening the capital base of domestic banks. Facilitated by financial sector

deregulation, the capital market and foreign banks have played a greater role in the provision of finance to the domestic economy. Significantly, such deregulation has led to the merger of several domestic banks in order to achieve enhanced efficiency through economies of scale.

After the nationalization of two major banks and the incidence of one bank insolvency in Japan during 1998, nine other major banks announced their intention to merge into four banks by early 2000. Among them were the merger between Sakura Bank and Sumitomo Bank with combined assets of 102 trillion yen (\$950 billion) and the fusion of Dai-ichi Kangyo Bank, Fuji Bank and the Industrial Bank of Japan. The latter will result in a megabank with 141 trillion yen (\$1,330 billion) in assets. However, these prospective alliances appear to be largely defensive in nature rather than inspired strategic moves with a growth objective.

The long-term impact of these merged banks in Japan remains to be seen since it is not merely size but the quality of credit appraisal and the rationalization of costs that need priority attention. Nevertheless, the emerging alliance of major banks may have considerable implications for the other sectors of the domestic economy. It may loosen the long-standing *keiretsu* (business) links between companies and banks. The merger of banks may also mean an expansion of the client base in the individual business sector, given the corporate tradition of obtaining finance through the "main banks". For example, the planned merger of Dai-ichi Kangyo Bank, Fuji Bank and the Industrial Bank of Japan means that four of the five largest steel manufacturers and half of Japan's large construction companies will seek loans from the merged bank. In principle, this should enable the new entity to judge more effectively the profitability and creditworthiness of different firms in the same sector. Nevertheless, the new bank might decide to discriminate between potential borrowers in practice, thus giving rise to different or diverse financing costs for similar firms operating in the same sector.

While Japanese banks have had to struggle with bad debt problems for almost a decade, the gradual penetration of foreign banks in the domestic financial markets continues and foreign banks in Japan are enjoying explosive growth thanks to the deregulation. For example, total assets stood at 55.3 trillion yen (\$465 billion) in 1999 against 621.4 billion yen (\$4.7 billion) in the previous year.

The government's recapitalization programme has gradually brought about some improvement in the bad loan problem in Japan. Nevertheless, the Financial Supervisory Agency has estimated that the outstanding bad loans in the Japanese banking system were close to 90 trillion yen, or around one fifth of GDP, as of March 1998. About half of the total is held by 17 major banks, and the bad loans are equivalent to some 12 per cent of their total loans outstanding. Among the several measures introduced for resolving the problem debt is the creation, from two previous loan disposal agencies, of a new Resolution and Collection Corporation with stronger powers to acquire bad loans from solvent as well as failed banks. Legislation has also been introduced to facilitate the setting up of special-purpose mechanisms for securitizing loans backed by real estate and for allowing tax deductions of debt forgiveness in connection with comprehensive restructuring agreements.

Other significant measures include the bank reform bills which allow the government to nationalize insolvent banks and recapitalize weakened but solvent institutions through the injection of public funds. Under the financial stabilization plan, some 60 trillion yen (or as much as 12 per cent of GDP) is available for the nationalization of bankrupt banks (18 trillion yen), the recapitalization of weak but viable banks (25 trillion yen) and the protection of depositors (17 trillion yen). The framework for financing and debt guarantee has been expanded through an allocation of 20 trillion yen to guarantee SME loans obtained through local credit guarantee associations. Of this amount, some 14 trillion yen had been used by March 1999; the scheme contributed to a sharp reduction in the number of bankruptcies.

In response to heavy criticism from the public, the government has attempted to curb the growth of "loan shark" financial institutions which have charged borrowers, usually SMEs, interest rates of as much as 40 per cent on loans. Such extortionate interest rates coupled with questionable and harsh means of collecting repayments underline the severity of the credit crunch affecting these enterprises. But, ironically, these practices have led to an outstanding record of profitability of the unregulated financial institutions and this has, in turn, attracted domestic as well as overseas investment in their operations. The Japanese authorities have recently lowered the upper ceiling on interest to 29.2 per cent per annum from 40 per cent and have introduced punitive clauses for violators.

Meanwhile, the Japanese monetary authorities have maintained a liberal policy stance with the official discount rate remaining at the historically unprecedented level of 0.5 per cent since 1995. The uncollateralized overnight call rate was gradually reduced from more than 8 per cent in 1991 to 0.25 per cent from September 1998. The slow improvement in the creditworthiness of Japanese banks, despite this extremely accommodating interest rate, is partly attributed to their continued lack of access to additional capital. Deteriorating asset prices have also reduced their capital-to-assets ratios, forcing them to cut back on loans so as to comply with the standards of the Bank for International Settlements and rebuild their balance sheets. Under such circumstances, Japanese companies have been forced to seek alternative sources of funds, including through the sale of equity stakes or business divisions to foreign investors, and through an increase in capital market intermediation as embodied, for example, in a surge in equity issuance in 1999. By the end of November 1999, \$65.1 billion had been raised through the equity market by Japanese companies.

New Zealand's external debt, amounting to over 100 per cent of GDP in 1999, is largely (about 80 per cent) held by the private sector. The associated risks for financial institutions, however, appear to be small under the current circumstances. About half of the external debt is denominated in foreign currency and most of it is well hedged, given the country's experiences for an extended period with floating exchange rates and volatile interest rates. Thus, the banks themselves carry very little exchange rate or interest rate risk on their balance sheets. The capital ratios of banks are well above BIS standards and impaired assets amount to less than 1 per cent of the loan portfolios. The latter represents a striking decrease from the 9 per cent prevailing at the beginning of the decade. While short-term loans comprise around 40 per cent of the external debt, the country is unlikely to face difficulty in rolling over credits. This is because around two thirds of the short-term external debt consists of loans from foreign banks to their subsidiaries in New Zealand. The strong financial position and the international reputation of the foreign parents, as well as the fact that loans held by subsidiaries constitute a small proportion of global assets, are among the considerations which would encourage them to come to the rescue of their subsidiaries should such a need arise.

Since the financial reforms in 1980s, New Zealand's monetary conditions have been measured by the Monetary Conditions Index, which combines the weighted average of short-term interest rates and the trade-weighted index of the New Zealand dollar. Monetary policy has thus been conducted through periodic announcements about the desired level of the Index, as well as through official comments about the actual level of the Index. In March 1999, the Reserve Bank introduced the official cash rate system, an arrangement similar to the regime applied in many other developed countries. The Reserve Bank is to review the impact of external shocks, including any exchange rate depreciation, to achieve the targeted inflation rate of 0-3 per cent. The new regime is expected to be a more effective tool in the face of exchange rate volatility. It is also intended to provide clearer and more timely signals from the monetary authorities of their policy intentions vis-à-vis the domestic economy as well as overseas financial markets, given the close linkages between the official cash rate and other short-term interest rates as well as financial asset prices, and the comparability of the regime with those in other overseas financial markets.

After its introduction, the official cash rate was initially kept at 4.5 per cent; however, it was increased to 5 per cent in November 1999 in response to the recovery of most of the economies in Asia hit by the crisis and indications of continued domestic growth. The potential for an increase in inflationary pressures and their impact on other major macroeconomic variables thus came into sharper focus. The Reserve Bank's official cash rate influences short-term wholesale rates, mortgage rates and business lending rates, making borrowing and investment decisions much more sensitive to the official view on monetary developments. Its efficacy in a period of volatility, however, needs to be seen and tested over an extended period of application.

Policy issues and responses

The Australian economy not only weathered the Asian crisis, but also flourished, and the major challenge now is to maintain the momentum of economic growth while maintaining macroeconomic stability. A low savings rate has been the principal reason for the country's chronic current account deficit, and the government has yet to come up with

any definitive policy package to encourage domestic savings and reduce dependence on external sources of finance. A compulsory superannuation scheme introduced in the early 1990s has had no significant effect on personal savings thus far, since the required contributions are made by employers, rather than employees. Plans to amend this scheme in 1997 were abandoned in favour of a tax scheme, which is again to be abandoned in a move to overhaul the system of indirect and personal income taxes. The new tax bill approved in June 1999 includes the introduction of a more broad-based 10 per cent goods and services tax from July 2000, plus substantial cuts in personal income tax; there are also higher welfare payments to compensate for increases in the cost of living related to the new goods and services tax. Thus, there is to be a rebalancing between direct and indirect taxes and between revenue and expenditure to improve both supply-side and work incentives.

The policy focus in Japan is to nurture and transform the economic recovery, initiated by a succession of large fiscal stimulus packages, into broad-based and self-sustaining growth. This, however, involves the restoration of deeply impaired business and consumer confidence, a difficult issue for which there are few clear-cut policy options available, as well as persistence with ongoing restructuring and reform of the corporate and financial sectors. Indeed, the government has borne the brunt of this huge task in the past several years. The major deterioration in fiscal performance that has occurred in the process has consequently been relegated to the background. Given the pressing needs to nurture the process of economic recovery, heavy public expenditure is inevitable for the immediate future. Government gross debt was equal to 110 per cent of GDP in 1999, the highest among the developed countries. The operating budget deficit increased to 7.3 per cent of GDP in 1999, from 5.3 per cent in 1998 and 3.4 per cent in 1997.

More than \$1,160 billion has been spent in nine major stimulus packages since 1992, and another economic stimulus package worth \$171 billion (18 trillion yen), was announced in November 1999. The measures for "economic rebirth" include large spending on public works, credit guarantees for SMEs and resource allocations for retraining in response to increasing structural unemployment and the ongoing corporate rationalization, as well as for funding premiums for the elderly needing long-term nursing care. Along with the promotion of corporate

restructuring, the government has indicated its support for new businesses in order to generate additional employment opportunities. There is also a new policy focus on the promotion of labour mobility for new and growing businesses, instead of on the maintenance of a stable labour market with lifetime employment. The remarkable success of the United States economy in generating a substantial level of extra employment in the new, high technology industries has provided a model that the Japanese authorities would like to replicate, but, for the time being, the policy options available remain largely restricted to higher public spending. The draft budget submitted in December for the next fiscal year (starting in April 2000) proposes yet another increase of 3.8 per cent in public spending.

In New Zealand, the main policy challenge in the medium term is to ensure an improvement in the fiscal position and an increase in the savings rate. In the last few years, the government has been running an operating surplus, with a peak at around 3.3 per cent of GDP in 1995. The budget is expected to run a small surplus of 1.1 per cent in 1999; this is compared to a surplus of 2.4 per cent realized in the previous year. The earlier surplus enabled the government to reduce its debt to 32.3 per cent of GDP in 1998. This is a significant improvement from a debt level of 45.8 per cent of GDP in 1995 and a low figure in comparison to those of other developed countries. However, the aim of the 1998 budget to reduce net public debt to below 20 per cent of GDP by mid-2001 has been delayed by a deterioration in the fiscal situation. A reversal of this situation is an important policy objective in the short to medium term.

Like many other developed countries, the shifting demographic structure of New Zealand towards an ageing population is expected to create substantial pressure on the fiscal position through the heavy local dependence on the state pension scheme. The 1996 census forecasts of a doubling in the numbers of the elderly (65 years and over), from 427,000 in 1996 to 959,000 by 2031, imply that the ratio of working age people to every person over 65 years will fall from the current 5.6 persons to 2.8 in 2031. This demographic transformation will cause an enormous increase in public expenditure related to health and pensions. This is not an urgent policy issue as yet, but the huge magnitude of the potential problem suggests the strong need for weighing sustainable funding options for pensions and health care in the coming decades.

INTRODUCTION

Social security and safety net programmes are crucial to ensure that various segments of the population have reasonable access to minimal income and basic social services in the event of diverse contingencies such as involuntary unemployment, old age or sudden economic crisis. Policy makers in the region have always considered it important that such programmes should be set up either directly by governments or by the private sector with the active encouragement and support of government. This concern has been reflected in a wide variety of programmes in many areas: medical care, unemployment, emergency relief and poverty alleviation. However, the coverage of these programmes has not been comprehensive and implementation modalities have varied considerably across countries and over time.

Expansion of the coverage and the more effective implementation of social security and safety net programmes have been the focus of heightened attention in recent years. Several factors have contributed to this development. A more forceful demand for such programmes is being increasingly articulated by different cross-sections of society, including NGOs. The shift in development strategies in favour of openness to the global economy, liberalization, deregulation, privatization and fiscal prudence has entailed greater vulnerability for large segments of the population. And, more recently, following the Asian economic crisis, many governments were caught unprepared to deal with the scale and the intensity of social deprivation resulting from increased unemployment and aggravated poverty. In part, this was because of inadequate attention to the social aspects of development in the past. In several countries hit by the crisis, the growth of public expenditure on social sectors over the decade ending in 1997 barely kept pace with or indeed fell considerably short of growth in GDP during the same period.

The main objective of this chapter is to review the salient features of social security and safety net schemes currently in force in various developing ESCAP member countries and to bring out a number of policy issues and options that could help to improve the design and implementation of social security measures and safety nets. The analysis is confined to social security and safety net programmes in three main areas of almost universal concern: unemployment, old age, and health care and maintenance. Given the wide range of programmes being implemented in different countries, only a limited number of programmes are examined (see annex). To the extent possible, the operations of similar arrangements for the unorganized sector will also be discussed, in view of the overwhelming importance of this sector in many countries in the region.

CONCEPTS AND MODALITIES

Some conceptual issues

Social security and safety nets are part and parcel of social development, a process which serves to widen and deepen people's access to basic needs as a precondition for sustainable human development over time. Conceptually, they are based on the universal premise that societies should accept some responsibility for those members who are unable to meet the minimal requirements of life with dignity. It is natural for some members of any society to experience periods of reduced or non-existing work capacity (in childhood and old age) as an inevitable part of the normal life cycle. There are times when the available capabilities for work cannot be used properly, for instance during illness or temporary unemployment. Distressing situations may also arise when the return from labour is low (for example, owing to crop failure caused by drought or excessive rain), or when unforeseen needs emerge

(for example, following the destruction of dwellings during a natural disaster). Some members of society are not capable of finding gainful employment throughout their life cycle and are thus permanently unable to meet their basic needs. Any society has to provide a certain degree of security for all these groups.

A distinction is sometimes made between social security and safety nets. According to one view, social security refers to the protection which a society provides for its members, mainly through a number of public measures, against the economic and social distress that would be caused by stoppage or substantial reduction of earnings resulting from a variety of uncontrollable economic and social eventualities such as sickness, unemployment and old age. The target beneficiaries include employees, retirees and other persons who are unable to work for some reason. Not all of them are necessarily poor. Social safety nets, on the other hand, are designed to play both a redistributive and a risk-reduction role. The former function is to reduce the impact of poverty on the poor and disadvantaged social groups who are often found to be incapable of pursuing gainful employment owing to lack of education, training and financial resources, among other reasons. The risk-reduction role is to protect individuals, households and communities against uninsured income and consumption risks.¹ In practice, the distinction becomes blurred, particularly because the so-called social security programmes contain certain elements of redistribution as well. For the purpose of analysis in this chapter, no distinction is made between the concepts. The focus is on specific programmes.

A distinction can also be made among social security and safety net programmes on the basis of whether they are formal or informal mechanisms. A major common denominator in most, if not all, of these programmes is the creation of collective pools that make it possible for a large number of persons to share the benefit arising from each other's efforts and contributions. An informal method of organizing

and then sharing a resource pool exists under family systems whereby several generations could be living together and supporting each other. Family members receive security and protection through an inter-generational transfer of resources (from working middle-aged members to children and the aged) and through a lateral sharing of resources between working members as well. As regards formal schemes and programmes, at one extreme the fruits of labour of all citizens are put together by the state and the resources so pooled are redistributed according to individual needs, as is done under a socialist system. At the other end of the spectrum, the pure market model exists in which the allocation of resources (to meet consumption needs when gainful income-earning activities cannot be pursued) takes place through mutually agreeable financial arrangements between individuals and financial intermediaries (banks, insurance companies) or employers. The programmes examined in this chapter are mostly formal in nature with some involvement of the state in the form of facilitating legislation or some measure of financial support.

One reason for the focus on formal programmes is their increasing importance. However, the informal, family-based system has been an important instrument of redistribution of resources among or within households, regardless of whether this takes place on an inter-generational basis or not. Under this system, the pertinent benefits and the modalities are not usually specified in advance or standardized. The family system, as a means of ensuring social security for all members, can work well in an environment where the majority of working family members participate in common income-earning activities (including self-employment in agriculture or other activities). In this situation, there is a greater probability that all family members will stay in localities close to each other.

The importance of formal systems tends to increase over time with economic growth and structural transformation. There is a natural break-up or weakening of family ties as many working-age members migrate to cities where there is a concentration of manufacturing and other activities, and hence job opportunities. The proportion of the workforce engaged in formal jobs tends to rise while the risk and uncertainties associated with formal jobs tend to

¹ World Bank, "What are safety net programs?", web page on safety nets <www.worldbank.org/poverty/safety/index.htm> (11 November 1999).

be higher. Governments and societies thus become obliged to ensure the protection of a minimum living standard through predetermined, formal arrangements during sickness, long periods of unemployment due to economic slowdowns, and retirement at old age.

To some extent, the increasing importance of formal systems can be attributed to the advocacy role played by international institutions, particularly ILO, which has long been advocating formal social security arrangements. Most countries have endorsed the Declaration of Philadelphia concerning the aims and purpose of ILO adopted in 1944 and have ratified a number of international labour conventions, including the Social Security (Minimum Standards) Convention of 1952 (No. 102). That Convention stipulates that protection should be extended to the large majority of workers and their families so as to prevent extreme hardship in the case of accident, sickness, old age and other exigencies. The main types of benefit include medical care and sickness benefits, unemployment and employment-related injury benefits, and benefits for old age, maternity, invalidity, family members and surviving spouses. Broad suggestions are also made in the Convention for the financing of these benefits from the contributions of both employees and employers. The responsibility for designing a social security system and for ensuring its implementation is considered a state mandate. By the mid-1990s, 146 countries throughout the world provided some form of formal social security compared to just 50 countries in 1950.²

Approaches and modalities

A large number of formal social security and safety net arrangements are now in operation embodying one or a combination of four broad approaches: universal entitlement (such as free medical care in public hospitals), social insurance (such as a contributory pension schemes), public assistance (such as a free health card for the poor)

² *Sustaining Social Security* (United Nations publication, Sales No. E.97.IV.3), p. 25.

and market-based access through privately run schemes (for example, various group insurance schemes). These approaches can be financed in different ways. The various ways of financing them and the benefits associated with them, of course, directly affect the participants but also have certain macroeconomic implications (box III.1).

The provision of universal entitlement rests on the perception that social services are public goods and should be available and accessible to persons who need them irrespective of their economic status and other considerations. Under the schemes of universal entitlement, delivery of social services is normally organized by government agencies and institutions, and their costs are funded from government revenue.

Social insurance is a modality to pool individual risks and is widely used to cover a large variety of contingencies, including loss of income and impaired welfare due to sickness, industrial accidents, old age, disability and unemployment. Under social insurance schemes, the benefits of the insured are often not wholly dependent on the amounts of contribution. An element of redistribution is evident in most social insurance programmes. In addition, they often involve contributions from employers and the state.

The provision of social security through public assistance is normally directed to the "deserving poor", with the target beneficiaries having to undergo some form of means test or other qualifying requirements.³ The coverage is necessarily selective and the costs are largely underwritten by governments.

Among the private sector schemes for the provision of social security for their contributors, group insurance is most widely used to guard against a variety of risks (including sickness and accident). Market-based pension schemes underpinned by private savings have also gained in popularity in recent years.

³ *Causes, Characteristics and Consequences of Poverty: Reasons for and Modalities of the Use of Targeting in Selected Poverty Alleviation Programmes in the ESCAP Region* (ST/ESCAP/1591).

Box III.1. Macroeconomic implications of social security

In general, social security and safety net schemes can be funded from budgetary revenue, from voluntary individual savings (whether or not supplemented by contributions from employers), and from compulsory contributions from employees and employers. The approaches and modalities involved in implementing these schemes, as well as the benefits associated with them, are diverse. The design of these schemes can have significant macroeconomic implications. One of the macroeconomic issues which has received a great deal of attention is the impact of social security financing for the old and retirees on aggregate domestic savings. Under pay-as-you-go (payroll tax) financing systems, forced individual savings through mandatory social security contributions are accumulated over the working life to pay, at least partially, for old age and retirement benefits. This arrangement could potentially increase aggregate savings under certain circumstances. In particular, if young people have a high propensity to consume out of their current income, mandatory contributions could lead to a reduction in their overall consumption with a positive impact on the national savings rate. On the other hand, the assurance of large transfers when people grow old may encourage higher consumption, reducing the national savings rate in the process. Consumer expenditure surveys and other data from the United States, for example, show that large social insurance transfers to the elderly tend to raise consumption, and this accounts for much of the observed decline in national savings.^a

In a fully funded scheme, the accumulated savings of a working individual are used to create a personalized fund as an old age pension or a lump-sum payment on retirement. Under such schemes, the overall rate of savings of the working population is likely to rise as future financial benefits are directly linked to the contributed amount. In fact, the forced savings for the provident fund have been identified as a significant factor behind the very high national savings rates in some countries, especially Malaysia and Singapore.

Another macroeconomic issue of relevance to social security has to do with implications for price stability and investment opportunities. In order to generate support for social security, it is important to ensure that accumulated contributions generate safe and reasonable rates of return in real terms. This requires the pursuit of a low inflation policy to protect the purchasing power of future accumulated savings. Old age benefits may have to be provided over long periods after retirement. In addition, the economy has to provide opportunities for profitable investment of accumulated contributions without incurring undue risks.

^a *Sustaining Social Security* (United Nations publication, Sales No. E.97.IV.3), p. 80.

If the social security operations are financed from general tax revenue, the extent of benefits provided depends on the capacity to raise tax revenue. Increases in the benefits provided would automatically lead to a corresponding need to raise additional tax receipts.^b Alternatively, an unpalatable and eventually unsustainable outcome would be a higher budget deficit and may be tantamount to the financing of social security benefits through an "inflation tax". There would then be an erosion in the purchasing power of the nominal benefits giving rise to demands for further increase in nominal benefits.

In the case of social insurance, typically financed by the contribution of both employers and employees, larger contributions from the employees could lead to a demand for higher wage rates. Any additional social security contributions levied on employers would directly increase operating costs. These could result in more expensive labour and higher prices of goods and services. This, in turn, might cause a loss of international competitiveness. The evidence for this remains inconclusive. Some countries have high social charges, but remain competitive; others have low social charges but are not as competitive; still others display both high social charges and uncompetitiveness.^c

A persistent problem confronting many social security systems is a variety of moral hazards, especially if the available benefits are "overgenerous", or if the replacement ratio is high and of long duration.^d These problems are often most apparent in labour markets where the availability of generous unemployment and other benefits may encourage many of those out of work to remain unemployed. Liberal old age benefits could provide an incentive to opt for early retirement in certain circumstances. Insurance schemes are also not completely free from "ex ante" moral hazard issues. As people insure themselves against certain damages, their interest in preventing damages could be lessened. Cost-sharing stipulations and increased premiums or higher contributions on repeated claims are among the options to minimize this particular problem.

^b Universal entitlements are always financed from government budgetary resources. Under a pay-as-you-go framework of social insurance, the shortfall between the sum total of current contributions by employers and employees and the sum total of benefit payments due to the retired workers has ultimately to be borne by the government. Obviously, such shortfalls will have to be borne by general tax revenue.

^c *Sustaining Social Security...*

^d In the case of unemployment benefits, the replacement ratio could simply be defined as the ratio of income of an individual which he would receive during the period of unemployment to the income when he was employed.

SOCIAL SECURITY AND SAFETY NETS AGAINST UNEMPLOYMENT

Overview

The primary objective of various programmes in this context is to provide income protection during periods of involuntary job loss in order to preserve a minimum standard of living and well-being and, by extension, social stability and cohesion. In the Asian and Pacific region, unemployment benefit systems with relatively generous provisions are in place in Australia, Japan and New Zealand. Regional developing economies with unemployment benefit programmes for employees in the organized sector of the economy include China; Hong Kong, China; Mongolia; and the Republic of Korea. The Islamic Republic of Iran has introduced a scheme for the benefit of dismissed workers. A few other countries (for example, Bangladesh, India and Pakistan) have employer liability legislation under which workers of the organized sector are entitled to severance or retrenchment payments on termination of employment. Generic employment-intensive construction programmes and income-protection insurance schemes have also been used as substitutes for formal unemployment benefit programmes. Some public assistance schemes are targeted at workers of the unorganized sector of the economy during spells of unemployment or periods of reduced or no income.

In general, there are only a few institutionalized systems for unemployment benefits in the Asian and Pacific region. The absence of extensive unemployment insurance coverage and the inadequacy of legislated employer liability for severance payments can cause a rapid fall in personal income leading to a severe social crisis. This was clearly visible in the wake of the recent financial and economic crisis in Asia, which caused an abrupt and significant increase in unemployment rates in the countries affected by the crisis, especially in 1998 (table III.1). The unemployment insurance scheme of the Republic of Korea was rapidly expanded in response to the steep increase in unemployment in 1998.

Generally, however, institutionalized schemes are mostly applicable to employees of the non-agricultural, urban sectors, but non-agricultural employees often constitute only a small part of the total workforce. The agricultural sector still employs a large number of persons who are considered self-employed and these therefore remain outside many formal unemployment benefit schemes. In addition, employees constitute only a part of the workforce engaged in non-agricultural sectors (table III.2) and even among employees of the non-agricultural sectors, only those who work in registered establishments which comply with certain regulations are covered by formal schemes. Thus, there is a considerable segment of residual workers and the self-employed who are not covered by any form of social protection during periods of unemployment.

Table III.1. Unemployment rates in selected developing economies in East and South-East Asia affected by the crisis, 1990-1998

(Percentage)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Hong Kong, China	1.3	1.8	2.0	2.0	1.9	3.2	2.8	2.2	4.7
Indonesia	2.5	2.6	2.7	2.8	4.4	7.2	4.9	4.7	5.5
Malaysia	5.1	4.3	3.7	3.0	2.9	2.8	2.5	2.6	4.9
Philippines	8.1	9.0	8.6	8.9	8.4	8.4	7.4	7.9	9.6
Republic of Korea	2.4	2.3	2.4	2.8	2.4	2.0	2.0	2.6	6.8
Thailand	2.2	2.7	1.4	1.5	1.3	1.1	1.1	0.9	5.3

Source: ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999).

Table III.2. Percentage distribution of the economically active population in the non-agricultural sector by status in selected countries of the ESCAP region, various years

	Year	Employers and own account workers	Unpaid family workers	Employees	Not classifiable by status
Australia	1993	12.1	0.5	76.4	11.0
Bangladesh	1989	34.8	27.2	24.7	13.2
Cook Islands	1976	4.9	7.5	81.4	6.2
Fiji	1976	9.4	1.4	76.6	12.6
India	1971	34.1	9.1	56.8	0.0
Indonesia	1992	37.8	9.7	47.4	5.0
Iran (Islamic Republic of)	1986	24.0	1.1	51.9	23.0
Japan	1993	10.0	4.3	82.8	2.9
Malaysia	1990	15.6	4.8	79.5	0.0
Maldives	1990	29.2	3.1	60.9	6.8
Nepal	1976	48.6	8.8	42.6	0.0
New Zealand	1992	14.0	0.6	73.6	11.8
Pakistan	1993	30.9	7.1	50.6	11.3
Philippines	1993	25.7	4.0	55.1	15.2
Republic of Korea	1993	22.4	6.3	68.0	3.3
Samoa	1981	4.3	1.3	93.4	1.0
Singapore	1993	12.3	0.9	84.2	2.7
Sri Lanka	1986	17.1	4.0	55.9	23.0
Thailand	1990	23.4	10.9	58.2	7.5

Source: ILO, *Yearbook of Labour Statistics*, various issues.

The salient features of several formal arrangements currently in operation are presented below.

Salient features

Through legislative action, governments have played the primary role in creating programmes which provide unemployment benefits, and often in administering them. In addition, governments often provide subsidies and explicitly underwrite the financial viability of the schemes. The pertinent social insurance programmes are financed either from contributions of both employees and employers (China, Republic of Korea) or of employers only (Islamic Republic of Iran). The employee's share in such contributions, wherever applicable, is kept relatively low.

Another major feature is the limited and closed-end nature of the amount of unemployment benefits payable to the insured persons on their

involuntary dismissal (Islamic Republic of Iran, Republic of Korea). The stipulated contribution of an employee and the employer to the various schemes is based on the employee's monthly earnings (which vary considerably between employees). The amount of unemployment benefit is sometimes a fixed percentage of the current minimum wage rate, which is fixed by the government. Such limitations on entitlements serve to reduce the financial strain on insurance systems. The systems may, nevertheless, have a built-in mechanism to ensure some degree of equity in the payments. The replacement ratio, defined as the ratio of the unemployment payment to wage earnings during the period of employment, tends to be higher for low-income employees than their high-income counterparts. In the Islamic Republic of Iran, the level of unemployment payments is greater for employees with dependants, reflecting the higher needs of such employees.

The duration (counted from the day of dismissal) of unemployment benefits shows wide variation, ranging from two months (Republic of

Korea) to two years (Islamic Republic of Iran). In addition to the period of insurance coverage, the duration of unemployment payments is also dependent on age (Republic of Korea) and dependency status (Islamic Republic of Iran). An explicit imputation of the different needs among the unemployed workers concerned in calculating benefit is a redistributive feature of the social insurance schemes for unemployment.

To address the issue of moral hazards, certain additional eligibility conditions have been specified to encourage the unemployed to return quickly to the labour market. Examples of such conditions are compulsory registration and regular reporting at the employment office; declared capability of and availability for work; demonstrated efforts and active search to obtain a job (China, Islamic Republic of Iran).

Employer liability schemes have been used in Bangladesh, India and Pakistan to provide very modest, one-time financial payments by employers to their dismissed workers. While the level of such benefits cannot be compared to the generally more generous entitlements under the social insurance schemes for unemployment, the existence of a statutory provision of severance payments ensures the availability of some income for dismissed employees during periods of unemployment. At the same time, such payments could act as a disincentive against indiscriminate dismissal of employees.

A general issue in the above context is that unemployment benefits (if there are any at all) provided for the most vulnerable groups of workers are inadequate, compared to even the modest benefits given to others. Such groups consist of employees of very small firms and those who work part-time or on a daily wage basis. Thus, employees of very small firms, and those hired as temporary or casual employees in big firms, are likely to be the first to face the prospect of unemployment as the employer's liability associated with dismissal is lower or non-existent. As already noted, a large segment of the workforce is at present not covered by any social insurance system; "excluded" or unprotected employees who become unemployed are compelled to rely on public assistance (under poverty alleviation programmes) to maintain their livelihood or to receive often meagre support from certain social safety nets.

Social safety nets for the unorganized sector

One way to assist the poor, unemployed workers of the unorganized sector is to provide them with opportunities for gainful employment until they find new jobs or are reabsorbed in their "usual" occupations (for example, seasonal work). New employment can be created by labour-intensive infrastructure programmes. Such programmes can be implemented in the rural areas during lean seasons when small farmers and agricultural labourers are not engaged in agricultural operations and have no alternative source of earning money. Similar programmes can also be designed and carried out in urban areas during periods of recession. As these programmes are implemented by governments, a high degree of flexibility is required to reorient existing and planned investment projects so as not to generate additional pressure on government budgetary resources.

In India, large volumes of employment have been generated through an income-earning scheme entitled "Jawahar Rojgar Yojana". One billion work days of employment had been created by 1995, covering 123 of the country's 350 underdeveloped districts. Recently, the scheme has been modified and renamed "Gram Samridhi Yojana", or Village Prosperity Programme. Under the programme, government funds will be placed with the village administration for the creation of rural infrastructure through employment-intensive activities.⁴ Other similar government programmes include the Maharashtra Employment Guarantee Scheme, which provides work for unskilled, manual workers resident in Maharashtra State for a certain period of time in small-scale public works projects such as the construction of roads or irrigation facilities. This programme is based on an explicit recognition of the right to employment expressed in a statutory act adopted in 1978 by the state government. Project planning and administration are performed at the district level, where the potential participants, and hence beneficiaries, are registered. Those registered have the statutory right to employment at the minimum wage rate within a stipulated period of time

⁴ "Finance ministers speech: summary (part 2)", *The Times of India*, 27 February 1999.

after applying for work. A small unemployment benefit is given if no work is provided or available within this time frame.⁵ The scheme is financed by the state government from earmarked taxes levied on the urban sector.

INCOME SECURITY FOR OLD AGE

The context

Over the next 10 years, countries in the Asian and Pacific region will undergo a significant demographic transformation in the form of increasing proportions of the elderly in the total population. This trend is the result of improvements in health care which have extended longevity, reinforced by successful implementation of programmes aimed at lowering birth rates. People have also become more health-conscious.

The projected increase in the elderly population is most dramatic in the developed countries in the region but the developing countries will also experience an upward trend. There was one person aged 60 or above for every 14 persons in the East Asian countries in 1980, compared to one in every eight projected for 2010. A similar situation holds for other subregions, though the magnitude of change differs.

One implication of the above demographic transformation is that an expanding number of older persons will need support from the narrowing base of the working-age population. This is reflected in the rising old age dependency ratio (table III.3). The pace of this increase is also quite fast, for example, 43 per cent for China, 66 per cent for Thailand, 115 per cent for the Republic of Korea and 152 per cent for Japan over the 30-year period from 1980-1985 to 2010-2015. There will thus be a quantum jump in the amount of resources needed to provide income security for the elderly. A pressing need has consequently emerged for a detailed review of existing programmes for old age income security to ensure that they are cost-effective and sustainable in the long term.

Salient features

Social insurance is the dominant modality for providing income protection for employees of the organized sector of the economy in their old age; its financing is on the basis of "pay-as-you-go" (Japan, Republic of Korea) or of accumulated savings (Malaysia, Singapore). In some cases, however, governments have undertaken direct responsibility for the provision of old age pensions and other benefits for civil servants and military personnel from budgetary resources, as in Nepal and Sri Lanka.

For contributory types of old age pension schemes (pay-as-you-go, provident fund), the rates of contribution of employees and employers are often fixed as a percentage of employee earnings, although this can change from time to time. The benefits available include old age pensions for pay-as-you-go arrangements, and lump-sum payments or annuities from the invested lump sum on retirement in the case of provident fund schemes. In most programmes, survivor benefits are also provided. The entitlements are based on the length of the employee's participation in the scheme and his or her earnings (for example, lifetime wages in Japan and last drawn salary in Sri Lanka). As a result, the pension of employees with a high salary is normally much higher than that of their low-earning counterparts. There is, however, a modality for some equalization in the pension scheme (for example, in the Republic of Korea) through the use of a lower coefficient for calculating the pensions of employees with higher salaries relative to those with lower salaries. On the other hand, lump-sum entitlements for all employees in provident fund schemes are usually completely defined and limited by the accumulated contributions.

An important difference exists in the benefits provided under these two systems. Financial entitlements are limited under the savings fund approach by the amount of accumulated contributions. No such restriction operates under the pay-as-you-go system. This is an arrangement in which benefits are not directly linked with contributions or receipts, because the receiving groups are different from the paying groups. As a result, the benefits can be open-ended and can easily exceed the total contributions made by the concerned retirees and their employers during the employee's working lifespan. These benefits are often indexed to changes in the cost of living.

⁵ *Causes, Characteristics and Consequences of Poverty...*, p. 39.

Table III.3. Old age dependency ratio of selected economies in the ESCAP region, 1980-2015

(Percentage)

	1980-1985	1985-1990	1990-1995	1995-2000	2000-2005	2005-2010	2010-2015
East Asia							
China	7.9	8.0	8.3	9.1	10.0	10.6	11.3
Hong Kong, China	9.5	10.8	12.1	13.7	14.6	15.3	15.6
Mongolia	5.5	5.6	7.4	6.6	6.5	6.1	6.3
Republic of Korea	6.1	6.5	7.2	7.9	9.4	11.4	13.1
South-East Asia							
Cambodia	5.0	5.4	5.1	5.5	5.5	5.4	5.8
Indonesia	6.0	6.2	6.4	6.9	7.3	8.0	8.7
Lao People's Dem. Rep.	5.1	5.3	5.7	6.1	6.3	6.4	6.5
Malaysia	6.4	6.5	6.2	6.5	6.7	7.5	8.0
Myanmar	7.1	6.7	6.7	6.7	7.2	7.6	8.0
Philippines	5.0	5.2	6.2	5.9	6.1	6.4	6.8
Singapore	6.9	7.5	7.7	8.8	10.2	11.8	13.2
Thailand	6.3	6.5	6.8	7.5	8.4	9.5	10.5
Viet Nam	9.1	8.1	8.5	8.4	8.6	8.2	7.6
South Asia							
Bangladesh	6.8	6.4	6.0	5.5	5.2	5.3	5.8
Bhutan	6.5	6.7	7.0	7.3	7.6	7.7	7.8
India	7.1	7.2	7.3	7.7	8.1	8.4	8.8
Iran (Islamic Republic of)	6.4	5.9	7.0	7.3	7.4	7.0	6.7
Maldives	7.9	6.0	6.5	6.8	6.6	6.2	5.9
Nepal	5.5	5.3	6.6	6.7	6.4	6.3	6.4
Pakistan	5.5	5.4	5.4	5.6	5.8	5.9	6.0
Sri Lanka	7.2	7.7	8.4	9.3	9.9	10.6	11.7
Pacific island economies							
Fiji	4.8	5.0	5.6	6.3	7.2	8.4	9.6
Papua New Guinea	2.8	3.5	4.3	5.1	5.2	5.4	5.3
Samoa	5.8	6.3	7.1	7.6	7.9	8.0	7.7
Solomon Islands	5.8	4.7	5.1	5.4	5.6	5.8	6.0
Vanuatu	5.6	6.2	6.9	6.5	6.0	5.6	6.2
Developed countries							
Australia ^a	14.7	15.3	16.7	18.1	18.0	18.4	19.8
Japan	13.4	15.1	17.2	20.9	25.0	29.0	33.8
New Zealand	15.7	16.1	17.0	17.8	17.7	17.9	18.9

Source: United Nations, *World Population Prospects: The 1998 Revision*, volume I: *Comprehensive Tables* (United Nations publication, Sales No. E.99.XIII.9).

Note: The old age dependency ratio is defined as the ratio of the number of persons in the age group of 65 and above to those in the age group 15 to 64 years. The ratio is expressed as a percentage and indicates the number of old persons (to be supported) per 100 persons of working age.

^a Including Christmas Island, Cocos (Keeling) Islands and Norfolk Island.

An open-ended scheme with generous provisions or allowances could prove financially unsustainable with a rising proportion of retirees among the contributing employees unless appropriate arrangements are put in place to raise supplementary resources. Among the options to do so are periodic increases in the rates of contribu-

tions from working participants and their employers, the imposition of a higher retirement age, and more frequent actuarial reviews to assess the status of financial health and, as appropriate, to assist in the design of remedial measures. The possibilities of financial unsustainability are typically strong for long-established or "old" pension schemes in which the

number of contributors per retiree is becoming smaller and is expected to decrease rapidly in future, as in Japan. In relatively "new" schemes, as in the Republic of Korea for example, financial sustainability is not a pressing issue in the short run.⁶

Employers' contributions have been a major source of finance for old age pension schemes. Obviously, this source has no relevance for self-employed workers. There are often large differences in the incomes of self-employed workers: a self-employed doctor or lawyer could command very high earnings whereas a self-employed plumber, electrician or handicraft worker could be very much poorer. Thus, any extension of pension schemes (especially the pay-as-you-go type) to cover self-employed groups has to take account of the absence of employers' contributions and the sharp differences in ability to pay among various self-employed groups.

The introduction of layers or tiers for both benefits and contributions can be a highly practical means of covering self-employed groups. This is practised in Japan. The arrangement consists of a basic pension scheme for which a flat rate monthly contribution is charged. Self-employed persons pay their contributions directly to the basic pension scheme, which provides all insured persons, both self-employed and employees, with a flat rate pension on retirement. Employees of the organized sector are entitled to the flat rate pension from the basic scheme, and the employee's contribution to this scheme is channelled through the employees' social insurance scheme. Employees are also entitled to additional pension on retirement under the employees' social insurance scheme, to which they pay an additional premium to the flat rate pension scheme; their contribution is also supplemented by the employer's contribution.

In the provident (savings) fund approach, the operation of the fund itself is a major task. The accumulated funds have to be invested efficiently to generate a high rate of return while ensuring safety.

In the Malaysian Employees Provident Fund scheme, investment activities are the responsibility of the fund operators, and the investment profits realized (net of administrative costs) are credited as dividends to the fund accounts of the participating employees. On the other hand, individual participants in the Central Provident Fund in Singapore can invest part of their accumulated savings themselves in instruments such as stocks, unit trusts and gold. Such an option of decentralizing investment may be conducive to efficient investment, assuming that individual participants make rational investment decisions and maximize their returns in the process. Central Provident Fund participants can also be encouraged to invest in socially desirable sectors (such as housing and the national bus service), thus raising the overall welfare of the population as a whole.

Highly effective governance of funds is necessary to ensure high returns at minimal administrative cost in the collection of substantial amounts of monthly contributions from numerous contributors, the taking of investment decisions, the supervision of investments made by participants, and the provision of periodic (often monthly) retirement payments. The governance of the funds concerned ought to be not only competent but also transparent, with a high degree of accountability. The Board of the Employees Provident Fund of Malaysia, which oversees the operations of the largest savings fund of the country, has been made accountable to parliament for its decisions.

Selected programmes for workers of the unorganized sector

It is generally more difficult, for many reasons, to design and implement contributory social security schemes for old age benefits for workers of the unorganized sector of the economy. These persons are often poor, with highly variable incomes; this greatly compromises their ability to pay regular contributions to any social insurance scheme. Besides, a large number of unorganized sector workers are dispersed over sparsely populated, rural areas, thus raising considerably the administrative costs involved in the collection of contributions and in the disbursement of benefits. Nevertheless, such difficulties are not insurmountable.

⁶ Robert Holzmann, Ian W. MacArthur and Yvonne Sin, "Pension systems in East Asia and the Pacific: challenges and opportunities", social protection background paper, Washington DC, World Bank, October 1999.

In China, for example, old age income security for rural workers is provided through a contributory scheme; indeed, the country has had a long experience of providing universal social security, including pensions, through decentralized institutions such as enterprises and collectives in rural areas. The importance of decentralized institutions and channels in providing social security for the workers of the unorganized sector is thus highlighted. A contributory system for pension benefits for workers of the informal sector is also found in the Philippines, an arrangement implemented by an association of cooperatives.

In some countries, public assistance programmes provide old age income security for the poor workers of the unorganized sector (India, Republic of Korea). Legislative action (for example, by the state government of Kerala, India) is sometimes used to create welfare funds from which benefits can be paid to certain vulnerable groups such as agricultural workers of the unorganized sector. However, the levels of benefit are very low, often at or below the subsistence threshold.

An innovative method has been designed in Singapore whereby intra-family transfers are relied on to provide old age protection for those who are not covered by institutional schemes or who are not capable of maintaining themselves. Legislative action has ensured that older persons receive a maintenance allowance from their children. A number of tax deductions and financial incentives are granted to induce the offspring to provide financial assistance and help to maintain their aged parents.

HEALTH SECURITY FOR WORKERS AND EMPLOYEES

Health care is widely recognized as an important public good. Governments in the ESCAP region have attempted to provide universal access to such services free of charge or at subsidized prices through public hospitals, clinics and other health care centres. The provision of these services is in the nature of universal entitlement. However, as is the case in most services provided by government, access, quality and standards have often tended to deteriorate because of the chronic constraints on budgetary resources, compounded by low levels of

cost efficiency. Privatization and the promotion of private sector participation in providing health care services are among the available options which have been considered and adopted, although such options themselves may be problematic. Under the current circumstances, the relatively less well-off workers and self-employed persons in both the organized and the unorganized sectors often face major hurdles in obtaining the needed health care and maintenance services, or have to bear a heavy financial burden relative to their capacity to pay.

Governments have introduced measures to reform operational modalities and other details of social security systems concerning health care and maintenance. These reforms relate, inter alia, to eligibility criteria, contributions by beneficiaries, employers' responsibility and the participation of hospitals and clinics in providing health security services.

Salient features

Social insurance has been a common modality to supplement universal entitlement to the provision of health security for workers and employees of the organized sector. First, in almost all cases, the rates of monthly contributions, or premiums, borne by employees are matched by equal or higher contributions from their employer or the government. Second, affordability, and not the extent of risks covered, is the main basis for determining such contributions. Third, the contribution rates are normally a fixed percentage of the participant's wage or salary while benefits are similar, thus incorporating an element of progressivity in the pertinent programmes.

The benefits available are fairly extensive and include various kinds of medical emergency, hospitalization, outpatient services, home care and ambulance facilities. The financial burden arising from prolonged spells of illness has been explicitly incorporated in the programme in Thailand through the provision of a cash benefit. One of the reasons for the absence of such cash payments in many other schemes is the availability of paid (and partially paid) sick leave, an entitlement separately available under the rules and regulations of service and employment in the majority of the organized enterprises or governments. However, an explicit incorporation

of some cash benefits in all social insurance schemes is an important issue for consideration, especially if the sickness extends beyond the permissible ceiling of paid leave.

Two distinct modalities are followed with respect to the actual delivery of medical and health services to the beneficiaries. One concerns the establishment of hospitals, clinics and dispensaries for the exclusive use of the participants in various social insurance programmes (for example, the Employees' State Insurance Scheme and the Contributory Health Service Scheme in India). Under the second approach, participants are given free choice among the available medical facilities in selecting treatment, regardless of whether they are in the public or the private sector.

The latter option appears to be more popular among participants. When medical and other health care services are provided by exclusive hospitals and clinics, with the participants having no choice in their selection, the quality and standards of services could be less than desirable primarily because of lack of competition. On the other hand, the cost and scope of treatment could become an issue if participants have free choice coupled with generous reimbursements. Often, the beneficiaries would be likely to use more expensive and extensive services (which might not necessarily be of a higher quality or even necessary from a medical point of view), and there is also greater scope for fraud and abuse.

These possibilities can be contained in various ways, to be discussed later. In general, however, reliance on all existing or available medical infrastructure, both private and public, is justified from an economic point of view. First, the operation of institutionalized social insurance schemes in the area of health care and maintenance which does not discriminate between the use of public and private sector facilities contributes to an expansion in the demand for related health services. As such, the private sector is provided with potentially viable opportunities for investment in health projects, thus relieving pressure on limited public sector facilities in the process. Second, there is likely to be a higher level of capacity utilization of all the established facilities. Third, competition among them can lead to an improvement in the quality of services. These factors can be expected to enhance both the productivity and the quality of services within the health care sector as a whole.

Health insurance schemes are usually financed from the contributions of employees, and employers, and sometimes of governments. The rates are usually kept at relatively low levels. Thus, the need for cost control and containment is ever-pressing, especially when beneficiaries are allowed to opt for treatment in private facilities on a reimbursement basis. Cost containment is effected in various ways among the variety of programmes reviewed. First, the extent of the benefit is limited in terms of the amount of the payment per incidence of sickness, or of the duration of the required treatment. For example, the cash benefits for insured workers (per sickness) are paid for a limited period in Thailand, while in the Republic of Korea the duration of treatment of one sickness is limited to six months. Second, co-payments are frequently relied upon so that the insured persons and beneficiaries bear a certain percentage of the medical expenses involved. For example, insured patients must meet 20 per cent of hospital fees and 30 per cent of outpatient fees in the Republic of Korea. Such co-payments are expected to act as a disincentive to using unnecessary health care and treatment services. Third, an assessment of true medical needs at the initial stage of sickness or health complaint is another means employed to check the overuse or abuse of medical services. In Indonesia, for example, a two-tiered managed health care system has been introduced by the government in which doctors at primary health centres can refer a patient to outpatient services in larger hospitals; however, actual hospitalization requires clearance from an official of the social insurance scheme.

As regards the quality of services rendered, one way to ensure an acceptable level is through the close and constant supervision and monitoring of the facilities and services involved by committees consisting of representatives from stakeholder groups. In the case of India, such a committee consists of representatives from the country's parliament, employees, employers, the medical profession and the programme administration. Committees have also been relied upon to provide policy guidance for various schemes. For example, the Medicare programme in the Philippines is governed by a committee comprising senior officials from various ministries, as well as representatives of labour, employers, self-employed sectors and health care providers. Such a wide representation ensures cross-sectional support for the implementation of

unpopular decisions for enhanced financial viability, or for the maintenance of the quality of services of the programmes concerned. Such unpopular decisions might include increasing user charges and contribution rates or restructuring benefit systems.

Selected country programmes for workers in the unorganized sector

In contrast to the more structured schemes available for workers in the organized sector of the economy, the programmes available for workers in the unorganized sector (and sometimes the self-employed poor) are not very well defined in terms of their coverage, the extent of benefits provided, and financing requirements. As well as the government at various levels, NGOs have become active in designing and implementing a large number of health care schemes.

A focus on ensuring universal entitlement, whereby anybody needing medical care can make use of the facilities available, is a feature in many schemes, such as that in Sri Lanka. Other programmes have specific beneficiary groups for the provision of targeted social assistance, such as the issue of health cards for the poor in Thailand and the welfare funds in India. Group insurance is an integral element, for example, in the Gonoshasthaya Kendra programme of Bangladesh and the Integrated Work Security Insurance Scheme of India, both of which are non-government programmes. In other arrangements, social insurance entitlements cover the unorganized sector, with financial assistance from governments. In the Republic of Korea, for example, co-payment charges can be obtained as loans without interest from the government.

Financial resources for the implementation of many schemes with health services as a universal entitlement and for social assistance programmes typically come from government budgets (Republic of Korea, Sri Lanka, Thailand). However, budgetary resources are scarce in many countries and the social sectors are often not adequately funded, which has an adverse impact on access, quality and coverage of health care and maintenance schemes, particularly for the relatively less privileged workers in the unorganized sectors.

Against this backdrop, financial viability and self-sustainability have become an important issue. Some forms of group insurance or user charges have been adopted by programmes which do not depend wholly on government financial assistance; this is the case of the Gonoshasthaya Kendra programme of Bangladesh and the Integrated Work Security Insurance Scheme of India. The latter has been able to establish cooperative linkages in both financing and implementation with a commercial insurance company. Such an arrangement shows that active collaboration between NGOs and the private sector is both possible and attractive.

A prerequisite of the group insurance approach is the organization of beneficiaries and other targeted persons into groups or unions. Under the schemes in Bangladesh and India, "organizations" have been set up through the recruitment of "members", who then pay small membership fees. Government action may be of crucial importance in establishing a conducive or enabling environment, although the actual social mobilization is to be carried out by NGOs; the Integrated Work Security Insurance Scheme of India, for example, is a scheme run by the Self Employed Women's Association, a kind of trade union legitimized by an act of parliament.

An acute lack of trained medical human resources for delivering the needed services is another issue of significant importance in the establishment and extension of health security and safety nets for the benefit of unorganized workers, who are often widely dispersed in rural areas. To help ease this constraint, for example, in Bangladesh, the Gonoshasthaya Kendra programme has created a pool of paramedics by training local young people for the purpose.

SELECTED POLICY ISSUES AND DIRECTIONS FOR THE FUTURE

An important and common aim of all governments in the ESCAP region is to raise the cost-effectiveness of social security and safety nets, and to increase their coverage and access to them. The design and implementation of comprehensive social protection and safety nets are not an easy task; nor is the operation of existing schemes free from weaknesses. Governments will continue to face hard

choices in allocating resources, ensuring the financial viability of the programmes and providing quality services either directly or through some form of collaborative relationship with other actors in societies. Governments are the ultimate guardians of social security and safety nets. A number of policy issues and options with a bearing on more effective discharge of this responsibility are discussed below.

Inadequate and unequal access

The brief review in this chapter has shown that large segments of populations, especially in the unorganized sector of both rural and urban sectors, remain virtually excluded from social security coverage. They have to depend mostly on the redistributive and poverty alleviation type of social safety nets for protection against income losses because of unemployment, old age or ill health. Indeed, the combined coverage under publicly mandated private sector and government employee schemes has been estimated at less than 30 per cent of the total labour force in several Asian countries, an understandably low ratio given the continued importance of agriculture and the informal sector as sources of employment.⁷

A two-pronged strategy is needed to increase the coverage of social security and safety net programmes. First, the design and operation of existing schemes need to be improved and strengthened, including such areas as the modalities of financing, levels of benefits provided, the standards and cost-effectiveness of services delivered, and supervision and control. This should be accompanied by the introduction of new programmes or revised schemes based on the lessons learned from the existing set-up. Second, targeted safety nets for basic social protection, such as unemployment assistance, old age benefits and health services, should

be strengthened, extended or introduced in favour of the excluded groups. The selectivity inherent in targeted programmes is essential because it would be unrealistic to expect that effective coverage for all workers and self-employed persons would be feasible in the foreseeable future.

Greater reliance on market-based or other non-governmental arrangements

Social insurance will continue to be the major modality for providing social security benefits. Nevertheless, market-related mechanisms or other non-governmental arrangements can be a useful complement to programmes operated by the public sector. The introduction of certain types of group insurance programmes which can be organized with the joint collaboration or participation of NGOs and the private sector could be an important step in that direction. The examples provided earlier of programmes in Bangladesh and India are illustrations of this nature.

The introduction of appropriate schemes for unemployment benefits is another issue which requires the urgent attention of policy makers. The feasibility of severance payments (for involuntary dismissal) may be an option which can first be examined by governments in countries which do not currently have such a mandated employers' liability. These payments constitute a simple means of ensuring some measure of stopgap income security for dismissed workers, regardless of their contract status or duration of prior service.

As noted previously, it is simply impossible to ensure or extend formal social security cover to all workers and employees during transient or even prolonged periods of unemployment. Employment guarantee schemes may therefore be introduced to provide employment in public works programmes for targeted categories or segments of the unemployed, especially those in rural areas. Several such programmes in operation within the region have been noted earlier. Here again, it is important to strike a balance between the minimal income needs of those offered employment under such programmes and the financial liability of governments.

⁷ As already mentioned, there is an almost universal requirement that employees should be covered by social security schemes; those working in the informal sector are effectively excluded from these schemes. Some estimates of coverage under formal retirement schemes available to private sector and government workers and employees are given in Holzmann and others, "Pension systems in East Asia and the Pacific...", p. 20.

In the case of permanent workers within the formal sector, however, the ultimate policy objective should be the initiation of a formal unemployment insurance system, with contributions from both workers and their employers. The trade-off lies in the potential loss of competitiveness due to higher labour costs. In order to address this issue, both the amount and the period of payment of unemployment relief can be limited. The amount of relief can be determined on the basis of the minimum wage level and not necessarily on the basis of the salary drawn by the unemployed worker immediately before dismissal or lay-off. Such restrictive benefits would reduce employers' costs, reduce strains on financial viability, and contain the extent and intensity of moral hazard problems, thus providing a reasonably good start for the newly created arrangements.

Reforms of old age and retirement benefit schemes

The provision and maintenance of such benefits will become increasingly important in the government agenda on social protection in view of the upward trend in the proportions of the ageing population across the region. Reform of existing pension and retirement benefit systems is needed for enhanced efficiency and extended coverage, and new schemes should be introduced to incorporate various groups of workers and retirees not previously covered. At the same time, the importance of ensuring fiscal sustainability cannot be ignored.

Many pension systems in the region are based on the pay-as-you-go principle. This has a major advantage as well as a major risk. The advantage is that the system can allow payment of generous benefits when the current working population is young and the number of beneficiaries (old persons and retirees) is relatively small, but it can eventually become unsustainable as the number of retirees increases relative to contributors. One solution to this problem could be periodic increases in contributions, but this might adversely affect the incentive of working contributors because the beneficiaries and contributors are different groups of people and the available benefits (which are already agreed upon or defined) may have only a limited relationship with contributions (which are flexible and hence not defined).

Thus, there are limits to periodic increases in contribution rates under the pay-as-you-go schemes. This constraint, however, can be minimized by ensuring correspondence between entitled benefits and the amounts of accumulated contributions. In the provident fund system, the benefits are "fully funded" by the contributions and this approach is of particular relevance for financial sustainability. However, a transition from the pay-as-you-go system in countries where such schemes already exist to a provident fund arrangement is likely to involve a noticeable reduction in the current recipients' pension benefits and may thus be difficult to implement. It should be easier to implement fully funded systems for new employees.

Provident fund benefits are limited by the accumulated contributions plus their accrued returns on investment. This feature has some disadvantages. The final entitlements in the form of annuities may be relatively low as a result of a shorter period of contributory payments by some employees or lower levels of returns. The latter underscores the need for profitable investment of accumulated funds. Besides, there is the issue of inflation which could erode the real value of annuities. The feasibility of inflation-indexed annuities clearly depends on the availability of investment opportunities in sophisticated and advanced financial instruments such as price-indexed bonds.

One approach in the reform of pay-as-you-go schemes concerns a judicious investment of the reserves generated at the early stages of their operation.⁸ This is a period when the total pension payments to retirees are low and the number of contributors is large, leading to an excess of collections over disbursements even at moderate levels of contribution. Such excess can be substantial; it is estimated to be 1.3 per cent of GDP in the case of the Republic of Korea.⁹ The returns on investment of excess collections can improve somewhat the financial sustainability of the system and provide some breathing space in the transition from a pay-as-you-go scheme to a provident fund scheme.

⁸ For a detailed discussion on this approach to pension reform, see David Miles and Allan Timmermann, "Risk sharing and transition costs in the reform of pension systems in Europe", *Economic Policy*, October 1999, pp. 253-286.

⁹ Holzmann and others, "Pension systems in East Asia and the Pacific...", pp. 33 and 48.

Another option to minimize the risk of financial insolvency and, at the same time, secure a reasonable level of welfare for the ageing population is through the introduction of a multi-pillar structure of retirement benefits. One pillar of this structure can be a benefit scheme mandated by legislation. The others could be provided by privately managed schemes funded with voluntary contributions. These schemes would provide retirement benefits additional to those of the mandated scheme. This multi-pillar approach can also be devised and adopted for the provision of other types of social protection, especially health care and maintenance.

Governance framework

Governments have the primary responsibility to ensure adequate protection for the citizens of a country. They do not necessarily have to finance or implement the programmes entirely themselves. There are a myriad ways in which other actors, including beneficiaries, employers and financial institutions, can be involved. Governments, however, have to provide the necessary legislative and regulatory framework.

The role of the government is prominent in the operation of many provident fund schemes. Many governments often limit the channels for investment of provident fund resources through, for example, specification of both the instruments and the amounts that can be invested in them. Such intervention may be necessary to minimize risky investment or to support other domestic policy goals.¹⁰ In addition, all developing countries of the region have traditionally restricted the investment of provident funds in foreign assets (which could potentially carry better yields) in an attempt to keep investible funds at home.

By and large, the existence of regulations on investment of provident fund resources has often led fund managers to select portfolios biased towards public sector instruments and domestic bank deposits at the expense of better-performing equities and shares. The implication of such a bias is often lower financial rates of return on contributors' funds. Consequently, the annuitized value of the provident fund

is reduced and so is the amount of potential pension (and welfare) available to the recipients. This issue deserves careful consideration when regulations are being drafted.

Governments have played an active role in the management, operation and supervision of many social security and safety net schemes. In this regard, it may be desirable to seek the involvement of all stakeholders in major aspects of management and implementation, which may include investment portfolios for provident funds, the level and delivery of modalities for medical services, rates of contribution by beneficiaries, and cost-control measures pertaining to different schemes. Typically, such participation can be achieved by constituting boards with adequate representation from government, employees, employers, providers of services (hospitals, financial institutions etc.) and parliamentarians. Such cross-sectional boards would allow for more effective expression and articulation of the interests of beneficiaries and a better appreciation of the difficulties and constraints faced by the service providers and financial underwriters.

In addition, the feasibility of decentralizing the provision of social security deserves consideration. It is particularly important to cover a large number of workers scattered in rural areas. The implementation of a devolution process may effectively extend the scope and coverage of protective social security schemes and redistributive safety nets and may facilitate the operation of contributory social insurance schemes in those areas.

Formal social security and safety net programmes will assume increasing importance as a vehicle for social protection. However, informal family support to meet various types of contingencies still remains important and will remain so in the foreseeable future. In the Asian and Pacific region, such intra-family transfers have deep cultural roots and have proved their effectiveness in the face of rapid socio-economic changes over the years.¹¹ Due advantage should be taken of family relationships as a complement to formal social security and safety net programmes through, for example, the provision of tax incentives or appropriate legal and regulatory frameworks.

¹⁰ In certain cases, these goals can be socially desirable, for example when provident fund resources are invested in the national bus service or in housing schemes.

¹¹ During the recent economic crisis, a significant number of unemployed workers in the cities of the affected countries returned to their villages and rejoined their extended families for support.

Annex

**SELECTED SOCIAL SECURITY AND SAFETY NET PROGRAMMES
IN THE ASIAN AND PACIFIC REGION**

1. Unemployment benefit schemes for workers in the organized sector

<i>Type of scheme</i>	<i>Country</i>	<i>Reference</i>
a. Employment insurance scheme	Republic of Korea	Hyungpyo Moon, "Growth with equity: policy lessons from the experience of the Republic of Korea", in <i>Growth with Equity: Policy Lessons from the Experiences of Selected Asian Countries</i> (United Nations publication, Sales No. E.00.II.F.14), pp. 211-265
b. Social insurance	China	T.S. Sankaran and others, eds., <i>Social Security in Developing Countries</i> (New Delhi, Har-Anand Publishers, 1994), pp. 139-150
c. Social insurance	Islamic Republic of Iran	P. Singh, <i>Social Security in Asia and Pacific: A Comparative Study</i> (New Delhi, Friedrich-Ebert-Stiftung, 1992), p. 137
d. Employers' liability scheme	Bangladesh, India, Pakistan	"Social security programs throughout the world, 1999 < http://www.ssa.gov/statistics/ssptw/1999/English > September 1999

2. Old age income security schemes for workers in the organized sector

<i>Type of scheme</i>	<i>Country</i>	<i>Reference</i>
a. Comprehensive old age pension scheme	Japan	International Social Security Association, Manila, <i>Current Social Security Issues in Asia and the Pacific: Social Security Documentation, Asia and Pacific Series No. 21</i> , 1997, p. 157
b. Old age pension scheme	Republic of Korea	<i>Lifelong Preparation for Old Age in Asia and the Pacific</i> (ST/ESCAP/1684), pp. 110-111
c. Employees Provident Fund	Malaysia	International Social Security Association, Manila, <i>Current Social Security Issues in Asia and the Pacific: Social Security Documentation, Asia and Pacific Series No. 21</i> , 1997, pp. 169-174
d. Central Provident Fund	Singapore	T.S. Sankaran and others, eds., <i>Social Security in Developing Countries</i> (New Delhi, Har-Anand Publishers, 1994), pp. 225-228
e. Civil service employees retirement scheme	Nepal	T.S. Sankaran and others, eds., <i>Social Security in Developing Countries</i> (New Delhi, Har-Anand Publishers, 1994), pp. 201-205
f. Life Insurance Corporation of India's group insurance scheme	India	T.S. Sankaran and others, eds., <i>Social Security in Developing Countries</i> (New Delhi, Har-Anand Publishers, 1994), pp. 293-296

3. Old age income support schemes for workers in the unorganized sector

Type of scheme	Country	Reference
a. Social welfare services for senior citizens	Republic of Korea	<i>Towards Social Security for the Poor in the Asia-Pacific Region</i> (ST/ESCAP/1673), p. 396
b. Old age income support scheme for persons associated with agricultural activities in the rural area	China	<i>Lifelong Preparation for Old Age in Asia and the Pacific</i> (ST/ESCAP/1684), p. 70
c. Old age pension schemes for men and women with little or no income	India	T.S. Sankaran and others, eds., <i>Social Security in Developing Countries</i> (New Delhi, Har-Anand Publishers, 1994), p. 260
d. Pension scheme for agricultural workers	India	T.S. Sankaran and others, eds., <i>Social Security in Developing Countries</i> (New Delhi, Har-Anand Publishers, 1994), pp. 258-259
e. Old age protection for informal sector workers	Philippines	<i>Towards Social Security for the Poor in the Asia-Pacific Region</i> (ST/ESCAP/1673), pp. 348-349
f. Income protection at old age provided by the family	Singapore	Tan Hwee Seh, "Household structure and the role of older persons: national policies and programmes designed for the welfare of the elderly in Singapore", paper prepared for the Regional Seminar on the Family and the Elderly, Bangkok, 6-9 October 1998, pp. 1-8

4. Health security scheme for workers in the organized sector

Type of scheme	Country	Reference
a. Social insurance scheme	Thailand	T.S. Sankaran and others, eds., <i>Social Security in Developing Countries</i> (New Delhi, Har-Anand Publishers, 1994), pp. 245-247
b. Compulsory health insurance scheme (Medicare)	Philippines	International Social Security Association, Manila, <i>Current Social Security Issues in Asia and the Pacific: Social Security Documentation, Asia and Pacific Series No. 21, 1997</i> , pp. 93-96
c. Employees' State Insurance Scheme	India	International Social Security Association, Manila, <i>Current Social Security Issues in Asia and Pacific: Social Security Documentation, Asia and Pacific Series No. 21, 1997</i> , pp. 65-70
d. Medical insurance scheme	Republic of Korea	International Social Security Association, Manila, <i>Current Social Security Issues in Asia and the Pacific: Social Security Documentation, Asia and Pacific Series No. 21, 1997</i> , pp. 85-89
e. Social security health insurance programme (PT Askes and PT Astek)	Indonesia	International Social Security Association, Manila, <i>Current Social Security Issues in Asia and the Pacific: Social Security Documentation, Asia and Pacific Series No. 21, 1997</i> , pp. 77-83

5. Health security schemes for workers in the unorganized sector

<i>Type of scheme</i>	<i>Country</i>	<i>Reference</i>
a. Health-care card system	Thailand	<i>Towards Social Security for the Poor in the Asia-Pacific Region</i> (ST/ESCAP/1673), p. 435
b. National health-care system	Sri Lanka	<i>Towards Social Security for the Poor in the Asia-Pacific Region</i> (ST/ESCAP/1673), p. 414
c. Health insurance scheme (Ministry of Health)	Republic of Korea	<i>Towards Social Security for the Poor in the Asia-Pacific Region</i> (ST/ESCAP/1673), p. 395
d. Welfare funds	India	T.S. Sankaran and others, eds., <i>Social Security in Developing Countries</i> (New Delhi, Har-Anand Publishers, 1994) p. 262
e. Self Employed Women's Association	India	T.S. Sankaran and others, eds., <i>Social Security in Developing Countries</i> (New Delhi, Har-Anand Publishers, 1994) pp. 82-89
f. Gonoshasthaya Kendra programme	Bangladesh	A.T.M. Shamsul Huda, "Non-government initiatives for rural health care: a case study of Gonoshasthaya Kendra in Bangladesh" in A. Bhatt and others, eds., <i>Building from Below: Local Initiatives for Decentralized Development in Asia and the Pacific</i> , Vol. 2 (Kuala Lumpur, Asian and Pacific Development Centre, 1987), cited in <i>A Review of the Incidence of Poverty and Target Oriented Poverty Alleviation Programmes</i> , (ST/ESCAP/1568), p. 38

PART TWO

**ECONOMIC AND FINANCIAL
MONITORING AND SURVEILLANCE**

ACKNOWLEDGEMENTS

During the preparation of this study, the ESCAP secretariat benefited from consultations with and comments from several international organizations, in particular the ASEAN secretariat, the Asian Development Bank, the Bank for International Settlements, the International Monetary Fund and the World Bank, as well as from relevant private sector organizations, the Institute of International Finance, Fitch IBCA, Moody's and Standard & Poor's. A significant contribution to the background research and drafting was made by George Manzano, Director of Research, Department of Economics, University of Asia and the Pacific, Manila.

IV

MONITORING AND SURVEILLANCE: THE THEORETICAL UNDERPINNINGS

INTRODUCTION

Economic and financial crises are not everyday phenomena, but when they come, they inflict untold economic and social costs.¹ The severe economic contraction, widespread bankruptcies, large-scale unemployment, social and political discontent and continued vulnerability to speculative attacks entail a very great burden for any country to bear. As observed in the Asian crisis, the poorest sectors of society tend to be the ones that bear the brunt of the difficulties. The aftermath of the crisis is usually accompanied by intense soul-searching by all affected parties, creditors, debtors, the private sector and policy makers alike. Why did the crisis occur? What could we have done to manage it better? Why was it not spotted in advance? And, perhaps more wistfully, how can a recurrence be avoided?

The Asian crisis has sparked worldwide interest in reform of the international financial system. The main thrust of proposals for a new financial architecture – the buzzword for a reformed system – is to ensure both that the potential benefits of the globalization of markets are realized and that the risks inherent in the process are mitigated. While these objectives are not new, the changing circumstances, including technological advances in communications that underpin financial market integration and the presence of massive and volatile capital

flows, give rise to new challenges in managing national and international financial systems. The ideas behind reforms in the financial architecture are multifaceted and include elements of promoting transparency and accountability; strengthening financial systems through better supervision; managing the process of capital account liberalization by better sequencing; ensuring the appropriateness of exchange rate regimes; dealing with volatile capital flows; and involving the private sector in crisis prevention and resolution. The call for improved surveillance (defined to include international cooperation in monitoring and exchange of information and views, as well as the application of peer pressure on policy matters) is an integral part of the overall response to the need to reform the international financial system.

At the global level, there have been some important initiatives by IMF, BIS and the World Bank, as well as by private organizations such as IIF and rating agencies, to revamp and strengthen their information collection and monitoring activities (for a review of these efforts see chapter V). The idea of a regional surveillance or monitoring mechanism, first proposed during the Manila Framework meeting in November 1997,² has gradually advanced to the point where 14 countries have agreed to meet twice a year to review economic and financial development in the region. The ASEAN Finance Ministers Meeting in February 1998 endorsed an ASEAN Surveillance Process³ (discussed in chapter VI).

¹ In the past 20 years, more than 125 countries have experienced at least one serious banking crisis. In some cases, the extent of the crisis was so deep that the cost of resolution would exceed 10 per cent of total GDP. See Morris Goldstein, *The Future International Financial Architecture*, report of the Independent Task Force on Safeguarding Prosperity in a Global Financial System, chaired by Carla Hills and Peter Peterson, Council on Foreign Relations, 1999, available at <<http://www.foreignrelations.org/public/IFATaskForce.html>> (18 January 2000).

² Communiqué of the agreed summary of discussions of "A new framework for enhanced Asian regional cooperation to promote financial stability", Meeting of Asian Finance and Central Bank Deputies, Manila, 18-19 November 1997.

³ Joint Ministerial Statement, Special ASEAN Finance Ministers Meeting, Kuala Lumpur, 1 December 1997, available at <www.aseansec.org/economic/prfin97.htm> (18 January 2000).

Designing an effective surveillance or monitoring mechanism is complicated. History is replete with attempts at the international level that failed to take off owing to various constraints. While at the national level the technical challenges to collecting data accurately, on time and with the required frequency, are daunting, it is much more difficult, given political sensitivities, to design and implement monitoring measures at the regional and global levels. In many regions, especially within groupings of developing countries such as ASEAN or SAARC where trade issues have tended to dominate the agenda, cooperation on financial matters is quite novel. Thus, the creation of any regional or subregional initiative necessarily involves a steep learning curve, with many technical and institutional hurdles.

On top of all of this the world is becoming more complex. As the recent experience of the Asian crisis illustrates, policy makers have yet to come to grips with the modalities for operating in an environment of floating exchange rates and free flows of capital, both within the ambit of the expectations and reactions of global markets. Thus, given the possible negative externalities arising from financial crises in either developed or emerging markets, it is in the interest of the world community, and not just the countries affected by a crisis, to take steps to improve the management of the world financial system.

Background and scope of the study

The members of ESCAP have been reviewing regularly the overall economic situation in the region, including the impact of the financial crisis which hit East and South-East Asia in 1997. The spillovers from the crisis affected many countries in the region and outside negatively. Though the worst predictions did not materialize (see chapter II), all were caught unawares by the force of the crisis. However, such reviews have not been in the nature of what can be considered surveillance, as defined earlier. The Commission, at its fifty-fifth session in April 1999, adopted resolution 55/2 in which, *inter alia*, it requested the ESCAP secretariat to undertake a study on possible regional mechanisms for the exchange of information and early warning systems in relation to the financial and economic situation in the countries of the region, with a focus on crisis prevention and reduction of the vulnerability of countries to economic and financial turmoil. The ultimate objec-

tive of the study is to make recommendations for future activities, including ways and means of making regional contributions to the global monitoring and surveillance programmes of IMF and other multilateral entities while complementing, but not duplicating, efforts already made by multilateral financial institutions in this direction.

ESCAP is not about to set up its own economic and financial surveillance mechanism, operating in parallel with current or new international, regional or subregional mechanisms. Rather, the intention is to explore ways in which ESCAP could complement and support these mechanisms with a view to enhancing the effectiveness of such activities for crisis prevention for the benefit of ESCAP members. This study, which responds directly to resolution 55/2, first looks at what constitutes monitoring, surveillance and early warning systems and the experience with these systems in terms of the ability to predict a crisis. This is followed by a brief review of the existing mechanisms in IMF, BIS, IIF and the rating agencies in terms of the process followed, the technical aspects of the approach and new activities initiated since the crisis. In chapter VI, an effort is made to explore how some regional/subregional approaches could help fill the gaps identified in the review of existing mechanisms, these approaches being of varying degrees of formality and catering for the needs of different groups of countries depending on the degree of their current involvement in world financial markets. The last chapter presents some suggestions for further action, particularly by ESCAP, to assist the countries in the Asian and Pacific region in identifying and coping with vulnerabilities to economic and financial crises.

SURVEILLANCE AND MONITORING

The logic of international cooperation

The growing interdependence among the economies in the world has stepped up the need to engage in international economic cooperation. As economies become more interdependent, spillovers become more important and developments in one economy affect the welfare of other economies in the world. The more extensive the trading and investment links between countries, the deeper are the spillovers. Spillovers or externalities can be either positive or negative. For instance, a high economic

growth rate in a country implies a healthy demand for imports from trading partners, whereas a recession in one country can have a negative effect on the performance of the export sector of its trading partners. The main objective of economic cooperation is thus to exploit the positive externalities and minimize the negative ones. Cooperative efforts, such as policy coordination, are intended to ensure that the external effects on partner countries are taken into account adequately in the decision-making calculus of a national government.

The public goods aspect of overall economic stability at the international level provides another motive for international economic cooperation. A stable international trading and financial system may be considered a public good in that all countries benefit from it, whether or not they have contributed to it. Public goods may be supplied by a government agency at the domestic level, such as a central bank that oversees the financial and economic stability of a country, but there is no comparable institution at the international level.⁴ Without modalities for coordination, countries may be tempted to seek the benefits of stability without assuming their share of the burden (free rider problem). The public good of stability may thus be undersupplied. International cooperation aims to instil in countries an understanding of their responsibilities in contributing to a stable economic and financial environment in the world. In addition, it would be impossible for the national institutions of a single or a small number of countries, however important, to ensure the stability of the global trading and financial system.

While there exist various reasons to promote the positive externalities, very often the avoidance of negative externalities provides the most compelling motivation for cooperation. For example, an upsurge in protectionist measures may be resisted in a country because of the beggar-thy-neighbour behaviour to which such a move could give rise. Cooperation can help minimize the prospect of competitive devaluations. Another important dimension to negative spillovers occurs when the policy mix pursued by a country is unsustainable and, in all

likelihood, will be reversed in the near future. Sharp policy reversals have implications for the domestic allocation of resources and therefore carry domestic costs. Moreover, this introduces instability, imposes reallocation on the rest of the world, especially on trading partners, and generates negative international spillover effects. Cooperation can help avoid both the initial disturbance and the policy reversal.

Today an additional reason for international cooperation arises from the growth of open capital accounts and highly integrated capital markets of various sorts. Financial markets, by nature, are inherently prone to instability, owing to the fractional reserve system on which they are based. Weak financial systems at the national level can have long-lasting and insidious macroeconomic implications that are naturally of concern to central bankers; monetary stability and financial stability are two sides of the same coin. With integrated markets, financial instability is unlikely to remain contained within national borders. All financial disruptions are likely to have an international dimension because the three pillars of a domestic financial system, financial institutions, financial markets and payment and settlement systems, are increasingly international. The fact that financial transactions can be made, as well as market information disseminated, instantaneously and at almost no cost around the globe increases the probability that shocks in individual countries will be propagated elsewhere, even when such contagion might not be warranted by underlying economic fundamentals. The crises are increasingly coming in waves; they tend to be regional in scope and, even though they have more severe effects within the region of origin, no region is spared.

Indeed, the prospect of financial contagion argues for greater consultation and cooperation. The integration of the capital markets across the globe brings efficiency benefits in terms of competitive cost of funds, diversification benefits etc. However, there are also attendant risks associated with notions of contagion and systemic risks. There are at least three important characteristics of today's capital markets that raise different perspectives on risk.

First, a multiplicity of channels characterizes the transmittal of financial strains from one system to another. Traditionally, trade and investment links are considered to be the main transmission mechanism of disturbances across boundaries. It is now apparent that the transmission mechanism is wider

⁴ While there exist multilateral institutions such as IMF tasked with the oversight of elements of the international financial system, the role of IMF at the international level is not analogous to that of a central bank at the domestic level.

and can include a sell-off instigated by a reassessment by the creditors of a country who become exposed to a previously ignored weakness in another country. The herd mentality of investors who pull out of a region composed of both crisis and non-crisis countries in one sweep on the basis of margin calls, internal risk-management guidelines, or plain panic provides another mechanism for contagion. A series of competitive devaluations in response to a similar action initiated by a country that faces an imminent currency crisis constitutes another channel for the propagation of contagion in a region.

Second, today's capital market is marked by the extremely high speed of transmission of information and transactions. Thus, any change in expectations could trigger massive fund transfers from one system to another and the loss in confidence by investors in a country can result in large and rapid capital outflows with very significant changes in asset prices, which could trigger a financial crisis. The implications of the speed of operations for the reaction time of policy makers in responding to a crisis are that they no longer enjoy the luxury of having a long time to analyse or to determine the appropriate policy response to the initial disturbance.

The third characteristic involves asymmetries in size, particularly between the financial resources available to the private capital market participants and the liquid assets of the official financial sector, and between the size of private capital flows and that of the domestic financial system of an emerging market. Private capital markets far exceed official assets, and international capital flows dwarf the size of the stock markets of almost all emerging markets. One implication of these disparities is that the speed and size of private flows, particularly short-term flows, can significantly destabilize the financial markets of emerging markets. Another implication is that speculative pressure arising from the markets can be very powerful and easily destabilize the asset markets and the exchange rate regimes.

The aforementioned realities impose several challenges on the task of promoting global financial stability. Any such strategy must begin by recognizing two facts: the pace of change in modern financial markets is extraordinary, ongoing and irreversible and financial transactions are becoming increasingly complicated and opaque, involving an ever-widening and changing cast of actors. Thus the system which policy makers aim to stabilize is

both difficult to define at any moment in time and rapidly mutating. Moreover, new participants such as pension funds, mutual funds and hedge funds are not likely to behave in the same manner as traditional banks, implying new uncertainties about how the international financial system will react during periods of stress.

Key elements of economic policy cooperation

Economic relations among national governments can be viewed as ranging along a spectrum from open conflict to integration, where governments set policies jointly in a supranational forum to which they have ceded a large measure of authority. At the midpoint of the spectrum lies policy independence, in which governments simply take the policies of other governments as given, attempting neither to influence them nor be influenced by them. Between independence and integration lies coordination – joint problem identification and pursuit of mutually beneficial ways of achieving national objectives. There are a variety of forms of cooperation, such as information exchange, consultation and mutual encouragement to adopt certain strategies or policies. Consultation lies closer to independence than true coordination; it is more informal, less binding and essentially involves sharing views and information without actually tying policies to formally agreed norms.

In the light of the spillover effects where part of the benefit or cost arising from the policy decision of one country affects others, there is a felt need in today's increasingly integrating world for governments to consult with each other and attempt to coordinate their actions to take these linkages into account. In theory, they should then be better off than if they had acted independently. This argument becomes even more compelling in the light of recent rapid advances in information technology and the integration of financial markets discussed earlier.

There are several steps needed for effective international cooperation:⁵

- A common understanding of the objectives that are being pursued

⁵ A. Crockett, "Strengthening international economic cooperation: the role of indicators in multilateral surveillance", *IMF Working Paper*, No. 76 (Washington DC, 1987).

- An appreciation of the nature of the economic environment within which national economies interact
- An analytical framework for assessing the international impact of the economic policies and the performance of individual countries
- A set of procedures that allow international considerations to be taken into account properly in framing national policies

In the Group of Seven (G-7)⁶ framework for economic cooperation, which is one of the more long-lasting and developed systems,⁷ there are three main steps:

- Surveillance, using statistical (also called "objective") indicators for the projection of the effects of economic policies and for measuring actual performance, to assist in assessing the emergence of internal and external disequilibria
- Policy objectives and guidelines developed in the light of existing knowledge about the linkage between goals and policies, against which the member countries' economic performance can be appraised and remedial changes recommended, if necessary
- Adoption of recommended policy changes

Surveillance thus has an important role to play in international economic cooperation, but it is only one element. In the G-7 framework, for instance, surveillance is the first step in a coordination process that should end with the adoption of policy changes. In less ambitious cooperative efforts, the surveillance indicators are used to give focus to the process of exchanging views. Without these objective elements that provide a common starting point, there is the attendant risk that such consultations will be unfocused and therefore ineffective. The process of surveillance itself contains several

elements, including the selection of indicators which measure economic performance as well as provide an early warning of the emergence of unsustainable trends. In the G-7 context, there are two kinds of indicators: the target indicators and their actual values; target indicators reflect domestic policy objectives, such as growth of real incomes, low inflation and full employment.

Monitoring is the process of comparing the target variables against actual performance. Therefore, one must necessarily undertake monitoring when performing surveillance, that is, monitoring is an essential component of surveillance.

Determining the targets for these variables or their paths can be done using quantitative projection methods. Sometimes, on top of the target variables, the set of instruments that countries use to achieve their targets, such as open market operations, public-sector expenditure and tax rates that are controlled by monetary and fiscal authorities, may be quantified and monitored. In many cases targets include intermediate variables such as interest rates and exchange rates, nominal income and growth of monetary aggregates. International targets may refer to what in the domestic economic context would be intermediate variables, such as reduction of current account deficits, stabilization of exchange rates, or reduction of protectionist pressures. Monitoring is used to provide policy analysis of why targeted paths were successfully attained or not or to give an early warning of a potential crisis situation. Adequate monitoring can lead to improvements in the ability of governments to recognize warning signals early and to act swiftly.

Monitoring can and should take place at different levels of policy-making as economies are made up of several subsectors: real, financial, fiscal etc. The implications of the interrelationships between these subsectors for the overall economy also need to be considered. Thus a monitoring hierarchy may consist of at least two levels: monitoring at the level of the sectors and at an overarching economy-wide level.

In the aftermath of the recent crises, as domestic policy makers, IMF and other multilateral institutions came to grips with the apparent failure of surveillance to foresee them, there has been a movement towards countries adopting internationally developed codes or standards in a number of areas affecting the operation and supervision of financial

⁶ The seven countries are Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

⁷ The G-7 consultation process began as the Group of Five process in 1985, in which the economic leaders of the five major industrialized countries met and discussed policy coordination matters in an informal setting.

markets. The most developed of these so far is the Basel capital adequacy standard, although standards or codes on transparency, fiscal, financial and monetary policies, stock markets, accounting systems, bankruptcy etc. are being developed. Such codes and standards can provide clear parameters for monitoring exercises in the financial sector.

An important element in a successful economic coordination framework is a set of policy guidelines developed to conduct surveillance of members' policies and performance and to identify the need for remedial action. The G-7 practice has been to make policy commitments and exchange rate objectives public through communiqués issued at ministerial meetings. In this exercise, exchange rate commitments are analysed first, together with the measures that were used for comparing commitments with actual performance; this is followed by an analysis of the norms that were used in judging the need for changes in macroeconomic policies.

The third element of successful coordination is to find means to encourage remedial policy action once the need for it has been identified. In theory, this can involve peer pressure from other countries, bargaining to accomplish linkage with other desired objectives, or retaliation for failure to take the remedial action. From the above, it is clear that the ultimate effectiveness of any form of international economic cooperation has to be judged by the ability of such efforts to influence the behaviour of countries.

The process of selection of indicators

Any multilateral surveillance process has to make use of a variety of indicators. It is important not only to define the purposes for which the indicators are to be used but also the analytical framework within which they are to be interpreted. International cooperation thus has two levels: the technical level, at which the primary concern is the selection of indicators, and the interpretation level, at which judgements of whether a country is headed towards economic turmoil are made based on the movements or performance of the indicators. The selection of appropriate indicators is thus an important element in the process of international coordination/cooperation because they provide focus for the discussion of policy options. In the G-7 framework, for instance, these should be broad enough to

identify the underlying causes of imbalances, not just the imbalances themselves. In national surveillance, the use of leading indicators is more focused on assessing the prospects of recession or an inflationary surge. In essence, indicators should be useful in judging economic trends in a systematic way.

While a set of basic macroeconomic indicators is used in most countries on an ongoing basis for monitoring domestic developments,⁸ there are a number of other important elements that determine the selection at the international level. First, as the use of indicators at this level is geared primarily to analysing the international interactions of economic policies and performance, trends in domestic policy and performance variables need to be viewed in terms of their implications for international variables such as exchange rates and payment patterns. This, in turn, requires an analytical framework for relating trends in domestic variables to external objectives. Second, emphasis should be on the medium term, and short-term developments should be assessed in the light of their medium-term implications. Third, the actual developments in particular indicators need to be measured against standards or criteria that would establish a regionally or internationally accepted desirable pattern.

EARLY WARNING SYSTEMS

The provision of an early warning of a crisis is really the product of monitoring. One can make two conclusions after monitoring: either everything is on track or some things are going wrong. Once significant deviations from the desirable trend of a set of indicators are identified policy makers are alerted to the possibility of crisis. Early warning systems are models that attempt to predict systematically which

⁸ This set includes GDP growth rates, interest rates, fiscal deficit as a percentage of GDP, monetary growth rates, exchange rates, inflation rates, unemployment rates, current account and trade balance, foreign-currency reserves, budget performance, monetary conditions, domestic demand growth, fiscal balance and composite indicators. For a discussion of these indicators, see Wendy Dobson, "Economic policy coordination: requiem or prologue?", in *Policy Analyses in International Economics* (Washington DC, Institute for International Economics, 1991), pp. 283-297.

countries are more likely to suffer from crises. Among these, models designed to predict currency crises are common (see box IV.1 for typologies of crises). The advent of the Asian crisis has stimulated work in this field further. The post-Asian crisis research can be mapped into the following two areas: the development of leading indicators or early warning systems to predict the onset of a crisis; and policy measures that can be taken to avoid similar problems in the future.

Here the concern is primarily with the first, including reviewing the various early warning

systems that have been proposed. The second is of interest insofar as it can guide the construction of leading indicators. However, it should be noted that having an early warning system would be of great advantage if it were complemented by a reaction kit of policy response options whenever bad signals were flashing. If the authorities are required, on the basis of warning signals, to consider actions based on a set of policy options (similar to the prompt corrective action rules developed in the United States), then a speculative attack may be averted. It should be recalled that speculative attacks on a currency are significantly affected by uncertainty over

Box IV.1. Identifying crises

The important issue that arises when considering an early warning system is what exactly constitutes a crisis.^a A useful starting point is the IMF taxonomy in *World Economic Outlook*,^b which classifies crises into the following types:

- Currency crisis – when there is a significant devaluation of a currency with loss of reserves and/or a significant rise in interest rates in an attempt to defend the currency, caused by a speculative attack on the currency or a sudden unexpected event
- Banking crisis – when potential or actual bank failure or bank run causes banks to suspend internal servicing of their liabilities or leads to large-scale government intervention
- Foreign debt crisis – when a country cannot service its foreign debt, whether public or private

All of these are crises not only in the sector of origin but for the economy as a whole, as they cause drastic falls in output and employment. While international early warning systems are primarily concerned with currency crises, the three types of crisis are closely interrelated, particularly for countries with open capital accounts.

^a There are also political crises, for example, the Aquino assassination in the Philippines, current political turmoil in Indonesia etc., which have important impacts through economic channels, such as capital flight and reduced investment flows, but which are not included here.

^b IMF, *World Economic Outlook* (Washington DC, May 1999), p. 74, available at <<http://www.imf.org/external/pubs/ft/weo/1999/02/index.htm>> (24 January 2000).

An alternative classification of crises has been provided by Radelet and Sachs.^c While the IMF classification focuses on the manifestations of crises, the Radelet-Sachs classification focuses on the possible causes:

- Macroeconomic policy-induced crisis – this basically follows from Krugman's analysis^d of excessive domestic credit expansion being inconsistent with the pegged level of the exchange rate
- Financial panic – a situation of multiple equilibria where adverse equilibria occur. Each creditor rationally withdraws from a solvent borrower if other creditors also withdraw, often preceded by a circumstance in which each creditor extends further loans (and is willing to do so) if the other creditors do likewise
- Bubble collapse – investors purchase financial assets above their fundamental value in the expectation of future gain; the bubble eventually bursts and a crisis occurs
- Moral hazard crisis – banks overlend and, in the process, lend to risky ventures
- Disorderly workout – a grab race by creditors for an illiquid or currently insolvent borrower's assets, even though the borrower would be worth more as an ongoing enterprise. The problem here is essentially a lack of coordination among creditors

^c Steven Radelet and Jeffrey Sachs, "The onset of the East Asian financial crisis", *HIID Working Paper* (Massachusetts, Harvard Institute for International Development, March 1998), available at <<http://www.hiid.harvard.edu/pub/other/eaonset2.pdf>> (25 January 2000).

^d Paul Krugman, "A model of balance-of-payments crisis", *Journal of Money, Credit, and Banking*, vol. 11, No. 3 (August 1979), pp. 311-325.

the timing and quality of policy responses to disturbances. A reaction kit of policy options may well serve as a clearly articulated contingency plan for governments that could improve the confidence of market participants.

A fundamental issue confronting research in this area is whether crises are, by nature, predictable. If a crisis implies a correction of an unsustainable economic trend, presumably generated by an inconsistent set of policies, then crises should be predictable. This corresponds to the first case in the Radelet-Sachs classification (see box IV.1). To the extent that the monitoring or regulation of banks can spot problematic practices, moral hazard-based crises can also be predicted. It is also contended that some crises may be inherently unpredictable. This would be so in the case of contagion; Radelet and Sachs argue that the Asian crisis belongs more to this category. In their view, the macro-economic fundamentals of most if not all of the affected countries did not justify the severity of the crisis.

Apart from such theoretical considerations, there are other issues that impinge on the practical side of predicting currency or other types of crises. First, there are doubts that crises are sufficiently similar across countries and over time to allow generalizations from past experience. There is also the question of whether adequate data on the signals of crisis are available, on time, with adequate accuracy and in a way that is interpretable by policy makers. There are difficult measurement problems for some vital indicators. For instance, much of the literature on the Asian crisis has identified underdeveloped banking supervision as a major factor in increasing the vulnerability of the banking system to a crisis. This variable, however, is difficult to quantify, and qualitative assessments may vary significantly. Lastly, even if data were available, the presence of "noise" may not guarantee that a correct interpretation is possible.

A second related issue is the difficulty of constructing an early warning system based on historical data to warn of a crisis that has origins in something new, that is, not covered by previous theories of crises. The world of finance is known for its rapid innovation and increasing complexity of instruments and so this situation is likely to arise. It is also true that policy makers, civil servants and technocrats tend to lag in their understanding of the innovations and their impact on policy.

Still another issue is how an early warning system could cope with a major structural change. For instance, currency crises erupt when an exchange rate peg is deemed unsustainable. In an era of freely floating exchange rates, would there be currency crises? If so, what is the transmission mechanism? Early warning systems constructed using data from a time when fixed exchange rates prevailed may not be useful or meaningful in predicting a crisis under a floating exchange rate regime.

If an early warning system was accurate and therefore credible, and authorities always acted on the basis of the warning, then policy action might avert a crisis. This is the intended effect. However, because of the action, technically the warning raised earlier becomes a false alarm as no crisis materializes – and the system may be seen as perverse. Thus an automatic reaction function of policy to crisis signals may ironically limit the predictability of crises.⁹

If the markets deem the early warning system to be credible, then a signal of an impending crisis may in fact also precipitate or trigger a crisis. This possibility, which works through the formation of expectations of the market players, creates a dilemma, and not just a conceptual problem, as market expectations have a tendency to overshoot and so may influence the economic situation of countries unnecessarily. Therefore, does having more information and warnings create crises, or lessen their severity? Does hiding information from the market avert crises or only postpone the day of reckoning and deepen the result?

In any case, if indeed leading indicators can be found, or early warning systems constructed, efforts in this direction are worthwhile in view of the large costs of a crisis. However, to anticipate a crisis, access to timely and accurate information and data is critical. Policy makers need to know the status of and changes in key economic variables. Surveillance, and the monitoring of key economic variables, are thus an important function of policy-making. Moreover, in a more open global economy, with greater economic links between countries via trade, finance and investment, this function needs to be fulfilled on the international level and not just nationally.

⁹ Andrew J. Filardo, "How reliable are recession prediction models?", *Federal Reserve Bank of Kansas City Economic Review*, vol. 84, No. 2 (Second Quarter 1999), pp. 35-56, available at <<http://www.kc.frb.org/publicat/econrev/ermain.htm>> (19 January 2000).

Identification of leading indicators

As the term implies, an early warning system consists of economic indicators that signal in advance the onset of a crisis. This idea, however, is not without its difficulties. The development of leading indicators presumes that an economy exhibits consistent and regular patterns of behaviour prior to a crisis. It assumes that the same economic variables will get out of line ahead of an impending crisis, crisis after crisis. However, not all crises are alike, and consequently one would not expect that the same indicator would be a good signal for each type of crisis. Ideally, one would like to have several observations for the same type of crisis and test which indicators would signal each of them. This ideal has to be tempered, however, by empirical considerations. It is highly unlikely that enough observations can be gathered on crises of a similar origin or nature¹⁰ in recent times to make statistical analysis feasible. If they could, it would certainly reflect badly on the ability of policy makers to learn from mistakes.

Most of the research studies on early warning systems analyse data on crises for a cross-section of countries to identify the indicators that have historically foreshadowed crises. One could argue, though, that each country (or economy) is unique and indicators that work for some countries might not work for others. For example, in developed countries a significant proportion of the population invests in stock markets, making stock market indexes an important indicator. On the other hand, in many developing countries the stock market may be too thin and insignificant to have major implications for the economy. Again, this issue reflects an empirical constraint that instances of crises for a single country may not afford enough observations for statistical testing.

The models used for predicting crises can be classified into three types:

- A signals approach – a set of economic indicators exceeding a certain threshold constitutes a signal of an approaching

¹⁰ In practice, not all crises may be put neatly into boxes that is, the delineation between one type of crisis and another may not be black and white.

crisis. Policy makers can keep track of a single indicator deemed representative of the sector being monitored (an example is the New Zealand Reserve Bank focus on the inflation rate). Instead of relying on a single catch-all indicator, a group of indicators considered reflective of various aspects of the economy may be chosen. This form is more common as the use of a number of indicators is less likely to be thrown off by "noise" than that of a single indicator. In both cases, often one cannot predict the exact timing of a crisis but can indicate stress or vulnerabilities in the system

- Probit or logit models that compute the probability of a crisis occurring based on indicators
- A regression model approach

The first two approaches have also found application in the economic literature for forecasting business cycle turning points. Conceptually, the only difference in the currency crisis literature is that the approaches are used to signal or estimate the probability of a currency crisis rather than a turning point in the business cycle.

Whichever approach is adopted, the leading indicators should ideally possess certain properties:

- Timeliness – a signal of an impending crisis, even if correct, is of limited use if it arrives after the onset of the crisis or with insufficient time left to avert it
- Low noise – the number of false signals is minimized, and a leading indicator should not fail to signal a crisis that does occur

Recent research

A brief survey of the theoretical literature on early warning systems may be found in the annex to this chapter. Three of the recent and more comprehensive empirical studies are summarized below; other recent empirical studies are listed and described briefly in the annex.

In a recent example of the use of multiple indicators, eight indicators of a financial crisis were proposed.¹¹ It is argued that these would have signalled the Asian crisis. These eight indicators, their critical regions (as determined by the author's rules of thumb), and their values in 1996 for the five Asian countries most affected by the crisis are presented in table IV.1. (Unfortunately, the author does not explain the basis for his rules of thumb for the critical range of values.)

It is clear from the table that not all of the countries were experiencing values for the variables that were critical in 1996, except for foreign debt as a percentage of GDP. However, each country (except Malaysia) had at least two variables in the critical range. Such an approach has the advantage of being fairly simple to understand. Nevertheless, the data requirements in terms of timeliness and accuracy are not easy to meet.

In another paper,¹² 28 selected empirical studies on leading indicators for currency crises by various authors were surveyed covering a number of countries, both industrial and developing, and spanning the period from the 1950s to the 1990s. The approach involves monitoring the evolution of several indicators that tend to exhibit unusual behaviour in the period preceding a crisis. When an indicator

exceeds or goes below a certain threshold value, this is interpreted as a warning signal that a currency crisis may take place within the following 24 months. The variables (either levels or growth rates) reported as having the best track record within this approach include exports, deviations of the real exchange rate from the trend, the ratio of broad money to gross international reserves, output and equity prices.

This research suggests that: (a) an effective warning system should consider a broad variety of indicators – a currency crisis usually seems to be preceded by economic and sometimes political problems; (b) those variables that receive ample support as useful indicators of currency crises include international reserves, the real exchange rate, credit growth, money supply as a ratio of international reserves, real GDP growth and the fiscal deficit; (c) several foreign, political, institutional and financial variables also have some predictive power in anticipating a currency crisis – banking-sector problems stand out in this regard; and (d) (surprisingly) variables associated with the external debt profile did not fare well. Also contrary to expectations, the current account balance did not receive much support as a useful indicator of crisis. This may be because information provided by the behaviour of the current account balance may

¹¹ Dominick Salvatore, "Could the financial crisis in East Asia have been predicted?", *Journal of Policy Modeling*, vol. 21, No. 3 (May 1999), pp. 341-347.

¹² Graciela Kaminsky, Saul Lizondo and Carmen Reinhart, "Leading indicators of currency crises", *IMF Staff Papers*, vol. 45, No. 1 (March 1998), pp. 1-48.

Table IV.1. Leading indicators of financial crises, 1996

	Indonesia	Malaysia	Philippines	Republic of Korea	Thailand	Critical region
1. Savings rate (% of GDP)	29	37	20	33	33	< 24
2. Budget deficit (surplus) (% of GDP)	(1.2)	(0.9)	0	0.1	(3)	> 3
3. Current account deficit (% of GDP)	3.3	4.9	4.7	4.8	7.9	> 5
4. Foreign debt (% of GDP)	59.7	42.1	47.3	32.1	50.3	> 30
5. Short-term debt (% of GDP)	14.9	..	9.1	10.3	20.8	> 10
6. Current account deficit less foreign direct investments (% of GDP)	1.4	4	0.6	5.2	6.8	> 3
7. Debt service (% of exports)	36.8	8.2	13.7	7	11.5	a
8. Months of import cover	5.5	3.3	2.3	1.1	5.1	a

Source: Dominick Salvatore, "Could the financial crisis in East Asia have been predicted?", *Journal of Policy Modeling*, vol. 21, No. 3 (May 1999), pp. 341-347.

^a The author does not mention a specific critical value.

already have been reflected to some extent in the evolution of the real exchange rate.

There are limits to the usefulness of this approach for a particular country precisely because the set of indicators proposed are those that perform well in warning of crises over a large sample of countries. If each country is peculiar to itself, as this research suggests, then the best set of leading indicators for a particular country is unique and not necessarily the same as the general set. Nevertheless, the proposed set could be useful as a starting point for those countries or economies that have not yet found a set of leading indicators.

However, if it is accepted that the more important ability of an indicator is to predict a crisis when one in fact does occur later¹³ (in other words, not miss a true crisis), then the results are not very promising. The literature would refer to this as avoiding a type I error that is, failing to signal a crisis that in fact occurs; a type II error corresponds to a false alarm that is, signalling a crisis when none in fact follows. The following simplified version of the table reported in the *IMF Staff Papers* highlights this aspect of the results. On the average, the indicators signalled a crisis correctly only 68 per cent of the time; that is to say, they missed 32 per cent of the crises.

Berg and Pattillo¹⁴ undertook a comparison and evaluation of three early warning models of currency crisis. The models they picked represented the three classes of early warning models enumerated earlier. Specifically, they evaluated the Kaminsky-Lizondo-Reinhart model discussed earlier as a representative of the signals approach, the Frankel and Rose probit model¹⁵ as a representative

Table IV.2. Performance of early warning indicators

Indicator	Number of crises with available data	Percentage of crises called
Real exchange rate	72	57
Banking crises	26	37
Exports	72	85
Stock prices	53	64
M2/international reserves	70	80
Output	57	77
"Excess" M1 balances	66	61
International reserves	72	75
M2 multiplier	70	73
Domestic credit/GDP	62	56
Real interest rate	44	89
Terms of trade	58	79
Real interest differential	42	86
Imports	71	54
Bank deposits	69	49
Lending rate/deposit rate	33	67
		Average = 68.1

Source: Graciela Kaminsky, Saul Lizondo and Carmen Reinhart, "Leading indicators of currency crises", *IMF Staff Papers*, vol. 45, No. 1 (March 1998), table 1, p. 20.

of the probit/logit approach, and the Sachs, Tornell and Velasco model¹⁶ for the cross-country regression approach. They attempted to replicate the results of these three models, introducing and experimenting with slightly different specifications along the way. Unfortunately, their conclusion is not very promising from the perspective of those who hope for a viable early warning system. While they find that the models are better than naive guesswork, they would not have predicted the 1997 crisis very well.

All the models surveyed tried to come up with leading indicators that performed well over a cross section of countries and crises. As pointed out earlier, precisely because crises and economies can vary in nature, "one size may not fit all" when it comes to leading indicators. In most developed economies, work has been done to identify leading indicators of business cycles (see box IV.2 for a discussion of those used in the United States). In terms of the elements of the

¹³ This might be the case if, whatever early warning system is used, it is not disseminated to the public. From a policy maker's perspective, it might be more tolerant of a system issuing false alarms rather than one which fails to signal a crisis that in fact occurs later.

¹⁴ Andrew Berg and Catherine Pattillo, "Are currency crises predictable? A test", *IMF Staff Papers*, vol. 46, No. 2 (June 1999), pp. 107-138.

¹⁵ Jeffrey Frankel and Andrew Rose, "Currency crashes in emerging markets: an empirical treatment", *Journal of International Economics*, vol. 41, Nos. 3/4 (November 1996), pp. 351-366.

¹⁶ Jeffrey Sachs, Aaron Tornell and Andres Velasco, "Financial crises in emerging markets: the lessons from 1995", *Brookings Papers on Economic Activity*, vol. 1 (Washington DC, Brookings Institution, 1996), pp. 147-215 with summary of the article available at <http://www.brook.edu/press/bpea/bpea1_96.htm> (25 January 2000).

Box IV.2. Conference Board leading indicators of economic activity

At first blush, this strand of the literature does not seem directly of interest to the question of financial or currency crises. However, some papers^a suggest an important link, that banking and balance-of-payments crises are normally preceded by or contemporaneous with either recessions or below-normal economic growth. If this is the case, then these Conference Board-type leading indicators could function as early warning systems, or at least complement them. An interesting question also arises concerning the composition of the many early warning systems for financial crises as compared with leading indicators of an economy, say, the Conference Board Indexes of Leading Indicators. If in fact they are similar, then this again suggests their possible use as an early warning mechanism.

The Conference Board has a set of leading indicators, as well as sets of coincident and lagging indicators. These indicators, which were first constructed by the National Bureau of Economic Research,

have been used in the United States since 1961. The U.S. Bureau of Census continued this work after the National Bureau turned over responsibility for maintaining the indexes to it in that year. The indexes were presented in its monthly government economic report, *Business Cycle Developments*. Recently, the responsibility for maintaining these indexes was transferred to the Conference Board. The latest composition of these indexes is presented below. While they have not been 100 per cent accurate, they have arguably been of great help to policy makers, and the latest updates are awaited with anticipation by market watchers.

Since the pioneering efforts of the National Bureau of Economic Research, other organizations have come up with their own leading indicators. For example, the American Institute for Economic Research regularly features its own primary leading, roughly coincident, and lagging indicators in its research papers.^c

The Conference Board Composite Indexes of Indicators^b

Leading Index

- 1 Average weekly hours, manufacturing
- 2 Average weekly initial claims for unemployment insurance
- 3 Manufacturers' new orders, consumer goods and materials
- 4 Vendor performance, slower deliveries diffusion index
- 5 Manufacturers' new orders, non-defense capital goods
- 6 Building permits, new private housing units
- 7 Stock prices, 500 common stocks
- 8 Money supply, M2
- 9 Interest rate spread, 10-year Treasury bonds less federal funds
- 10 Index of consumer expectations

Coincident Index

- 1 Employees on non-agricultural payrolls
- 2 Personal income less transfer payments
- 3 Industrial production
- 4 Manufacturing and trade sales

Lagging Index

- 1 Average duration of unemployment
- 2 Inventories to sales ratio, manufacturing and trade in 1992 dollars
- 3 Labour cost per unit of output, manufacturing
- 4 Average prime rate
- 5 Commercial and industrial loans
- 6 Consumer instalment credit to personal income ratio
- 7 Consumer price index for services

^a See in particular Daniel C. Hardy and Ceyla Pazarbasoglu, "Leading indicators of banking crises: was Asia different?", in *IMF Working Paper*, No. 91 (Washington DC, June 1998) and Graciela L. Kaminsky and Carmen M. Reinhart, "The twin crises: the causes of banking and balance-of-payments problems", *The American Economic Review* (June 1999), pp. 473-500.

^b The Conference Board, "Composite indexes of leading, coincident, and lagging indicators: September 1999", *Leading Economic Indicators & Related Composite Indexes*, available at <<http://www.tcb-indicators.org/leiarchive/leisep99.htm>> (20 January 2000).

^c American Institute for Economic Research, "AIER's primary leading, coincident and lagging statistical indicators", *Research Paper* (December 1999), available at <<http://www.aier.org/businesscycles.html>> (20 January 2000).

The table below shows the components of the Institute's indicators for comparison with the Conference Board's counterparts shown above.

A comparison of the sets of leading indicators reveals that, while they are not exactly the same (the American Institute's leading indicator has 12 components to the Conference Board's 10 components), there is a

remarkable commonality in the nature of the economic variables included, for example money supply, stock prices, housing etc. A similar finding holds for the coincident and lagging indicators of both institutions. This suggests validity in the type of variables included as components in the indicators and lends credence to the idea that there is an early warning system for the business cycle.

Components of American Institute for Economic Research indicators^d

Primary Leading Indicators

- 1 M1 money supply
- 2 M2 money supply
- 3 Month percentage change in sensitive materials prices
- 4 New orders for consumer goods
- 5 Contracts and orders for plant and equipment
- 6 New housing permits
- 7 Ratio of manufacturing and trade sales to inventories
- 8 Vendor performance, slower deliveries diffusion index
- 9 Index of common stock prices
- 10 Average work week in manufacturing
- 11 Initial claims for state unemployment insurance
- 12 Three-month percentage change in consumer debt

Primary Roughly Coincident Indicators

- 1 Non-agricultural employment
- 2 Index of industrial production
- 3 Personal income in manufacturing
- 4 Manufacturing and trade sales
- 5 Civilian employment as a percentage of the working-age population
- 6 Gross domestic product

Primary Lagging Indicators

- 1 Average duration of unemployment
- 2 Manufacturing and trade inventories
- 3 Commercial and industrial loans
- 4 Ratio of debt to income
- 5 Percentage change from a year earlier in manufacturing labour cost per unit of output
- 6 Composite of short-term rates

^d American Institute for Economic Research, "AIER's primary leading, coincident and lagging statistical indicators", *Research Paper* (December 1999), available at <<http://www.aier.org/businesscycles.html>> (20 January 2000), p. 3.

composite indexes of leading indicators of business cycles as compared with those for currency crises, it is noticeable that the former tend to be more micro in nature. The only variable common to both is stock prices; other variables which measure similar economic phenomena are the monetary aggregates (M1 and M2), interest rates and GDP. This finding is consistent with the work of Estrella and Mishkin,¹⁷ who found that financial variables (specifically stock prices) are useful for forecasting recessions in the United States economy.

¹⁷ Arturo Estrella and Frederic S. Mishkin, "Predicting U.S. recessions: financial variables as leading indicators", *Review of Economics and Statistics*, vol. 80, No. 1 (February 1998), pp. 45-61, available at <<http://mitpress.mit.edu/journal-abstracts.tcl?issn=00346535&volume=80&issue1>> (25 January 2000).

In general, all the models attempting to produce early warning systems or leading indicators of currency crises focused only on macro variables. Some even avoided using micro variables (specifically banking industry variables) in favour of macro variables whose forecasts are more readily available.¹⁸ It is therefore not surprising that there is very little overlap in the composition of both types of indicators. However, even if these types of leading indicators were effective as early warnings of currency crises, their usefulness outside of OECD countries may be limited, as not many other countries collect data on similar leading indicators.

¹⁸ See, for example, Asli Demirguc-Kunt and Enrica Detragiache, "Monitoring banking sector fragility: a multivariate logit approach with an application to the 1996-97 banking crises", *Policy Research Working Paper*, No. WPS 2085 (Washington DC, World Bank, 1999).

THE WAY FORWARD

Does the fact that the prediction of a crisis appears difficult render early warning systems, surveillance and monitoring mechanisms futile? Not exactly, but it may mean a change in the orientation of such mechanisms. Rather than concentrate efforts on avoiding crisis or identifying oncoming shocks to the system, it may be more realistic to engage in activities that monitor how robust or vulnerable a country/financial system is to any internal and external disturbance. This can be carried out by engaging in monitoring the conditions of countries related to economic, financial and institutional stress. Thus, even though accurately forecasting the timing of crisis is likely to remain an elusive goal for academics and policy makers alike, there is clearly a need to develop a warning system that helps monitor whether a country may be slipping towards a potential crisis.

There appear to be at least two strategies in which countries, regional or multilateral institutions can engage in order to avoid or contain the effects of crisis. The first is to engage in surveillance and early warning systems that can detect the possibility of oncoming shocks, as discussed earlier. The second is to concentrate efforts in making the real and financial economy more robust and less vulnerable to shocks. Closely allied to this are measures to strengthen financial systems and improve risk

management. Of course, these two strategies are not mutually exclusive, but the choice of priority will have implications for where efforts and budgets are directed.

In the light of the inherent limitations of surveillance and early warning systems, the second strategy of strengthening the financial system and making the economy more robust against stress requires to be pursued simultaneously. There are two channels through which a crisis can occur:

- Pursuit of policies that leave economies dangerously exposed to the loss of investor confidence; in this sense, crises are internally generated
- Crises occur because of systemic risks, of which contagion is a familiar manifestation. However, the degree of damage to countries hit by contagion varies according to the extent of weakness of the fundamentals of those countries. The implication is, again, that good fundamentals made possible by sound policies still matter

While the role of international cooperation in surveillance and monitoring was underscored in the wake of the recent Asian crisis, an appropriate crisis-prevention strategy also involves improving policy-making at the national level. There is thus great scope for enhanced international cooperation to assist countries in this area.

Annex

EARLY WARNING SYSTEMS FOR CURRENCY CRISES: RECENT RESEARCH

Theoretical underpinnings

Most leading indicator models or warning systems employ economic theory to guide them in the selection of the indicators to be included. At this point, the literature is sufficiently rich in theories on the causes of currency crises to separate them into first- and second-generation models.

First-generation models focused on imbalances in macroeconomic fundamentals, often citing the role of excessive public-sector deficits. The seminal paper in the first-generation category is that of Krugman.^a In his model, under a fixed exchange rate regime, domestic credit expansion in excess of money demand growth leads to a gradual but persistent loss of international reserves and ultimately to a speculative attack on the currency. This suggests that expanding money supply to finance fiscal deficits may cause excessive credit growth, which in turn brings pressure to bear on a currency in a fixed exchange rate regime, and eventually causes its collapse. Variables like the fiscal deficit and the monetary base grow faster and beyond a certain size before a crisis. A number of papers have extended Krugman's basic model to suggest that the evolution of the real exchange rate, the trade or current account balance and domestic interest rates could be used as leading indicators of crises.

While the traditional approach stresses the role played by declining international reserves in triggering the collapse of a fixed exchange rate, some recent models have suggested that the decision to abandon the parity may stem from the authorities' concern about the evolution of other key economic variables. For example, the presence of banking problems reflected in the relative price of bank stocks, the proportion of non-performing loans, central bank credit to banks or a large decline in deposits could also indicate the high likelihood of a crisis. Leading indicators may also include political variables.

Second-generation models allow the possibility of crises even though an economy does not suffer continuous deterioration in its economic fundamentals. These models underscore the role of expectations of economic agents in a crisis. Some of these models introduce the concepts of herding behaviour and contagion effects. In

herding behaviour, "information costs may lead foreign investors to take decisions based on limited information and therefore to be more sensitive to rumours".^b Further, as financial markets are now much more interrelated than they were a decade ago, individual investors now have many more ways to cover risks, and losses in one market may force liquidations in others. Thus, a loss by investors in country A may cause them to liquidate in country B (or a set of countries B, C etc.), possibly triggering a crisis, if not at least putting some stress on the financial system of country B. These models have the unpleasant implication that crises arising in financial markets are likely to be unpredictable; if a crisis can occur in a country even without poor fundamentals, then it will not be reflected in its usual macroeconomic variables since it is merely guilty by association.

There are three variants of the contagion effects hypothesis.^c The first hypothesizes that trade links may be the channel through which attacks on one currency are transmitted to another. If a country's competitor in exports suffers a devaluation of the currency, then the country itself may also suffer a currency attack owing to the perceived need to maintain export competitiveness with the other country. It has been found that the greater the correlations of export shares, the greater is the tendency of these countries' currencies to depreciate by more or less the same amount.

The second channel of contagion is related to financial market linkages. There is a demonstration effect on the part of borrowers; when domestic borrowers saw what was happening in other Asian countries where the exchange rate peg had given way they tried to cover themselves to avoid the same fate. This only served to increase the downward pressure on their own currencies. Another financial channel saw the crisis spread through the action of international lenders; heavy losses in one market by retail investors forced liquidation in several

^b Gerardo Esquivel and Felipe Larrain, "Explaining currency crises", *Development Discussion Paper*, No. 666 (Massachusetts, Harvard Institute for International Development, November 1998).

^c There may be several reasons for expecting crises to be contemporaneous in time. See, for example, the discussion in Paul R. Masson, "Contagion: monsoonal effects, spillovers, and jumps between multiple equilibria", *IMF Working Paper*, No. 142 (Washington DC, 1998).

^a Paul Krugman, "A model of balance-of-payments crises", *Journal of Money, Credit, and Banking*, vol. 11, No. 3 (August 1979), pp. 311-325.

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markets. It is still typical for investors to calculate historical correlations between rates of return on investments in different countries; high correlations would thus lead to immediate selling of all investments should one of them come under pressure.

A third variant relates to a common cause. For instance, policies undertaken by industrial countries may have similar effects on emerging markets. An interest rate increase in the United States may decrease the attractiveness of several other markets at the same time, leading to a sudden and unexpected outflow of short-term capital, which is highly sensitive to interest rate differentials, or a change in tax rates in a developed country may affect the savings behaviour and so the size and composition of international capital flows.

These theories of contagion provide important reasons why the empirical relationship between economic data and the occurrence of crises is likely to be imperfect.

Recent empirical studies

Most recent empirical studies on early warning systems follow one of the three models outlined in this chapter: the signals approach, probit or logit models, and regression models. A few additional studies belonging to each category are described briefly below.

(a) Signals approach

Work by Lawrence Lau and Jung-Soo Park^d (which preceded that of Salvatore) sought to identify signals of fundamental vulnerability in selected Asian countries similar to those which existed in the economy of Mexico prior to the Mexican crisis. This work was initially carried out in September 1995 and is therefore certainly a prescient one. Selected economic indicators for China; Hong Kong, China; Indonesia; Malaysia; Philippines; Republic of Korea; Singapore; Taiwan Province of China; and Thailand were compared with those of Mexico. The paper itself provides sparse details on the authors' criteria for determining whether the indicators are at problematic levels, that is, sufficiently similar to Mexico.

Most of the countries that were later hit by the Asian crisis were found to have several of the following commonalities with Mexico (though not necessarily all at the same time): falling real exchange rates; low or

lowered rate of growth of real GDP; high relative rate of inflation; high interest rate differential; rising interest rate differential; high real rate of interest; large negative trade balance; large negative current account balance; and high ratio of foreign portfolio to foreign direct investment.

(b) Probit or logit models

A study by Dongchul Cho and Kiseok Hong^e examined the cause of the Asian crisis empirically. The study first identified the general causes of a currency crisis using a comprehensive data set, and then applied the result to the Asian case. The study then compared various international linkages of currency crises with each other and determined which one was most relevant.

The study used a probit equation that related crisis episodes to standard macroeconomic fundamentals along with various contagion measures to determine which variables were most significant. The dependant variable for probit estimation was a crisis index, which took the value 1 if a currency crisis occurred and 0 otherwise. A currency crisis was defined as a depreciation of the nominal exchange rate of at least 25 per cent, which was also at least a 10 per cent historical increase in the rate of depreciation for the country. Three sets of variables were used in the model: (i) macroeconomic indicators: GDP growth rate, real domestic credit growth rate, inflation rate, fiscal deficit/GDP ratio; (ii) external variables: current account/GDP ratio, changes in the terms of trade, changes in the real exchange rate, foreign reserves/short-term debt ratio, FDI/GDP ratio, total foreign debt/GDP ratio, short-term debt/total foreign debt ratio; and (iii) foreign conditions: GDP growth rate, interest rate in developed countries, crisis incidents of foreign countries. Data covered 103 developing countries, including the crisis-hit Asian and Latin American countries, for the years 1980 through 1996.

The results of the estimation suggested that in general a country might undergo a currency crisis even when its domestic fundamentals were not particularly weak. The contagion of crises was found to take place most often among countries that were in geographical proximity; economic linkages such as international trade and finance turned out to be insignificant once geographical proximity was taken into account. This pattern of contagion implied that intraregional cooperation was critical in preventing future currency crises.

^d Lawrence J. Lau and Jung-Soo Park, "Is there a next Mexico in East Asia?", paper presented at the project LINK World Meeting, Pretoria, South Africa, 25-29 September 1995.

^e Dongchul Cho and Kiseok Hong, "The Asian currency crisis: domestic fundamentals and international linkages", *Working Paper* (Korea Development Institute, August 1999).

A study by Daniel Hardy and Ceyla Pazarbasioglu^f used a multinomial logit model to identify the role of the macroeconomic, banking sector and real sector indicators in the emergence of banking system difficulties. The data sample covered 50 countries, 38 of which suffered a total of 43 episodes of banking system crisis and comprised 323 observations for the period 1980-1997. Three groups of explanatory variables were used: real-sector variables (rate of growth, consumption growth, investment growth and capital-output ratio); banking-sector variables (deposit liabilities, credit to private sector, and foreign gross liabilities); and potential shocks (inflation, real interest rate, real exchange rate, real growth in imports and terms of trade).

The empirical findings suggested that banking distress was associated with a fall in real GDP growth, boom-bust cycles in inflation, rapid credit expansion, rapidly increasing capital inflows, rising interest rates, a declining capital/output ratio, and a sharp reduction in real exchange rates with an adverse trade shock. The paper also found that in Asian countries, variables such as credit growth and rising foreign liabilities, which were proxies for vulnerability of the banking and corporate sector, were more important than traditional macroeconomic indicators. This suggests that the construction of early warning systems should not focus solely on macroeconomic indicators. In fact, this seems to have been the story of the Asian crisis: everyone was pre-occupied with the "nice" macroeconomic picture but missed seeing the weaknesses at the micro level, for example, banking system flaws.

(c) Regression models

Kaminsky and Schmukler^g conducted a regression analysis to determine the reaction of financial markets to news – either rumours or fundamentals – in crisis episodes. The test was conducted for the Asian crisis for the period beginning in 1997 until the end of 1998. Nine economies were included: Hong Kong, China; Indonesia; Japan; Malaysia; Philippines; Republic of Korea; Singapore; Taiwan Province of China; and Thailand. The analysis concentrated on the 20 largest one-day swings in stock prices.

The results indicated that the source of the largest one-day swings could not be explained by any apparent substantial news – either economic or political – but seemed to be driven by herd instincts of the market

itself. The results also indicated that rumours, or concerns unrelated to the actual information, affected foreign markets as strongly as they affected domestic financial markets, suggesting the presence of important contagion effects. There was also some evidence that investors overall reacted instantaneously and more strongly to bad news than to good news.

Dadush, Riordan and Wolfe^h used a regression model to identify the main sources of error in World Bank forecasts completed at the end of 1997. Recognizing that the evolution of a crisis was inherently impossible to anticipate with accuracy, the authors sought to draw some lessons for macroeconomic modelling and prediction which might improve the understanding of the forces at work.

Analysis of forecast errors was carried out for GDP growth, domestic demand, private consumption, total investment, exports, imports and current account balance. The substantial forecast errors for these variables were attributed to four factors: a failure to appreciate fully the interactions of foreign credit with the domestic banking sector and highly indebted domestic firms; underestimation of the extent of spillover effects within the region; inadequate forecast of the decline in regional import volumes and in prices of traded goods induced in part by the downturn in regional activity; and failure to anticipate the depth of the continued recession in Japan.

The study suggested that in the light of the foregoing, the following lessons can be drawn: (i) more careful and frequent monitoring of balance-sheet effects is called for, particularly for the accumulation of short-term foreign currency liabilities in the banking system and changes in corporate leverage; (ii) in determining the severity of a crisis, it is clear that expectations matter; the light of this, investors ought to hedge their exposures; (iii) since the advent of contagion is an important factor, analysis and forecasting of developments should be conducted in a regional or global context; (iv) forecasting models should incorporate interactions between the banking and non-financial corporate sectors; and (v) in the projection of the effects of external shocks, there is a need to account for the special nature of developing countries as marginally creditworthy borrowers.

To conclude, although each of the above models does make some contribution to understanding the causes of crises and contagion, none of them can accurately predict the timing of a crisis. Hence, these models have a useful but limited role in formulating an early warning system.

^f Daniel C. Hardy and Ceyla Pazarbasioglu, "Leading indicators of banking crises: was Asia different?", *IMF Working Paper*, No. 91 (Washington DC, June 1998).

^g G.L. Kaminsky, and S.L. Schmukler, "What triggers market jitters? A chronicle of the Asian crisis", *World Bank Working Paper* (April 1999).

^h U. Dadush, M. Riordan, and B. Wolfe, "Some lessons from forecasting errors in the recent crisis", *Development Prospects Group* (World Bank, May 1999).

Monitoring and surveillance activities are carried out at different levels (national, regional and global) and focus on different aspects (macro-economic, financial and institutional), varying with the mandate of the specific body involved. Depending on their structure and objectives, monitoring mechanisms employ different methodologies and approaches. There are two general approaches to monitoring and crisis prevention.

The first refers to the traditional practice of surveillance, which is a process by which certain bodies oversee the economic policies of its members to promote global well-being (meaning financial and economic stability). IMF, for example, undertakes bilateral consultations and policy advice under Article IV of its Articles of Agreement. In the G-7 system, surveillance implies policy coordination so that exchange rate and macroeconomic stability are maintained. Under this approach, the forum or specific body takes the initiative in identifying certain worrisome trends that demand correction if global or regional economic stability is to be achieved.

A more recent paradigm, in contrast to the watchdog approach, is to promote transparency and standards in policy formulation at the national level and in business practices at the enterprise or financial firm level. It is now widely recognized that, in the light of the increasing sophisticated and rapidly changing markets, policy makers and regulators must rely increasingly on market-led processes to provide the discipline required to lead to prudent and stabilizing behaviour.¹

¹ See the arguments in support of this in William R. White, "Promoting international financial stability: the role of the BIS", paper presented at the Conference on Coping with Financial Crises in Developing and Transition Countries: Regulatory and Supervisory Challenges in a New Era of Global Finance, organized by the Forum on Debt and Development, Nederlandsche Bank, Amsterdam, 16-17 March 1998.

Promotion of transparency at all levels – decision-making in the multilateral institutions, domestic policy-making and disclosure by financial entities and business corporations – is deemed a crisis-prevention step insofar as a financial crisis happens as a result of a paucity of information and asymmetries in access to it. Transparency is considered the best solution to contagion because at the core of contagion is the lack of accurate and timely information which would allow economic agents to distinguish which economies or institutions are sound and which are not. Panic often occurs because of uncertainty; better information aids good judgement and minimizes the risk of bad judgement. If the problem is a lack of publicly available information, then the answer lies in better data quality and improved dissemination methods. The rationale is that better-informed investors, creditors or economic agents would be in a more sound position to take prudent decisions with respect to lending, borrowing and investment. It is also expected that the collective action of the (better-informed) markets could impose discipline on countries which are pursuing unsustainable policy mixes. In this sense, the approach of enhancing transparency is more market-oriented and that of traditional surveillance more interventionist.

There are also practical reasons for including standards for transparency in monitoring exercises. The pace of innovation in products, transactions and financial instruments makes it difficult for monitoring agencies to keep track of developments. Furthermore, market participants are engaging in rapidly changing and more complex transactions which regulators cannot be expected to anticipate with appropriate legislation; the regulatory catch-up is a daunting challenge. In addition, the number of players that invest in emerging markets is large and growing, and this is increasing pressure on monitoring agencies. In the light of these changes, rather than respond with stricter regulation of the traditional sort, regulators are increasingly choosing to rely on the judgement of market participants,

who are likely to have a better understanding of market developments. Such judgements require standardized information distributed on a frequent basis.

In reaction to these arguments, IMF is taking steps to enhance transparency by promoting the Special Data Dissemination Standard (SDDS) which is intended for countries that have or seek access to international capital markets, and the General Data Dissemination System (GDDS) for the other countries. BIS is also improving the coverage, quality, timeliness and availability of its data series. Further, in 1999, the Group of Ten (G-10)² countries committed themselves to a template for revealing their foreign exchange positions with a view to encouraging emerging markets to do the same.

The two approaches of surveillance and transparency are not exclusive, but rather complementary. Thus, initiatives aimed at improving the provision of information and facilitating its effective dissemination should be considered a concrete modality of crisis prevention.

The setting up of standards and codes for prudential purposes represents another aspect of the new paradigm, as the provision of agreed standards helps policy makers and markets to interpret the data. Standards provide benchmarks (and targets) that can assist authorities in monitoring their financial systems and initiating corrective responses when the actual situation deviates from the prudential standards. Furthermore, international standards help markets make informed judgements about the credit risks of countries as well as allowing them to discriminate sufficiently among countries to prevent contagion. Codes provide best-practice benchmarks for policy formulation. To the extent that standards and codes promote better policy formulation, which, in turn, makes the economic and financial systems of countries more robust, they should be considered as part of any crisis-prevention package. The work-

ing groups of the Financial Stability Forum³ have recommended the establishment of standards of best practice in a number of areas affecting financial stability. They are exploring improvements in disclosure by large financial institutions of all kinds that would be most effective for improving systemic stability. They are also considering the feasibility of providing additional aggregate information on activities in currency markets that could improve market stability by enhancing the capability of market participants to identify the potential for large exchange rate movements and for contagion, especially in emerging markets.

The provision of standards and codes through international cooperative efforts can also be justified on the basis of scarce resources and efficiency. Because certain institutions have expertise in specific areas, they are in the best position to formulate the standards. Furthermore, these and other bodies can facilitate the adoption of codes of best practices or standards by providing training and other forms of technical assistance for capacity-building. The concerted adoption of codes and standards could help build confidence. Peer pressure can also be used to push the adoption of transparency and best practices. One strategy is to convince a small number of financially robust countries to adopt the standards, and other countries will then be under pressure to follow. In fact, IMF has moved in this direction with the release of the initial transparency reports, a development discussed later in this chapter.

In the following sections, the processes and technical aspects of the crisis-prevention mechanisms in place in international institutions are discussed in more detail. Annex V.1 provides a succinct summary of measures taken in the last two years by international institutions to strengthen the international financial architecture in terms of surveillance monitoring and transparency. Annex V.2 provides a brief summary, in alphabetical order, of the status of international codes and standards affecting financial markets.

² The Group is made up of 11 industrial countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States), which consult and cooperate on economic, monetary and financial matters.

³ The Financial Stability Forum is the current modality for coordination on promoting international financial stability set up by the Group of Seven Finance Ministers and Central Bank Governors. The web site is available at <<http://www.fsforum.org/Home.html>> (26 January 2000).

INTERNATIONAL MONETARY FUND

IMF surveillance

Given the rapid transmission of financial disturbances in the world capital markets, IMF⁴ is increasingly called upon to play a central role in the prevention, containment and resolution of crises. This section reviews the different modes of surveillance and crisis prevention functions that the IMF performs, either traditionally or in the context of the new financial architecture.

Under its Articles of Agreement, the principal function of the Fund is to supervise the international monetary system. This involves (a) surveillance over the monetary and exchange rate policies of the members; (b) issuing policy recommendations; and (c) granting credit to members with temporary balance-of-payments difficulties subject to certain policy conditions.⁵ In addition, the Fund has a mechanism to enhance the international supply of liquidity through the allocation of special drawing rights (SDRs). The Fund has three broad areas of activity: surveillance, programmes supported by financing arrangements, and technical assistance. Through these, the Fund exercises its responsibility of oversight of the international monetary system and of the code of conduct to which members have subscribed.⁶ The members are required to provide the Fund with the necessary information and to enter into consultation over their exchange rate policies when they are requested by the Fund to do so.

The Fund's surveillance refers to all aspects of analysis and advice concerning the economic situation, policies and prospects of member countries (for the main features of IMF surveillance, see table V.1). The Fund collects the information required for surveillance during regular consultation between the Fund and members (Article IV consultations) as well as through frequent contacts between national authorities and Fund management and staff. It also collects information through discussion held in connection with its multilateral surveillance activities. Because timely surveillance can help prevent or minimize negative externalities as a result of sound policy coordination among members, surveillance can potentially benefit both the international community and individual member States.

The specific activities of surveillance can be classified under the broad headings of information, policy advice and policy coordination. Provision of information, including economic data, can be treated as a public good and, as such, may be under-supplied by markets. Besides, because the Fund is assumed to be neutral with no conflict of interest, unlike governments, it can provide objective information and analysis, especially when the country-specific information is not very positive. Giving policy advice is an offshoot of the expertise it possesses as well as its institutional memory. Finally, the Fund has a role to play in fostering policy coordination owing to its neutrality. It can provide information and analysis of the spillover effects of policies that help policy makers internalize spillovers in their national policy calculus.

Traditionally, there have been two levels of surveillance practised by the Fund: bilateral and multilateral.⁷ Bilateral surveillance refers to the Article IV consultations undertaken by the Fund with individual member countries, while multilateral

⁴ The origins of the Fund can be traced to the great depression of the inter-war years. In July 1944, a conference was held in Bretton Woods, New Hampshire, which aimed to form an institution to promote and supervise the international monetary system. The Fund and the World Bank together form the Bretton Woods institutions.

⁵ The origin and legal basis of the surveillance function stem from Article IV, section 3(b) of the Articles of Agreement, which states that "the Fund shall exercise firm surveillance over the exchange rate policies of members and shall adopt specific principles for the guidance of all members with respect to those policies. Each member shall provide the Fund with information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies". See IMF, Articles of Agreement, Article IV, section 3b, available at <<http://www.imf.org/external/pubs/ft/aa/aa04.htm>> (18 January 2000).

⁶ Leo van Houtven, "Half a century after Bretton Woods: the role of the IMF in the international monetary system", in A. Bakker, H. Boot, O. Sleijpen and W. Vanthoor, eds., *Monetary Stability Through International Cooperation* (Dordrecht, the Netherlands, Kluwer Academic Publishers, 1994) p. 283.

⁷ Lately, with the emergence of regional blocs as single markets, for example the European Union, there has been some limited activity pertaining to regional surveillance. At present, the focus of this level of surveillance is on monetary integration, as the euro was introduced in the market this year. Nonetheless, this does not diminish or remove the Fund's bilateral surveillance on the 11 individual members of EU.

Table V.1. Purposes of IMF surveillance

Surveillance at IMF has six main features:	
1. Policy advice	The Fund offers advice and proposals as well as serves as a sounding board for policy dilemmas facing a country.
2. Policy coordination and cooperation	The Fund helps policy consultation among groups of countries by providing inputs such as reliable data, forecasts and analysis and the machinery through which policy coordination can take place.
3. Information gathering and dissemination	The Fund maintains databases that are useful for policy formulation, and disseminates information which can benefit private market participants and the general public.
4. Technical assistance and aid	In many developing countries, surveillance is tantamount to providing technical assistance, owing to the scarcity of expertise in macroeconomic policy-making.
5. Identification of vulnerabilities	This is an extension of the information and policy advice role that is relevant in the light of the unsustainable mix of policies of certain countries. In this context, early warnings and policy advice, including on risks in their financial sector, given by the Fund to vulnerable countries play a role in formulating prompt corrective policy measures.
6. Delivering the message	The Fund disseminates, through policy advice, the prevailing consensus of the economics profession to governments and the world.

Source: J. Crow, R. Arriazu and N. Thygesen, "External evaluation of surveillance report", in *External Evaluation of IMF Surveillance* (Washington DC, IMF, 1999), available at <<http://www.imf.org/external/pubs/ft/exev/surv/index.htm>> (26 January 2000).

surveillance refers to the systemic analysis and forecasting of the world economy, published in the *World Economic Outlook and International Capital Markets Report*. Partly as a result of the debate on the new financial architecture, the Fund has recently focused on developing and/or promoting standards, codes of best practices and transparency reports. These activities have repercussions for its surveillance functions.

Bilateral surveillance

Bilateral surveillance involves monitoring the economic circumstances of the individual members of IMF leading to policy prescription. In the immediate post-war period, IMF was tasked with monitoring the Bretton Woods par value system and encouraging the members to move towards convertibility of the current account. Following the collapse of the Bretton Woods system, the Fund's mandate turned towards surveillance over the exchange rate policies of its members. This level of surveillance focuses more on policy implementation and monitoring as it aims to gather information and provide policy discussion and advice.

The process

An Article IV consultation is divided into three parts.⁸ First, the internal process consists of preparing a briefing paper before a Fund mission visits a country. This paper describes the economic situation of the country and includes the views of IMF staff on current policies and on the needed changes. Senior staff and Fund management review the paper to ensure that problems are sorted out in house before the actual review is undertaken.

Second, the mission to the country starts once the briefing paper has been cleared and usually lasts for two weeks. Four or five staff members from the different departments of the Fund form the mission team. Meetings are held with senior and mid-level officials from the finance ministry, central bank and other agencies involved in policy formulation. The staff also meet with representatives of the private sector and the business community. The

⁸ See Richard H.R. Harper, "The machinery of policy work", in *Inside the IMF: An Ethnography of Documents, Technology and Organizational Action* (San Diego, California, Academic Press Inc., 1998), pp. 124-125.

purpose of the mission is information-gathering and policy discussion and advice. A concluding meeting is held with the senior officials (Secretary of Finance and Central Bank Governor). Once the mission has been completed, a staff report is prepared, reviewed and sent to the Executive Board.

Lastly, after the Executive Board has discussed the staff report, the Chair (either the Managing Director or Deputy Managing Director) will sum up the views of the Board. This completes the Article IV consultation process.

Following the meeting of the Executive Board, a Public Information Notice (PIN) may be released to the public upon approval of the concerned national authorities. A PIN consists of a factual summary of recent economic developments and a summary of the discussion in the Executive Board. In addition, under the terms of a recently adopted time-bound project, Article IV consultation reports may be released to the public, following their consideration by the Executive Board, if the national authorities so desire.

For most countries, Article IV consultations take place annually. While there have been attempts to reduce the frequency of the consultations for smaller countries on a voluntary basis, in practice countries are reluctant to move to biennial consultations. At present, there are 23 members on a biennial consultation cycle. In financial year 1998/99, the Fund completed 25 Article IV consultations.

Technical aspects

Initially, the scope of the Fund mission was confined to the exchange rate and macroeconomic (monetary and fiscal) policies of a country. Over time, its scope has expanded into several other policy areas, concomitant with increasing global

economic integration through trade and capital flows, including capital mobility and capital account convertibility, and resultant interrelationships among countries (external shocks, spillover and contagion effects). The scope of consultations has also been expanded over time in response to the greater understanding of the linkages between macroeconomic policies and outcomes, on the one hand, and structural factors such as the health of financial systems, on the other.

The Fund's main concern is that macroeconomic policies be consistent with a viable external payments situation that is sustainable over time. Its objective is to ensure that countries adjust macroeconomic policies in a timely manner to forestall crises and, in particular, to prevent countries having recourse to balance-of-payments restrictions and controls that are detrimental to the international monetary system. On monetary policy, the main concern of the Fund is usually to keep the level of inflation to a minimum. On fiscal policy, its thrust has been directed at the following areas: making public finances more transparent; making public sector accounts more complete; containing fiscal deficits; developing and clarifying the concept of quasi-fiscal deficit due to, inter alia, central bank operating losses; and analysis of structural and cyclical factors in government finance. In terms of exchange rate policy, surveillance centres on the appropriate exchange rate system and exchange rate levels. Both fixed and flexible exchange rate systems are being allowed by the Fund as long as the country's macroeconomic policy is consistent with the system chosen. Lately, the Fund has been tackling structural and institutional issues, especially in labour markets and financial systems, in addition to the standard macroeconomic ones.

Key economic indicators of member countries typically published in a PIN are given in table V.2.

Table V.2. Indicators used in Public Information Notices

<i>Sector</i>	<i>Indicators</i>
Real	Real GDP growth rate, inflation, unemployment, savings, investments
Public finance	Budget deficit, public debt
Money and credit	Money supply growth, domestic credit growth
Interest rates	Short- and long-term rates
Balance of payments	Trade balance, current account, reserves
Exchange rates	Exchange rate regime, nominal rates, real effective rates

However, there are other indicators, such as the debt service ratio, which are frequently used for developing countries. All of these are macro-economic indicators which have relevance to a country's exchange rate and balance-of-payments position. In view of the nature of the crisis in Asia, the Fund, in its assessment of the vulnerability of countries, is placing increased emphasis on measuring contingent liability, the composition of external debt, and forward positions.

Multilateral surveillance

The process

Multilateral surveillance is geared more towards analysis of recent world developments, projections of future development, identification of risks of instability in the international economic system and the proposing of the ensuing policy recommendations. The primary vehicle for the Fund's multilateral surveillance is *World Economic Outlook*, produced twice a year, which provides a comprehensive set of economic forecasts for the world economy. It usually covers the broad areas of the world economic situation, global economic prospects and related policies issues, especially policy stances in industrial countries. There is an emphasis on financial and foreign exchange markets and external payments, financing and debt.

Technical aspects

The forecasts used by IMF are produced by a bottom-up rather than top-down procedure, that is, they are not produced by a single model of the world economy, but rather compiled from forecasts for individual countries by the Fund's area departments. The country projections are prepared on the basis of internationally consistent assumptions about world activity, exchange rates, and conditions in international financial and commodity markets. For approximately 50 of the largest economies, accounting for 90 per cent of world output, the projections are updated for each *World Economic Outlook* exercise. For smaller countries, the projections are based on those prepared at the time of the Fund's regular Article IV consultations with the member, after reflecting changes in assumptions and global economic conditions.

The focus of multilateral surveillance is on examining the impact of national policies on the global environment. These "environmental" projections are fed back into the forecasting and analysis that underpins the bilateral Article IV consultations. The regular monitoring of key economic developments helps in the assessment of the consistency and sustainability of national policies in the light of developments in the world economy. Monitoring further helps identify situations that warrant policy review and consultations. Special attention is devoted to developments in exchange rates, trade and capital flows, which are the principal elements of international interaction, as well as the broad range of economic policies underlying them.

Regional surveillance

The Fund has engaged in surveillance at the regional level in response to the integration of Europe into a single market, that is, the European Union. Furthermore, the crises in Mexico and Asia have highlighted the need for surveillance at the regional level. A framework is now in place for twice-yearly policy discussions with European Union institutions responsible for common policies in the euro area, including the European Central Bank. Discussions are expected to focus on the common monetary policy, exchange rate implications and the fiscal position of the euro area as a whole. The European Central Bank has been given observer status on the IMF Executive Board. Nonetheless, members of the European Union will continue their Article IV consultation on an annual basis.

The Fund has been active in providing inputs to other regional mechanisms for policy consultations. It has been designated as the technical secretariat to the Manila Framework group. The Fund has also been invited to present economic briefings for the ASEAN Finance Ministers' process (for further details on these initiatives see chapter VI). Similarly, the Fund has contributed inputs to the APEC forum. The Fund's main contribution has been the preparation of background papers; however, these papers do not focus much on regional inter-relationships but rather are drawn from available materials resulting from country-level consultations. The Fund conducts regular discussions with regional entities of a number of currency unions, such as the West African Economic and Monetary Union, the Central African Economic and Monetary Community and the Eastern Caribbean Currency Board.

Other regular statistical publications of the Fund

The Fund produces a number of regular statistical publications covering its member countries, of which the following are the most important:

Balance of Payments Statistics Yearbook: An annual publication covering balance of payments data for about 160 countries and international investment position data for 48 countries, as well as regional and world totals of major balance-of-payments components.

Government Finance Statistics Yearbook: An annual publication providing detailed data on revenue, expenditures, financing and debt of central governments and, when available, data on state and local governments and institutional units of government.

International Financial Statistics: A monthly publication reporting current data on exchange rates, international liquidity, international banking, money and banking, interest rates, prices, production, international transactions, government accounts and national accounts, by country and for regional and world aggregates.

Recent initiatives in crisis prevention: transparency, standards, surveillance and strengthening the financial system

Transparency and standards

Along with other international organizations, national agencies and the private sector, IMF has been active in devising new strategies to contribute to crisis prevention and resolution in the context of the new financial architecture. The initiatives of the Fund have focused on (a) enhancing transparency, standards and surveillance; (b) strengthening financial systems; (c) capital account issues, such as the use of capital controls; (d) involving the private sector in crisis prevention and resolution; and (e) more systemic issues, such as exchange rate regimes. In the context of this chapter, the focus is on the first two categories.

Initiatives to enhance transparency

The Fund, through its Executive Board, has taken important steps to enhance the transparency of its members' policies through encouraging (a) the release of PIN after Article IV consultations; (b) voluntary public release of Article IV staff reports; (c) release of a Statement by the Chairman of the Executive Board after discussions on the use of Fund resources; and (d) publication of letters of intent, memoranda of economic and financial policies, and policy framework papers; as well as of external evaluations of the Fund's surveillance and economic research activities. The public release of the PINs and staff reports on Article IV is designed to inform the markets and policy makers about the economic situation of a country. The above mentioned initiatives will be reviewed in the future along with proposals to expand external reviews of the Fund's operating procedures.

Promotion of international standards

The international community has called upon IMF and other standard-setting agencies to develop standards or codes covering a number of economic and financial areas (see annex V.2), among which data dissemination and good practices for transparency in the fiscal area and in monetary and financial policies are of particular concern to IMF. While the codes and standards are still evolving and are likely to continue to do so, the main challenge is to implement them. To this end, the Fund is extending technical assistance to help countries implement the provisions in the codes.⁹

Standards on data. The hallmark programmes for promoting the best practices in data dissemination are the Special Data Dissemination

⁹ The Fund established a standards and codes web page, which provides information on standards in areas of direct operational relevance to the Fund (fiscal, monetary, and financial policy transparency, and banking supervision), a description of progress in developing standards in other areas, links to the web sites of other standard-setting bodies, and experimental reports on observance of standards in selected economies. The web site is accessible at <<http://www.imf.org/external/standards/index.htm>> (18 January 2000). The Fund established a separate web page for data standards, The Dissemination Standards Bulletin Board, available at <<http://dsbb.imf.org>> (10 February 2000).

Standard and the General Data Dissemination System. SDDS, which was established by the Executive Board on 29 March 1996, was set up to guide countries that have, or might seek, access to international capital markets in the dissemination of economic and financial data to the public. GDDS, on the other hand, which was established on 19 December 1997, focuses on improving data quality and provides a framework for evaluating the need for data improvements, and guidance and dissemination. GDDS is meant to improve data quality for countries that are not yet in a position to subscribe to SDDS. By the end of 1999, seminars had been held in all regions of the world and virtually all potential GDDS clients participated. Both SDDS and GDDS are expected to enhance the quality and availability of timely and comprehensive economic and financial statistics, and hence contribute to the pursuit of sound macroeconomic policies.

In December 1998, the Executive Board decided to introduce in SDDS a separate category for external debt. Also, in order to strengthen SDDS, it agreed in March 1999 to adopt a prescription for the dissemination of the new template on international reserves and foreign liquidity on a monthly basis with a lag of no more than one month. The transition period for observance of the new standard was one year, up to March 2000. In October 1999, IMF disseminated operational guidelines to assist countries in using the template and to promote data comparability across countries.

SDDS does not directly avert an economic and financial crisis, rather it enhances the transparency of data dissemination to the public and to various authorities, making surveillance and assessment easier for government departments, central banks or any regional monitoring bodies. Moreover, if and when a crisis strikes, policy- and decision-making with regard to solutions would be facilitated by having timely and comprehensive data on hand. Thus, SDDS will serve as an important ingredient in both the prevention and resolution of economic and financial crises.

Other codes. In April 1998, the Interim Committee of IMF adopted a Code of Good Practices on Fiscal Transparency to guide members seeking to increase fiscal transparency, and thereby to enhance the accountability and credibility of fiscal policy as a key component of good governance. The implemen-

tation of the Code is on a voluntary basis, but technical assistance is being offered to assist authorities in implementing it.

On 26 September 1999, the Interim Committee adopted the Code of Good Practices on Transparency in Monetary and Financial Policies as a guide to members to increase transparency in the conduct of these policies. The design of the good transparency practices rests on two principles: first, monetary and financial policies can be made more effective if the public knows the goals and instruments of policy and if the authorities make a credible commitment to meeting them; second, good governance calls for central banks and financial agencies to be accountable in areas where monetary and financial authorities are granted a high degree of autonomy.

To foster the adoption of various international standards, in 1999 IMF prepared a number of experimental reports on the observance of standards and codes, which are sometimes referred to as "transparency reports".¹⁰ These reports combine a description of country practice, based on discussions with the relevant national authorities, with independent assessments by Fund staff as to the consistency of those practices in relation to the specified standards. The reports focus mainly on areas of direct operational concern to the Fund, namely, data dissemination, fiscal policy transparency, monetary and financial policy transparency and bank supervision. The Fund is currently preparing another round of experimental reports in collaboration with the World Bank. The round will feature assessments of specific standards in selected countries, rather than a full set of standards for an individual country.

Refocusing surveillance

An external evaluation of the surveillance activities of IMF was undertaken and recommended that the Fund should continue surveillance of its traditional areas, exchange rate and macroeconomic policies, while at the same time placing more importance on the international and regional dimensions of surveillance, the contagion effects, and assessment

¹⁰ Completed reports are available at <<http://www.imf.org/external/standards/index.htm>> (10 February 2000).

of the financial vulnerability of countries. It should also pay more attention to the banking system and the capital account etc. The Fund intends to put greater focus on debt and reserve management practices as well. The enhancement of the surveillance dovetails with the initiatives to improve transparency and to develop and adopt codes of best practices.

Strengthening financial systems

The Fund, together with other international agencies, has been increasing its efforts to strengthen the financial systems of countries. In the Fund, this has included the development of codes of good practices, as mentioned earlier, as well as the launching in 1999 of the Financial Sector Assessment Programme (FSAP). The main goal of this programme, developed in the context of Article IV consultations and in collaboration with the World Bank, is the preparation and delivery to national authorities of comprehensive assessments of their financial systems. Such assessments are aimed at identifying strengths, vulnerabilities and risks; ascertaining the sector's development and technical assistance needs; assessing observance and implementation of relevant standards, codes and good practices; and designing appropriate policy responses. The focus of the FSAP is on helping governments reduce the likelihood and severity of financial crises and cross border contagion. To date, assessment reports for four countries (Canada, Colombia, Lebanon and South Africa) have been completed and assessments have been initiated for three countries (Cameroon, Estonia and Hungary). Six other countries, including India, have agreed to conduct assessments in the near future.

The Fund, alongside other institutions, is participating in a task force to review the 1988 Basle Capital Accord, by preparing comments on the proposed New Capital Adequacy Framework. In addition, the United Nations Commission on International Trade Law has expressed interest in collaborating with the Fund and the World Bank to promote orderly and effective insolvency systems and to ensure a proper legal environment for financial systems. Finally, the Financial Stability Forum was set up by the G-7 Finance Ministers and Central Bank Governors in February 1999 to coordinate responsibilities for promoting international financial

stability more effectively. Its members include the Basle Committee on Banking Supervision, BIS, IMF, the World Bank, IOSCO and IAIS, as well as three representatives (Finance Ministry, Central Bank and supervisory authority) from each of the G-7 countries. It first convened in April 1999 in Washington DC. It has established three working groups, on highly leveraged institutions, capital flows and offshore financial centres.¹¹

BANK FOR INTERNATIONAL SETTLEMENTS

BIS, created in 1930, is an institution essentially owned and controlled by central banks. It provides them with a number of highly specialized services. One of its overriding functions is to promote financial stability through international cooperation on sound bank supervision practices, developing standards relating to risk management, gathering and disseminating data and policy analysis.

BIS functions as a forum for forging international monetary and financial cooperation. It also provides central banks with a broad range of financial services for managing their external reserves. It serves as an agent and trustee in the execution of international financial agreements. Finally, it is a centre for monetary and economic research, contributing to a better understanding of international banking, national monetary policies and financial market developments. Since 1994, the Bank's Board of Directors has been drawn from the 11 countries comprising the Group of Ten (G-10), with which BIS has a close association. In 1996 and 1997, nine additional central banks were admitted to membership, including, from the ESCAP region, China; Hong Kong, China; India; Republic of Korea; and Singapore. In 1999, Argentina, Chile, Malaysia and Thailand also became shareholders.

¹¹ See IMF, *Progress in Strengthening the Architecture of the International Financial System*, Statement and Report of the Managing Director to the Interim Committee, IMF advance copy (Washington DC, September 1999), pp. 10-12, and the Financial Stability Forum web site, available at <<http://www.fsforum.org/>> (24 January 2000).

The international stature of BIS was enhanced in the wake of the Asian crisis, which highlighted the strong interrelationship between finance and the real economy. In both the resolution of the crisis and the discussions on the design of a new financial architecture, BIS provided important inputs, including taking a lead in policy analysis and the construction of standards for fostering financial stability.

The process: modalities to promote financial stability

BIS makes an important contribution to international financial stability by ensuring that policy makers, at least central bankers and other regulators, know each other well and have open lines of communication. In addition, the international community (particularly the central banks of the G-10 countries) has found it appropriate to provide bridging loans through BIS to countries in financial difficulties which are awaiting the receipt of funds from IMF, the World Bank or other sources. However, its main contribution to fostering international monetary and financial cooperation towards financial stability involves undertaking analyses for and organizing regular meetings of senior central bank and other officials on key issues of financial policy. These meetings, which are organized under the aegis of one of the committees outlined below, fall into four categories:

- (1) Regular consultations among central bank governors and senior officials on conjunctural and monetary issues and on matters affecting financial stability
- (2) Meetings of standing committees that formulate standards or recommend best practices to promote financial stability
- (3) Meetings involving broader sets of national authorities and international institutions
- (4) Meetings centred on technical areas of central bank activities.

To the extent that these activities contribute to exchanges of information and analysis, they should be considered as focused mechanisms for crisis prevention.

In the first category, the central bank governors of the G-10 countries meet regularly to discuss topical issues as well as receive various reports from the Standing Committees. A second set of larger meetings, held on the same day as the G-10 meetings, involves the governors of all BIS shareholding central banks and covers monetary and financial policy issues such as central banks' involvement in the surveillance and supervision of financial institutions; the role of rating agencies in the operation of financial markets; and the design and operation of financial safety nets; the containment of risks posed to the global economy by the Asian crises; as well as the implications of the introduction of the euro. In a third forum, involving central bank governors of the principal industrial and emerging market economies, some of the more important issues discussed have been current account and exchange rate adjustment in the wake of the Asian financial crises; the pace of bank restructuring in emerging markets; and the challenges posed by asset price inflation surrounded by deflationary pressures in goods markets.

BIS provides the secretariat for a number of standing committees¹² working to promote financial stability. The specific modalities pursued at BIS are three-pronged, corresponding to the three pillars of the financial system: financial institutions, financial markets and payment and settlement systems. There is a separate BIS committee dealing with each: the Basle Committee on Banking Supervision (institutions); the Committee on the Global Financial System (formerly the Eurocurrency Standing Committee) (market) and the Committee on Payment and Settlement Systems (infrastructure). In general, the meetings are geared towards policy analysis and capacity-building exercises. Included among the tasks of these committees are the design and dissemination of various standards and codes of best practices, of which the Basle Core Principles for

¹² These committees are usually set up by the G-10 central banks and national regulatory authorities, if independent of the central bank. BIS provides them with a secretariat and its offices serve as the location of the meetings of the committees. The secretariat of IAIS is also located at BIS and cooperates closely with the BIS secretariat in supporting the Basle committees.

Effective Banking Supervision constitute a landmark. BIS also collects and monitors financial data and participated actively in establishing the *Joint BIS-IMF-OECD-World Bank Statistics on External Debt*. The following is a more detailed description of the functions of the three main committees.

Basle Committee on Banking Supervision.

This Committee provides a forum for discussion on the handling of specific supervisory problems. It coordinates the sharing of supervisory responsibilities among national authorities with respect to banks' foreign establishments, with the aim of ensuring effective supervision of banks' activities worldwide. The Committee also seeks to enhance standards on supervision, especially with regard to solvency, so as to help strengthen the soundness and stability of international banking.

Committee on the Global Financial System.

Formerly the Euro-currency Standing Committee, this Committee deals with a series of market-related issues, such as the implications of international debt problems, the evolution of financial market structures, the macroeconomic and prudential implications of derivative instruments, and the collection of new statistical information. Now with a revised mandate, it focuses on the systematic short-term monitoring of global financial system conditions, longer-term analysis of the functioning of financial markets, and the articulation of policy recommendations for the improvement of market functioning and promotion of stability.

Committee on Payment and Settlement Systems.

This Committee is concerned with the promotion of robust payment and settlement systems, so as to strengthen financial market infrastructures and reduce systemic risk. Particularly, it is concerned with the reduction of foreign exchange settlement risk, the promotion of greater transparency in securities settlement arrangements, and an improved understanding of the retail payments industry.

In addition to the above activities, BIS engages in a number of ongoing collaborative activities with other financial institutions in helping to redesign the financial architecture. For instance, three working groups composed of members of the Group of

22,¹³ set up and backstopped by BIS and IMF, have tackled and made recommendations concerning transparency and accountability, strengthening financial systems and managing international financial crises.

Leverage of the Basle process

BIS does not normally use its own financial resources to promote or finance particular courses of action by its members, unlike other international financial institutions such as IMF, the World Bank and the regional development banks. Rather it organizes and facilitates meetings, and produces research.¹⁴ It also supports the setting of standards, codes of best practices and benchmarks, with the expectation that individual authorities from different countries will adopt these. The value added provided by BIS thus lies in the enhanced capacity and understanding of the national representatives who attend its meetings or read its papers.¹⁵

International cooperation at BIS rests on the principle of national (state) control; BIS only suggests and advocates policy changes or practices, and does not impose conditionalities. Members of the various committees that meet at BIS negotiate positions among themselves in order to find an agreement that is acceptable across countries as well as to public and private sector agents, and which can be approved by ministers and governors and eventually implemented through national legislation or regulation. While the members of the committees that meet at BIS are mostly from the G-10 countries, agreements reached are often also

¹³ Finance ministers and central bank governors from 22 countries with systemically important financial markets, established at the APEC meeting in November 1977 to move forward the reform of the international financial architecture. See IMF, "A Brief Guide to Committees and Groups", available at <<http://www.imf.org/external/np/ext/facts/groups.htm>> (31 January 2000).

¹⁴ White, "Promoting international financial stability: ..."

¹⁵ This is why countries such as Thailand have decided to buy shares in BIS and so be in a position to participate in the ongoing discussions (*Bangkok Post*, 12 November 1999).

accepted by non-G-10 members as effective global standards. In addition, private rating agencies, IMF and the World Bank play supporting roles in communicating what are deemed to be best practices to the non-G-10 countries. Thus, the general Basle process adheres to the modality that decision-making is left in the hands of nation States, while international organizations are tasked with information dissemination.

Case study: the Basle Committee on Banking Supervision and supervisory practices

Established in 1974, the Basle Committee on Banking Supervision follows the general Basle process. It does not possess any formal supranational supervisory authority as its conclusions do not have legal force. For this reason, central banks are neither compelled, nor required by law, to subject themselves to the decisions of the Committee. It formulates broad supervisory standards and guidelines and recommends statements of best practices in the expectation that individual authorities from different countries will take steps to implement them through arrangements suited to their corresponding national systems. Thus, the Committee encourages convergence towards common standards without detailed uniformity or harmonization of countries' techniques of supervision.

The standard-setting process starts with the identification of the salient issues by the Committee, such as capital requirements, credit risk, market risk or cross-border banking. The Committee seeks the endorsement and commitment for its major initiatives and projects from the central bank governors of the G-10 countries. A working group is then formed, which normally consists of supervisory authorities from the Committee members and selected non-G-10 countries, to formulate the principles and standards with regard to the issue at hand. The drafting of the document is done through a series of meetings of the working group, as well as consultations with a wider group of individual supervisors and regional supervisory groups. Usually, international institutions such as IMF and the World Bank are invited to comment on the work at various intermediate stages. After amendment and finalization of the document, endorsement by the central bank governors of the

G-10 countries is sought.¹⁶ Once this has been completed, IMF and the World Bank, together with other institutions and central bank groups, aid in the communication of the document to countries around the world, including non-members of G-10, for implementation. The next step is the assessment of compliance with the principles by the Committee through various methods, such as questionnaires. The process may start over again with the identification of other issues, which may eventually lead to additional papers or amendments of the current document – all with extensive consultation with supervisory groups and international institutions. Among the significant outputs of this Committee are the Basle Capital Accord (1988) and the Basle Core Principles for Effective Banking Supervision (1997).

IMF and the World Bank play an active role in the implementation and assessment of compliance. These two institutions encourage member countries to comply with such best practices, and work with them in assessing compliance. Furthermore, they seek to have countries remedy the identified weakness in their respective banking systems as a result of the assessment. Finally, both IMF and the World Bank, as well as the Financial Stability Institute recently established at BIS, provide technical assistance and training in order to address such weaknesses.

Technical aspects in BIS monitoring: the case of banking supervision

The choice of the variables to be monitored follows from the particular framework for analysis. Thus the variables used by the Committee to monitor banks correspond to the different types of risks identified by the Committee. These variables are described below.

Credit risk. This pertains to the risk of default of a borrower. Credit risk concentration owing to large exposures to a single borrower or to a group of related borrowers is a common cause of banking problems. The Core Principles recommend that banking supervisors set prudential limits to restrict

¹⁶ In some papers, there is no indication as to whether there is endorsement by the Governors of G-10, but important documents containing major principles and standards do state such endorsement.

bank exposures to single borrowers, groups of related borrowers and other significant risk concentrations. These limits are usually expressed in terms of the lending bank's capital and, although they may vary from one bank to another, 25 per cent of capital is usually the most that a bank may extend to a private sector non-bank borrower, or a group of closely related borrowers, without specific supervisory approval. In addition, supervisors are encouraged to monitor the banks' handling of concentrations of risk, wherein banks would report to them if any exposure exceeded a specified limit.

Country risk. A wide variety of factors, such as the economic, social and political environment of the home country, may prevent borrowers of that country from fulfilling their foreign obligations. In a published document,¹⁷ the Committee called for an assessment of these risks, involving the analysis of statistical information of the borrower country. The objective of this analysis would be to project a path for countries' external debt and to forecast their ability to service and repay. This entails examination of the outlook for official reserves and other balance-of-payments items, terms of trade, exchange rates, inflation, record in servicing and repaying external debt, and other relevant factors. Second, there is also a need for proper measurement of country exposure. For this, the Committee recommends a framework within which banks' measurement systems should be set. Finally, banks are also advised to review their appropriate weighting or limits applied to their individual country exposures. Although the Committee does not impose a specific limit or percentage as to the exposure on an individual country, it maintains that banks' limits to exposures must be in relation to the degree of perceived risk. One data set that is of help is the BIS semi-annual report of the maturity distribution of international bank lending.

Market risk and foreign exchange risk. Market risk is defined as the risk of experiencing losses from the on-and-off-balance-sheet positions arising from movements in market prices.¹⁸ In this category

are the risks pertaining to interest rate-related instruments and equities in the trading book of a bank; and foreign exchange risk and commodities risk throughout the bank. Hence, in a report on supervision of banks' foreign exchange positions,¹⁹ the Committee states that supervisory authorities must seek to ensure that the risks assumed by banks in their foreign exchange operations are never so large as to constitute a significant threat to either the solvency or liquidity of individual banks. The role of bank management and the establishment of internal control procedures covering foreign exchange business are considered pivotal in ensuring the safety of banks with regard to foreign exchange operations. The Committee leaves the setting of standards of limitation to national supervisors, but stresses the desirability of distinguishing between a bank's total uncovered position in foreign currencies and its open position in individual foreign currencies. In addition, in order to avoid the risk of overtrading, it is suggested that banks keep their foreign exchange turnover approximately in line with the size of their balance sheet. In several major countries, the standard used is the size of the bank's capital base. Finally, in monitoring banks' foreign exchange business, the Committee proposes that the authorities look into two types of information flows: statistical reports from the banks about their foreign exchange operations, and information about events and developments in the foreign exchange market.

Interest rate risk. The exposure of a bank's financial condition to adverse movement in interest rates can have a strong impact on a bank's earnings and capital base, and the economic value of its assets, liabilities and off-balance-sheet instruments. Thus, the Committee recognizes the need for an accurate, informative and timely management information system for measuring and managing interest rate risk exposure, both to inform management and to support compliance with policy. The reports that the Committee recommends should, at a minimum, include the following: (a) summaries of the bank's aggregate exposures; (b) reports demonstrating the bank's compliance with policies and limits; (c) results of stress tests, including those assessing breakdowns in key assumptions and parameters; and

¹⁷ See BIS, *Management of Bank's International Lending*, available at <<http://www.bis.org/publ/bcbasc002.htm#v1d5>> (21 January 2000).

¹⁸ See BIS, *Core Principles for Effective Banking Supervision (Basle Core Principles)*, available at <<http://www.bis.org/publ/bcbasc102.pdf>> (18 January 2000).

¹⁹ See BIS, *Supervision of Banks' Foreign Exchange Positions*, available at <<http://www.bis.org/publ/bcbasc117.pdf>> (21 January 2000).

(d) summaries of the findings of reviews of interest rate risk policies, procedures, and the adequacy of the interest rate risk measurement systems, including any findings of internal and external auditors.²⁰ Moreover, the bank is asked to submit sufficient and timely information to its supervisors on the range of maturities and currencies in its portfolio.

Liquidity risk. Liquidity risk arises when a bank cannot obtain sufficient funds to meet demand, either by increasing liabilities or by converting assets promptly. When a bank has inadequate liquidity, its profitability can be affected and, in some cases, insufficient liquidity can lead to the insolvency of a bank.²¹ The purpose of liquidity management is thus to ensure that a bank is able to meet its contractual commitments fully. The Committee maintains that the elements of strong liquidity management include good management information systems, central liquidity control, analysis of net funding requirements, diversification of funding sources, and contingency planning. The analysis of net funding requirements involves the construction of a maturity ladder and the calculation of cumulative net excess or deficit of funds at selected maturity dates. A bank's net funding requirements are determined by analysing its future cash flows based on assumptions of the future behaviour of assets, liabilities and off-balance-sheet items, and then calculating the cumulative net excess over the time frame for the liquidity assessment. Banks are advised by the Committee to construct a maturity ladder that will be used to compare a bank's future cash inflows with its future cash outflows over a series of specified time periods.

Capital adequacy. Pursuant to the Basle Capital Accord, the Committee also focuses on another important channel for monitoring banks, capital adequacy. The variable associated with this is the capital adequacy ratio, which the Accord has set at 8 per cent capital in relation to risk-weighted assets as the minimum capital adequacy ratio requirement for internationally active banks. One principle in the Basle Core Principles states that

banking supervisors ought to set minimum capital requirements for banks and, for international banks, this ratio must meet the minimum standard indicated in the Accord. This figure is perhaps the most widely quoted benchmark of BIS used in assessing the fragility of the financial systems of individual countries. As there were questions about the role of this standard in the run-up to the Asian crisis, the Accord is currently under review and amendments are likely to be adopted in the near future.

The above discussion illustrates the role of the Basle Committee on Banking Supervision with regard to surveillance and the development of early warning systems for banking crises. The Committee has one document focusing on each type of risk, discussing the different ways of managing from which one can gather the variables to be monitored. The documents also highlight the role of the banking supervisors in the development of risk management systems. The setting of standard or benchmark levels with regard to variables such as levels of foreign exchange exposure, levels of liquidity, country exposure etc. are all left to banking supervisors. The exceptions are the minimum capital adequacy ratio requirement (8 per cent), and the risk concentration ratio (25 per cent of capital). The Committee gives only the general framework of the management and procedures of risk assessment to be followed by each banking supervisor. By doing so, BIS is recognizing the autonomy of central banks and other banking supervisors, as well as taking into account the fact that, given the diversity of banks worldwide, the imposition of uniform standards could prove to be ineffective.

Publications of BIS

The BIS data collection exercises started more than 30 years ago with the recognition of the possible monetary implications of the rapid growth of the euro-currency markets. Over the years new issues arose and the need for the reporting of semi-annual international banking data on a fully consolidated basis was established. At the same time, the internationalization and growing scale of global financial market activity saw the need for increased statistical monitoring in the fields of both international banking and international securities financing. Recently, BIS has become involved with the monitoring of activities in the derivatives market.

²⁰ See BIS, *Principles for the Management of Interest Rate Risk*, available at <<http://www.bis.org/publ/bcbs29a.htm>> (21 January 2000).

²¹ See BIS, *Core Principles for Effective Banking Supervision...*

The data published by BIS are used by central banks for policy-oriented monitoring purposes, and by IMF in the compilation of its *International Financial Statistics*. In addition, the data have proved to be of interest to private-sector market participants. The BIS international database covers three basic areas: international banking; international securities markets; and derivatives and foreign exchange markets.²² The following are the main regular publications of BIS.

Annual report. The BIS annual report includes a discussion on the financial and banking trends of the world. It also deals with the latest economic developments in the advanced industrial countries, issues such as trade, labour and unemployment, wages and prices, as well as monetary policies of industrial countries, and recent developments in asset markets, foreign exchange markets and international financial markets. The latest report included a discussion on the crisis in emerging markets (Asia, Brazil and the Russian Federation), focusing on recent updates, the progress in restructuring, and their effects on other parts of the world. Discussions are backed up by statistical information, mostly at the macroeconomic level. The focus of the activities of BIS for the past year is also reported. In a concluding chapter, policy ideas are promulgated to promote both macroeconomic and financial stability in the light of policies adopted by major countries and their economic and financial experiences during the past year.

Quarterly review: *International Banking and Financial Market Developments*. This publication reports the quarterly developments in international banking and financial markets, particularly the international securities markets and the derivatives markets. It assesses the current situation in these markets through analyses of movements of key variables such as interest rates, exchange rates, inflation, and yield differentials, as well as international bank and securities financing and international debt securities financing. The countries in focus are usually Japan, the euro area countries (taken as a whole), the United Kingdom and the United States.

²² A description of the sources, compilation, transformation of data, and outputs is given in detail in *The BIS Statistics on International Banking and Financial Market Activity*, available at <<http://www.bis.org/publ/meth06.pdf>> (18 January 2000).

Consolidated International Banking Statistics. This publication is composed of semi-annual consolidated statistics on the maturity, sectoral and nationality distribution of international bank lending. Variables such as international bank lending (to Asia, Latin America and Eastern Europe) and international claims are broken down into maturity, sector and nationality. The data in this report are also included in the joint BIS-IMF-OECD-World Bank quarterly statistical release on external debt.

Recent BIS initiatives in surveillance and crisis-prevention measures

The Asian financial crisis and its global effects highlighted the need to understand the risks to financial stability better. It seems to be clear that reliance on self-regulation or on market discipline, while necessary, is not sufficient. By way of responding to this need, there were efforts to discuss in meetings among central bank governors such issues as the containment of the risks facing the global economy and the necessary adjustments needed in the current account, exchange rate and bank restructuring. While the BIS meetings have traditionally focused on events in the G-10 countries, an increasing number now focus on macroeconomic developments in emerging markets as well.

BIS has undertaken several measures in response to the crisis, as outlined below.

Enhancing transparency, data collection and dissemination

The Committee on the Global Financial System has often stressed that transparency in data is very important in crisis prevention. It has taken steps to improve the timeliness, quality and coverage of BIS international consolidated banking statistics. The following recent additions to the regular publications of BIS are initiatives of the Committee to enhance transparency and to improve the quality of data.

Joint BIS-IMF-OECD-World Bank Statistics on External Debt. First published in March 1999, these

statistics are a product of the Inter-Agency Task Force on Finance Statistics.²³ They bring together data, currently compiled and published separately by the contributing international agencies, on components of the external debt of 176 developing and transition economies, and their international reserve assets. The data are mostly from creditor and market sources, but also include information provided by debtor countries.²⁴ Particular emphasis is placed on debt due within a year. The latest release incorporates multilateral claims, including those of the African Development Bank, Asian Development Bank and Inter-American Development Bank. Moreover, there is a new series showing claims of debtor country residents on banks in BIS reporting countries. The different data series (such as bank loans, debt securities issued abroad, Brady bonds, non-bank trade credits, multilateral claims, official bilateral loans etc.) come from different sources, such as IMF, the World Bank, BIS, OECD or the development banks mentioned. Differences remain between the series in their coverage, frequency and the time lag before publication, and the data do not yet provide a completely comprehensive and consistent measure of total external debt in each country. Nevertheless, this set of statistics brings together, for the first time, the best international comparative data currently available on external debt. The organizations collaborating on these statistics are working to improve their collection systems and to gradually improve their content in terms of quality, coverage, frequency and timeliness, as part of more general efforts towards greater transparency.²⁵

²³ The Inter-Agency Task Force on Finance Statistics is one of the inter-agency task forces endorsed by the United Nations Statistical Commission and the Administrative Committee on Coordination Subcommittee on Statistical Activities, and was set up in 1992. The Task Force is chaired by IMF and includes representatives of BIS, IMF, OECD and the World Bank, as well as the European Central Bank, the European Statistical Office and the United Nations.

²⁴ Efforts are being made to understand better the reasons for the differences between creditor-based debt statistics and those provided by debtor countries.

²⁵ For more details, see *Joint BIS-IMF-OECD-World Bank Statistics on External Debt*, available at <www.bis.org/publ/r_db9909.htm> (18 January 2000).

The Global OTC Derivatives Market. This semi-annual statistical publication, first published in December 1998, covers the global over-the-counter derivatives market. Included are the notional amounts and gross market values outstanding and the worldwide consolidated over-the-counter derivatives exposure of major banks and dealers in the G-10 countries. They cover the four main categories of market risk: foreign exchange, interest rate, equity and commodity.²⁶

Central Bank Survey of Foreign Exchange and Derivatives Market Activity. This triennial survey, which covers 43 countries, focuses on turnovers in traditional foreign exchange market instruments (that is, spot, outright forwards and foreign exchange swaps), as well as turnover, notional amounts outstanding and market values of derivative instruments. "This survey also serves as a benchmark for the new semi-annual derivatives market statistics introduced at end-June 1998, and aimed at tracking the development of open positions... in the global over-the-counter derivatives markets over time."²⁷

The aforementioned reports do not recommend policies to be followed by individual banks (this task is left for central banks at the national or regional level), nor do they warn banks of critical levels in their banking operations based on statistical data. Rather, these publications merely report current developments within the three areas covered by the database (international banking, international securities markets, and derivatives and foreign exchange markets), with a thorough analysis of data trends.

In addition, the Committee, in October 1998, published a template for the comprehensive disclosure of official foreign exchange reserves and potential drains on them. The objective behind this was to remedy shortcomings in existing information regarding the on-and-off-balance-sheet activities of central banks and other public sector entities.

²⁶ See, for example, *The Global OTC Derivative Market at end-December 1998*, available at <www.bis.org/publ/otc_hy9906.htm> (18 January 2000).

²⁷ See BIS, "Central Bank Survey of Foreign Exchange and Derivatives Market Activity, 1998", press release of 10 May 1999, available at <www.bis.org/press/p990510.htm> (18 January 2000).

Establishing standards and best practices

Revisions to the Basle Capital Accord

During the past two years, the Committee on Banking Supervision has conducted a thorough review of the Basle Capital Accord and is now in the process of receiving comments on a consultative paper of revisions that it has proposed in order to take into account recent developments in the financial markets. The objectives of the revision are continued promotion of safety and soundness in the financial system; continued enhancement of competitive equality among banks; a more comprehensive approach to addressing risks; and a continued focus on internationally active banks, although its principles should be applicable to all types of banks. A definitive accord or new framework should be ready in 2000.

Core Principles Methodology

In order to promote the full implementation of the Basle Core Principles for Effective Banking Supervision, the Committee perceived the need to make an assessment of the extent of current compliance with the Principles among countries. This exercise could help identify weaknesses in the existing system of supervision and regulation, and could form a basis for remedial measures by government authorities and bank supervisors. In April 1998, the Committee initiated a survey through a questionnaire distributed to about 140 countries. Supervisors were asked to undertake a rigorous assessment of their supervisory systems. More than 120 countries complied with the self-assessments with varying levels of quality. At the same time, IMF and the World Bank conducted their own review of compliance in several countries at the countries' request. Such assessments provided the opportunity to test the applicability, clarity and completeness of the Core Principles. These preliminary reviews of compliance, by the Committee itself as well as those conducted by IMF and the World Bank, demonstrated the need to develop a uniform assessment methodology.

As a consequence, at its meeting in October 1998, the Basle Committee decided to produce a

document, *The Core Principles Methodology*, to be used in compliance assessments.²⁸ An ad hoc working group was formed composed of representatives of the member institutions of the Committee, IMF and the World Bank. Consultations were also conducted with the Core Principles Liaison Group of G-10 and non-G-10 senior supervisors, as well as representatives of IMF and the World Bank. The document describes under what conditions assessments should be made, as well as the preconditions for effective banking supervision that should be taken into account when forming an assessment. It also raises considerations regarding the conduct of assessment (such as the access to relevant information) and the compilation and presentation of results. More importantly, it enumerates all significant criteria that are relevant for compliance. Two categories of criteria are used: essential criteria and additional criteria. The essential criteria are those elements that should generally be present in individual countries in order for supervision to be considered effective and thus achieve full compliance with a Principle, while the additional criteria are the elements that further strengthen supervision, which all countries should strive to implement. The essential and additional criteria are drawn from the Core Principles document and related Basle Committee papers.

Supervisory lessons to be drawn from the Asian crisis

In the aftermath of the Asian crisis, the Committee on Banking Supervision formed a working group to study the possible lessons that could be drawn from the crisis for the benefit of the G-10 creditor banks and their supervisors. It focused on two major issues: the extent to which the Basle solvency rules played a role in the size and type of banks' exposure to the Asian countries; and the possible lessons for supervisors of creditor banks on the way these banks manage their country risk profiles. The recommendations of the group included the informal sharing between supervisors of approaches to the measurement and management of risk, and the support to the regular publication of

²⁸ See BIS, *The Core Principles Methodology*, available at <<http://www.bis.org/publ/bcbs61.htm>> (21 January 2000).

BIS reports on exposures by lending countries. They also included strengthening the role of the Board of Directors and senior management of an individual bank in establishing and monitoring compliance with policies and procedures; improving the measurement and monitoring of country risk; and recognizing and measuring the interaction among different risks through stress testing and scenario analysis. Finally, the group also identified three major issues regarding the Core Principles for debtor banks in relation to the Asian crisis: (a) foreign currency liquidity management: the need for guidelines on liquidity management in stress conditions; and closer follow-up of liquidity management; (b) credit risk management: the importance of knowing the customer's business, the risks associated with directed loan activity, and issues of guarantees and collateral; and (c) the Basle Capital Accord as a minimum standard: the need to tailor levels of capital adequacy to the level of development of banks in a country.²⁹

Providing inputs to efforts to reform the international financial architecture

From April 1998 to March 1999, three reports on the international financial architecture were completed by three working groups composed of representatives of the central banks and finance ministries of industrial countries and emerging market economies.³⁰ The Working Group on Transparency and Accountability considered the contributions that transparency and accountability could make to improvements in economic performance, as well as the nature of the information needed to give effect to those improvements. The Working Group on International Financial Crises formulated new principles and reviewed existing policies to avoid international financial crises and facilitate the early, cooperative resolution of crises that might occur in the future. Finally, the Working Group on Strengthening Financial Systems worked on principles and policies to foster the development of an efficient

financial system and enhance cooperation among national and international institutions concerned with financial stability.

Setting up new regional and global arrangements

In July 1998, BIS established the Representative Office for Asia and the Pacific in Hong Kong, China. It is hoped that the office will further enhance information exchange and cooperation among central banks in the region, and between them and central banks in the rest of the world. BIS also held a regional conference in Asia. Both of these moves reflect the importance of the Asian financial system in the monitoring function of BIS.

Furthermore, the Financial Stability Institute was set up by BIS in February 1999 in order to strengthen financial systems worldwide, through better and more independent supervision of banking and implementation of the Core Principles. The organization of seminars and training programmes, which also promote the interaction of supervisors from emerging markets and industrial countries, is the means to accomplish this goal.

INSTITUTE OF INTERNATIONAL FINANCE

IIF was created in 1983 by 38 banks of the leading industrialized countries as a response to the international debt crisis of the early 1980s. It is now a global association of financial institutions. Its members include most of the world's largest commercial banks and investment banks, as well as a growing number of insurance companies, export credit agencies, multinational companies, trading companies, investment management firms, and multilateral agencies. More than half of its members are European-based financial institutions, though there has been a steady rise in representation from the leading financial institutions in emerging market countries. The growth of the Institute can be seen in its present membership, numbering more than 300 and headquartered in more than 50 countries.

²⁹ See BIS, *Supervisory Lessons to be Drawn from the Asian Crisis*, available at <http://www.bis.org/publ/bcbs_wp2.htm> (21 January 2000).

³⁰ BIS, *69th Annual Report* (7 June 1999), available at <<http://www.bis.org/publ/ar99e.htm>> (21 January 2000).

Modalities of crisis prevention and early warning

The Institute lists three primary goals which reflect its monitoring functions. First, it seeks to support members' risk management, asset allocation, and business development in emerging markets. To carry this out, the Institute provides its members with quality reporting, data, and analysis of economic and financial developments and prospects in emerging market economies. Second, it aims to serve as a forum for engaging the private financial community in discussions with finance ministers, central bank governors, IMF, the World Bank and other multilateral agencies. These discussions focus on preventing financial crises in emerging market economies and mitigating political risks for private sector infrastructure projects. Lastly, it endeavours to provide a vehicle for the exchange of information and views on global financial supervision issues and to advance consensus on them among important regulatory institutions.

By engaging in policy research and analysis, and maintaining databases on emerging markets, the Institute is capable of helping its members with the following:

- Assess risk and manage exposure in emerging market economies
- Identify and understand key trends in emerging markets finance
- Anticipate the effects of economic policy decisions on debt and equity markets
- Develop business opportunities

The Institute also advises clients on emerging markets.

Information gathering and analysis

The Institute engages in information gathering, including the fielding of IIF economists on missions to emerging market economies to discuss policies directly with top government officials and representatives of private financial institutions and the business community. Another part of the Institute's economic work is the analysis of emerging markets. Its research output includes the following:

- *Economic Reports* offer in-depth analysis of the economic conditions, policies and prospects of individual economies; developments in domestic capital markets; and access to external finance.
- *Monthly Economic Reviews*, issued for approximately 25 markets, provide the latest data and analysis on key financial indicators and economic developments.
- *Special Economic Briefings* are issued periodically on selected economies. The notes are designed for senior bankers and executives and include special sections on key issues and the economic outlook for these economies. They are issued in connection with the annual meetings of IMF, the World Bank and the regional development banks.
- *Key Indicators: Selected Emerging Market Economies*, published three times a year, give senior bankers and analysts a handy reference to facilitate comparison of important data across emerging markets. This publication presents over 20 economic and financial indicators on approximately 20 emerging market economies, with special analysis of six to eight especially interesting economies in each issue, including a few that are undergoing difficulties.

An important aim of the Institute has been to improve access to timely and accurate data on emerging market economies. A comprehensive database incorporating time series data on a large number of variables is maintained for each of the economies monitored by the Institute. The database includes historical data and projections of macro-economic performance, balance of payments and external financing.

The Institute also publishes reports on regional and global economic and financial issues of current interest. Among these reports are the following:

- *Near-term Prospects for Emerging Market Economies* summarizes developments and key changes in financing prospects for major emerging market economies, including the composition and direction of

capital flows and the role of bond, equity and debt financing. It also provides an outlook on the global economy, including interest rates, exchange rates, commodity prices and world trade growth, as a framework for assessing economic developments in emerging markets.

- *Comparative Statistics for Emerging Market Economies* is a compilation of economic and financial data on major developing countries for the 10 most recent years.

In assessing countries, the Institute looks at a large number of indicators with respect to both external and domestic sectors. These include short-term debt, the participation of residents in external flows, the overall structure of capital inflows with an eye on the potential for reversal, the importance of derivatives, credit and money growth, the quality of banking and financial sector regulations and supervision, real estate valuation, problem loans, and the profitability of the financial sector and its exposure to exchange rate policies and the fiscal situation. The quantitative indicators are complemented by country-specific qualitative analyses.

Data standards

To improve data quality, in September 1995 the Institute published a set of data standards for emerging market economies (*Improving Standards for Data Release by Emerging Market Economies*). Furthermore, in April 1996 it issued a follow-up assessment of actual country practices in meeting these standards (*Data Release Standards for Emerging Market Economies: An Assessment of Country Practices*) and an update of this review in April 1997. A working group reviewed these standards and recommended a number of changes, which the Institute adopted. These were published in March 1999 (*Report of the Working Group on Transparency in Emerging Market Finance*).

Briefings and advice

The staff of the Institute also prepare briefings and presentations for members in financial centres, provide special country briefings on principal economies during the regular meetings of IIF and provide similar briefings timed to coincide

with the annual meetings of the regional and multi-lateral development banks, IMF and the World Bank.

The Institute is uniquely positioned to monitor and serve as a link between the private sector and the public sector, as seen by its establishment of the Steering Committee on Emerging Market Finance, a high-level committee of senior executives of the world's leading private financial institutions, to guide four working groups and a task force focusing on key issues related to preventing and resolving financial crises in emerging markets. Contact between these groups and official bodies undertaking similar work has resulted in the release of working group reports. In addition, discussions of specific issues have been organized by the Institute with finance ministers and central bank governors from major industrial and emerging market economies and with senior managers at IMF, the World Bank and the regional development banks.

Another part of the Institute's economic work involves global banking and regulatory issues. The Institute monitors and analyses how global trends in industry and the supervisory and regulatory framework affect its members.³¹ It offers financial firms both a unique venue for exchanging views on global financial issues and a voice in the public policy debate on key supervisory issues. In the early 1990s, the Institute was instrumental in forging models-based market regulatory capital rules. It also

³¹ The Institute's contributions are the following:

- It provides independent research and analysis on key global financial policy and supervisory/regulatory topics, through the *Banking Department Newsletter* and *Financial Law and Regulation Report*
- Consensus-building at the meetings of the Institute's task forces and working groups
- Dissemination of reports (for example, *Recommendations for Revising the Regulatory Capital Rules for Credit Risk*; *Year 2000 Checklist: A Guide for Financial Firms*; and *Report of the Task Force on Conglomerate Supervision*) to the members, public authorities and the media
- Informal discussions through the Basle Committee on Banking Supervision and the Joint Forum on Financial Conglomerates

developed an approach for disclosing derivatives-related credit exposures. The Institute is currently taking a key role in shaping industry consensus on changes to be made in the current guidelines of the Basle Capital Adequacy Accord. The Institute also brings together bank executives in emerging market regions once a year to discuss important issues of current interest.

Technical aspects

Basically, the Institute's monitoring function is through the dissemination of economic reports, which come out once to three times a week. Each contains an in-depth analysis of the economic conditions and policies of the economy or region, developments in domestic capital markets, and its access to external finance. The reports are backed up by a statistical databank. The Institute also publishes a monthly review, which gives a summary of the latest data and analysis on economic developments and financial indicators for the principal emerging market economies. Each issue is introduced by an overview that focuses on the key trends and issues in emerging markets³² during the past month.

The other works of the Institute include *Capital Flows to Emerging Market Economies*, which comes out three times a year and contains an analysis of developments in the international capital markets and the outlook for financial flows to emerging market economies, and *Survey of Debt Restructuring*, which is issued twice a year, and contains a brief description of restructuring arrangements with commercial banks and official creditors, presented country by country in chronological order.

Recent initiatives in crisis prevention

Since the Mexican crisis of the early 1990s, IIF has made substantial improvements in data dissemination, but the recent financial crises have shown the continuing gaps in the availability of relevant information. Beginning in the fall of 1999, the *Monthly Economic Review* includes each

quarter a supplementary set of economies, in addition to the core of 20-25 economies covered monthly. This initiative clearly reveals the intent of IIF to monitor more emerging markets. It has also published a number of research papers that deal with the risks of investing in emerging markets.³³

In 1998, IIF formed the Working Group on Transparency in Emerging Markets Finance. The Group's recommendations, released in a report in March 1999, fall into four main areas: standards for macroeconomic data transparency for emerging market economies; the desirability of improved disclosure by private sector suppliers of capital; the need for further improvements in disclosure by the multilateral official financial institutions, including IMF; and the need for better information on the health of the financial sector in emerging market economies.³⁴ The revised IIF data standards are grouped into three areas: national accounts, monetary accounts and fiscal accounts. Its standards are comparable with SDDS of IMF. In general, the Working Group recommends a stricter and more forceful implementation of the standards.

IIF also formed the Task Force on Risk Assessment, which released its report in March 1999; it proposed risk management practices for the private sector and policy recommendations for international financial organizations, in the light of the recent financial crises. The Task Force also sought to articulate risk management experiences among groups of leading financial institutions.³⁵

³³ These papers include the following: *Spreads and Risk in Emerging Markets Lending*, No. 97-1 (December 1997); *IMF-supported Adjustment Programs in the East Asian Financial Crisis*, No. 98-1 (May 1998), and *Impact of the East Asian Financial Crisis on Trade of Industrial and Emerging Market Economies*, No. 98-2 (June 1998), available at <<http://www.iif.com/public.htm>> (31 January 2000).

³⁴ IIF, *Report of the Working Group on Transparency in Emerging Markets Finance* (March 1999), p. 1, available at <<http://www.iif.com/descriptions.htm>> (21 January 2000).

³⁵ IIF, *Report of the Task Force on Risk Assessment* (March 1999), pp. 1-7, available at <<http://www.iif.com/descriptions.htm>> (21 January 2000).

³² The economies from the ESCAP region that are included are China; Hong Kong, China; India; Indonesia; Malaysia; Philippines; Republic of Korea; and Thailand.

CREDIT RATING AGENCIES

Private credit rating agencies provide another way of assessing country vulnerability. There are three major international firms: Standard & Poor's, Moody's and Fitch IBCA, as well as some more regional or domestic ones, such as the Japan Bond Research Institute, which rates bond issues in Asia. These provide assessments of both sovereign (government) and private sector credit risk. These agencies rate credit risk on a wide variety of credit instruments and issuers (both public and private sector) of bonds, debt etc. The process of establishing these ratings is in the spirit of monitoring and surveillance operations. While there is some question of their use as early warnings, the ratings should certainly be useful as inputs into monitoring and surveillance activities.

The rating agencies failed to predict the approaching problems in the Asian banking and financial sectors. Although their misinterpretation of signals³⁶ might have weakened their credibility, in fact their potential influence was increased to an almost quasi-official standing in the proposed revision of the Basle Capital Adequacy Rules released in June 1999. According to the new proposal, credit rating agencies were to be granted a dominant role in banks' internal credit risk evaluation processes. While this proposal has not been welcomed by many, including the rating agencies themselves, it justifies a closer look at the early warning capabilities of credit rating agencies.

In principle, rating agencies have some important advantages over IMF. While they may have less access to data and engage in less intensive discussion with governments, they have the advantage that they can reflect market perceptions about government policies and credibility to a much greater extent. Rating agency reports are updated more frequently to reflect sudden developments and provide a more continuous flow of information in a fast-changing world. Finally, rating agency reports grade countries on an ordinal scale that enables frequent adjustment to reflect marginal changes in the assessment of risk factors, even when the

change is small. This is a potentially important advantage, and there are likely to be more frequent adjustments as the rating agencies gain experience.

It is generally not well perceived that sovereign ratings are a relatively recent phenomenon and in fact account for a minor portion of the ratings business income; most of their business remains in corporate ratings. This argues favourably for the objectivity of the rating agencies with respect to country risk. It suggests that there does not exist a significant incentive for rating agencies to either favour or be biased against a particular country. Moreover, an agency's reputation could suffer adversely if its ratings of a sovereign were to be frequently out of line with the market experience of either public or private creditors of that country.

There are quite a few regional or national ratings agencies.³⁷ In contrast with the three major international agencies mentioned earlier, many of these regional or national rating agencies have links with their respective governments (or may have had, in that they were set up or mandated by a government body). Thus the degree of independence of some of these may be suspect. This may account in part also for the gap between the ratings by regional/national agencies and those of the three majors for the same entities.

It is worthy of note that the members of ASEAN established the ASEAN Forum of Credit Rating Agencies in 1993 and the countries involved have been cooperating with each other to improve methodology and to harmonize standards.

Ratings as an early warning system

Any crisis is likely to impair a country's ability to service debt obligations, and this should be reflected in a deterioration of the country's sovereign rating. If the ratings agencies are quick to recognize the weakening in fundamentals, then the downgrading of credit rating might even precede the onset of

³⁶ Fitch IBCA admitted: "We used to think that a high proportion of short-term debt was a worry only with highly indebted sovereigns. We were wrong." (*Financial Times*, 14 January 1998).

³⁷ For example, India and the Republic of Korea have three each, Malaysia has two, and China, Indonesia, Pakistan, Philippines and Thailand have one rating agency each. Meanwhile, Japan has had a 24-year record of experience in rating, the third longest following the United States and Canada.

crisis and serve as a signal. In practice, however, like most of the concerned institutions, the ratings agencies missed calling the Asian crisis. Ironically, they may have contributed to the crisis by maintaining high credit ratings which may have encouraged large capital inflows until the very last minute. Then, by announcing a sequence of quick downgrading within a very short time after the crisis broke, they may have signalled a continuous deterioration which likely added to the sense of panic. As shown in table V.3, Thailand and the Republic of Korea were still rated "investment grade" in June 1997, the eve

of the crisis. It was not until September-October 1997, when the crisis was already in full swing, that these countries were downgraded. The ratings agencies also seem not to have anticipated the severity of the crisis, downgrading these countries by the largest number of notches only in December 1997 or January 1998.

None of the major studies have yet tested the ratings agencies' performance as a leading indicator of a currency crisis. No doubt this is due in part to the ratings not being generally available except to

Table V.3. Ratings for three Asian countries during the crisis

<i>Indonesia</i>					
<i>Moody's</i>			<i>Standard & Poor's</i>		
<i>Date</i>	<i>Rating</i>	<i>Change</i>	<i>Date</i>	<i>Rating</i>	<i>Change</i>
25/6/97	Baa3	–	25/6/97	BBB	–
27/12/97	Ba1	–1	10/10/97	BBB–	–1
9/1/98	B2	–5	31/12/97	BB+	–2
			9/1/98	BB	–3
			27/1/98	B	–6
<i>Republic of Korea</i>					
<i>Moody's</i>			<i>Fitch IBCA</i>		
<i>Date</i>	<i>Rating</i>	<i>Change</i>	<i>Date</i>	<i>Rating</i>	<i>Change</i>
25/6/97	A1	–	25/6/97	AA–	–
27/11/97	A3	–2	11/11/97	A+	–1
10/12/97	Baa2	–4	26/11/97	A	–2
21/12/97	Ba1	–6	11/12/97	BBB–	–6
			23/12/97	B–	–12
<i>Thailand</i>					
<i>Moody's</i>			<i>Standard & Poor's</i>		
<i>Date</i>	<i>Rating</i>	<i>Change</i>	<i>Date</i>	<i>Rating</i>	<i>Change</i>
25/6/97	A3	–	25/6/97	A	–
1/10/97	Baa1	–1	3/9/97	A–	–1
27/11/97	Baa3	–3	24/10/97	BBB	–3
21/12/97	Ba1	–4	8/1/98	BBB–	–4

Source: "Credit ratings and the East Asian financial crisis", a presentation by Frank Packer at the Workshop on Economic Monitoring of Financial Systems in East and South-East Asia, organized by the ADB Institute and PECC Manila, 25-26 June 1998.

Note: Change is measured by the number of rating steps between the former and the new rating. A negative sign shows a downgrading.

subscribers of the ratings agencies. Therefore there is no empirical basis on which to judge their suitability for use in early warning systems. Nevertheless, they should be useful at least as a measure of an economy's vulnerability.

Standard & Poor's and Moody's have roughly corresponding ratings, though they differ in the symbols used. It has been found that they do not deviate too much from each other in their ratings.³⁸ Disagreements on a rating will be by a notch on the scale in most cases. The high degree of correlation

³⁸ Richard Cantor and Frank Packer, "Determinants and impact of sovereign credit ratings", *Economic Policy Review of the Federal Reserve Bank of New York* (New York, October 1996). The explanatory variables were per capita income, GDP growth, inflation, fiscal balance, external balance, external debt, and economic development (proxied by indicator for whether or not a country is industrialized).

found suggests that both agencies do in fact look at very similar macroeconomic factors (though they may weigh them differently) in coming up with a rating for a particular sovereign.

Standard & Poor's rating approach. In its sovereign credit ratings primer, Standard & Poor's confirms³⁹ these findings and notes that there is no exact formula for determining ratings. Moreover, Standard & Poor's readily admits that its procedure incorporates qualitative aspects as well. The broad categories in table V.4 show a close correspondence to the usual macroeconomic variables, with the additional category of "Political risk".

Moody's rating approach. Moody's tends to use a more general set of indicators. First, the

³⁹ Standard & Poor's, "Sovereign credit ratings: A primer", *Sovereign Ratings Service* (December 1998), p. 2.

Table V.4. Standard & Poor's sovereign ratings methodology profile

<p>Political risk</p> <ul style="list-style-type: none"> • Form of government and adaptability of political institutions • Extent of popular participation • Orderliness of leadership succession • Degree of consensus on economic policy objectives • Integration in global trade and financial system • Internal and external security risks <p>Income and economic structure</p> <ul style="list-style-type: none"> • Living standards, income, and wealth distribution • Market versus non-market economy • Resource endowments and degree of diversification <p>Economic growth prospects</p> <ul style="list-style-type: none"> • Size and composition of savings and investment • Rate and pattern of economic growth <p>Fiscal flexibility</p> <ul style="list-style-type: none"> • General government operating and total budget balances • Tax competitiveness and tax-raising flexibility • Spending pressures 	<p>Public debt burden</p> <ul style="list-style-type: none"> • General government financial assets • Public debt and interest burden • Currency composition and structure of public debt • Pension liabilities • Banking, corporate, other contingent liabilities <p>Price stability</p> <ul style="list-style-type: none"> • Trends in price inflation • Rates of money and credit growth • Exchange rate policy • Degree of central bank autonomy <p>Balance of payments flexibility</p> <ul style="list-style-type: none"> • Impact of fiscal and monetary policies on external accounts • Structure of the current account • Composition of capital flows <p>External debt and liquidity</p> <ul style="list-style-type: none"> • Size and currency composition of public external debt • Importance of banks and other public and private entities as contingent liabilities of the sovereign • Maturity structure and debt service burden • Level and composition of reserves and other public external assets • Debt service track record
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Source: Standard & Poor's, "Sovereign credit ratings: a primer", *Sovereign Ratings Service* (December 1998), p. 2.

qualitative aspect is underlined. While quantification is integral to Moody's rating analysis, particularly since it provides an objective and factual starting point for each rating committee's analytical discussion, ratings are not based on a defined set of financial ratios or a computer model. Rather, they are the product of a comprehensive analysis of each individual bond/debt issue and issuer by experienced, well-informed credit analysts. Second, their analytical focus is on fundamental factors that will drive each issuer's long-term ability to meet debt payments, such as a change in management strategy or regulatory trends. Third, their analysis focuses on an assessment of the level and predictability of an issuer's future cash generation in relation to its commitments to repay debtholders. Their main emphasis throughout the rating analysis is on understanding strategic factors likely to support future cash flow, while identifying critical factors that will inhibit it. The issuer's capacity to respond favourably to uncertainty is also key. Generally, the greater the predictability of an issuer's cash flow and the larger the cushion supporting anticipated debt payments, the higher the rating will be. Fourth, Moody's ratings do not incorporate a single, internally consistent economic forecast but aim rather to measure the issuer's ability to meet debt obligations against economic scenarios which appear reasonably adverse to the issuer's specific circumstances. Last but not least, Moody's analysts take into account the different accounting systems which exist. In examining financial data, Moody's focuses on understanding both the economic reality of the underlying transactions and how differences in accounting conventions may or may not influence true economic values. However, it is important to recognize that Moody's ratings are intended only to measure risk of credit loss. They are not intended to measure other risks in fixed-income investment, such as market risk.

Fitch IBCA approach. The sovereign rating methodology of Fitch IBCA draws on the recent instances of default and near-default to establish a range of key leading indicators of distress. These are incorporated in a risk model that gives a percentage score to sovereign borrowers, which is then converted into long-term ratings. There is also a separate short-term risk model that analyses the prospects of timely repayment within the next year, which highlights the importance of liquidity factors.

Recent initiatives after the crisis

In the aftermath of the crisis, the ratings agencies have also done a considerable amount of self-examination. Sovereign ratings are relatively new and the demand for them did not really take off until the 1980s. Consequently, agencies are still building their capabilities in this area, and strengthening their personnel and data collection systems to better address the drawbacks noticed during the last two years.

In particular, Standard & Poor's has launched a new product that grew out of the Asian crisis: a financial system stress rating. The latest survey on financial system stress, published in May 1999,⁴⁰ covered 62 countries, 11 of which are in the ESCAP region. Basically, the survey tries to monitor the degree of leverage within an economy. It uses four leading indicators (level and rate of credit growth; level of private sector debt; level and rate of increase of asset prices; and level and rate of growth of net external liabilities) to predict the likelihood of coming credit disturbances. While these indicators emit signals on potential financial vulnerabilities, they do not measure the extent of the problem or the degree of stress a financial system is undergoing. In order to obtain some indication of the level of stress, Standard & Poor's uses estimates of the potential level of the gross problematic assets of a financial system (calculated at its worst-case scenario of recession), expressed as a percentage of domestic credit to the private sector and non-financial public enterprises. This indicator simply measures the extent of assets that can turn bad in the face of undesirable events such as a recession.

OTHER REVIEW EXERCISES

There are many other reviews of economic development in the Asian and Pacific region undertaken by a variety of institutions, all of which contribute to monitoring exercises by collating, analysing and commenting on trends and events and issuing warnings on potential problems. Some of these are undertaken at the global level, where the developments in the countries of Asia and the Pacific are

⁴⁰ See Standard & Poor's, "Global financial system stress: 24 show adverse trends in credit quality", *Sovereign Ratings Service* (May 1999).

compared and contrasted with those in other regions. Examples of these that are produced by international organizations include the United Nations *World Economic Survey*, the UNCTAD *Trade and Development Report*, and the World Bank *Global Development Finance and Global Economic Prospects and the Developing Countries*. Each of these annual publications includes a survey of recent developments, sometimes at the country level and sometimes by groupings of countries, in their particular areas of interest, and they all also include an analysis of some important emerging issue at the global level. The OECD *Economic Outlook*, which monitors economic developments and policies in OECD member countries and is released twice a year, also covers some countries from the Asian and Pacific region (Australia, Japan, New Zealand and the Republic of Korea). In addition, there are monitoring exercises produced by research centres and universities in the private sector, such as the annual country surveys of the Economic Intelligence Unit of *The Economist*, which undertake an in-depth and critical review of developments, policies and future prospects.

At the regional level, there are two main publications from intergovernmental organizations which cover the entire region, the ADB *Asian Development Outlook* and the ESCAP *Economic and Social Survey of Asia and the Pacific*. Both of these undertake monitoring-type exercises and provide commentary and analysis of events, policies and special issues of importance to the region. There are also publications which cover more restricted groups of countries through subregional organizations or through private companies, as well as many government and/or private in-depth surveys at the country level.

TRENDS IN SURVEILLANCE MECHANISMS: SUMMARY AND CONCLUSION

As is evident from the preceding discussions, surveillance mechanisms differ according to scope, country coverage, variables monitored, type of leverage etc. Tables V.5 and V.6 review the modalities and indicate the coverage of developing countries of the ESCAP region within these global surveillance mechanisms. There are some overlaps in the scope of surveillance by different institutions.

BIS seems to have a comparative advantage in setting standards and codes for supervision of the banking system. However, until recently, it dealt almost exclusively with developed markets. Furthermore, it lacks the necessary leverage to elicit policy changes from countries. IMF, on the other hand, has a comparative advantage in exercising surveillance over financial systems and, in collaboration with other agencies, in assessing the compliance with international standards. It has relatively greater leverage in influencing policies but has traditionally concentrated on macroeconomic and exchange rate policies rather than the structural and financial issues which were at the heart of the crisis in Asia. IIF and the credit rating agencies which focus on variables that are closely associated with the financial crisis, such as the level of debt and international capital flows, share the limitations of BIS in respect of policy leverage. These institutions largely depend on market pressure as leverage in influencing needed policy corrections in countries.

How accessible are the findings of the global surveillance institutions? IMF publishes regularly documents on its multilateral activities, including *World Economic Outlook* and *International Capital Markets*. In addition, with the consent of governments of the concerned countries, information on the Fund's bilateral surveillance activities is increasingly being made available to the public through the release of PINs and, in the context of an 18-month pilot project started in the spring of 1999, Article IV consultation reports. However, there is a widespread perception that regional contagion was largely missed by IMF because of its mainly bilateral or global orientation. Most BIS data are available through its web site, but its monitoring-type analyses are confidential to those participating in the meeting. The private monitoring bodies, such as IIF and the credit rating agencies, largely offer their databases and analyses by subscription. Apart from difficulties in accessibility, these mechanisms vary in the nature of their source of database information. Member countries of IMF are required to submit official data on a regular basis. Of course the quality and comparability of the data vary across countries, but SDDS is meant to improve the quality of data reporting. Apart from official sources, BIS and IIF gather more specialized data (banking or capital flows, for example) from their members. Credit rating agencies rely on a multitude of data sources – official, Reuters and other proprietary information – to produce their sovereign risk ratings.

Table V.5. Modalities of global surveillance/monitoring systems

	IMF	BIS	IIF	Rating agencies
Policy surveillance	Bilateral – Article IV Multilateral – <i>World Economic Outlook</i> Regional – Euro			Global financial stress Sovereign credit ratings
Codes/standards	SDDS GDDS Fiscal transparency Monetary and financial policies	Banking supervision – Core Principles – Capital Adequacy	Risk management for firms investing in emerging markets	
Information/data	Dissemination Standards Bulletin Board Article IV Public Information Notices (PINs) Reports on observance of standards and codes External Debt Statistical publications	External debt Derivatives International banking statistics	Capital flows	
Leverage	Conditionality Article IV	Peer pressure Market pressure	Market pressure	Market pressure
Coverage of developing ESCAP members	Article IV reports from 1998 to Aug. 1999: 33 Report on observance of standards and codes: 1 SDDS: 7		Economic Monthly Review: 12	Standard & Poor's financial stress: 11 Standard & Poor's sovereign ratings: 15 Moody's sovereign ratings: 19

Table V.6. Monitoring of developing countries or areas of the ESCAP region

Countries or areas	Institute of International Finance		International Monetary Fund			Joint international financial institutions external debt tables	Standard & Poor's		Moody's Sovereign rating
	Monthly Economic Review	Article IV consultation	Financial programme ^a	Transparency report	SDDS		Sovereign rating	Financial stress	
South Asia									
Bangladesh		✓	✓			✓			
Bhutan		✓				✓			
India	✓	✓	✓		✓	✓	✓		✓
Iran (Islamic Republic of)		✓				✓			✓
Pakistan	✓	✓	✓			✓			✓
Sri Lanka		✓	✓			✓			✓
East and South East Asia									
Brunei Darussalam		✓	✓			✓			✓
Cambodia		✓				✓			✓
China	✓	✓				✓			✓
Democratic People's Republic of Korea		✓		✓	✓	✓	✓		✓
Hong Kong, China		✓				✓			✓
Indonesia		✓	✓			✓			✓
Lao People's Democratic Republic		✓	✓			✓			✓
Macao, China		✓	✓			✓			✓
Malaysia		✓				✓			✓
Myanmar		✓				✓			✓
Nepal		✓	✓			✓			✓
Philippines	✓	✓	✓			✓	✓		✓
Republic of Korea	✓	✓	✓		✓	✓	✓		✓
Singapore	✓	✓	✓			✓	✓		✓
Taiwan Province of China	✓	✓				✓	✓		✓
Thailand	✓	✓	✓		✓	✓	✓		✓
Viet Nam	✓	✓	✓			✓			✓
Central Asia									
Afghanistan		✓				✓			✓
Armenia		✓	✓			✓			✓
Azerbaijan		✓	✓			✓			✓
Kazakhstan		✓	✓			✓			✓
Kyrgyzstan		✓	✓			✓			✓

Table V.6 (continued)

Countries or areas	Institute of International Finance		International Monetary Fund			Joint international financial institutions external debt tables		Standard & Poor's		Moody's	
	Monthly Economic Review	Article IV consultation	Financial programme ^a	Transparency report	SDDS	Sovereign rating	Financial stress	Sovereign rating	Sovereign rating		
Mongolia		✓	✓								
Russian Federation		✓	✓					✓			✓
Tajikistan		✓	✓					✓			✓
Turkey		✓	✓		✓						✓
Turkmenistan		✓									✓
Uzbekistan			✓								✓
Pacific islands											
American Samoa											
Cook Islands								✓			
Fiji		✓									✓
French Polynesia											
Guam											
Kiribati		✓									
Maldives		✓									
Marshall Islands		✓									
Micronesia (Federated States of)		✓									
Nauru											
New Caledonia											
Niue											
Northern Mariana Islands											
Palau		✓									
Papua New Guinea		✓									✓
Samoa		✓	✓					✓			
Solomon Islands		✓									
Tonga		✓									
Tuvalu											
Vanuatu		✓									✓

^a IMF web site *Member's Position in the Fund*, available at <<http://www.imf.org/np/tre/tad/extend1.cfm>> (21 February 2000). Financial programmes include those active for any period between 1991 and 2000.

The various surveillance institutions differ according to their ownership structure. IMF is a Bretton Woods institution controlled by a board of official representatives of member countries. The degree of influence in the Fund of a particular member varies, to a large extent, with the amount of the membership contribution to the Fund. The Basle-based committees are more tightly-knit groups composed mainly of the representatives of the central banks of the G-10 countries (BIS is funded by central banks through the purchase of shares). IIF is an association of private financial institutions, while the rating agencies are private companies which are governed by their respective boards (Standard & Poor's is a division of the McGraw-Hill Companies).

A number of initiatives have arisen from the intense soul-searching among global surveillance mechanisms that inevitably followed after the Asian debacle. There appears to be a commonality in the responses of the surveillance mechanisms; many are geared to address or mitigate the perceived causes of the Asian crisis. Perhaps one of the more prominent responses of monitoring mechanisms is to focus on the financial sector and the capital account. This stems from the fact that the vulnerability of the financial system, by and large, escaped the scrutiny of most surveillance systems prior to the collapse of the Thai baht peg in July 1997. The emphasis on the financial sector is also a delayed reaction to the altered world external environment which is marked by deep integration of markets, very massive capital flows and powerful effects of changes in expectations. IMF and the World Bank, for instance, are engaged in the Financial Sector Assessment Programme, which is designed to identify strengths and vulnerabilities of a country's financial system. Standard & Poor's, on the other hand, has come up with financial system stress indicators, on top of its more traditional sovereign credit risk ratings.

Another common thread in the recent initiatives is the emphasis on best practices in disclosure, clarity in policy-making, dissemination of data, accounting practices and even the publication of Article IV staff reports. The set of proposals for the new financial architecture is characterized by a proliferation of standards and codes. One reason for the emphasis on codes and best practices is that in this era of global finance and free flow of capital, there is little choice for countries that wish to tap world capital markets but to adapt their policy-

making practices, supervisory systems, levels of information disclosure or accounting methods to world standards.

The stress on transparency is intended to limit the problems of informational asymmetries that seemed to be a significant factor in the Asian crisis, in that the lack of transparency prevented the markets from discerning the increasing fragility of the system. In addition, the availability of good quality data should greatly facilitate the monitoring process.⁴¹ It is increasingly recognized that transparency is critical in the functioning of markets as well as in instilling market discipline.

Obviously the codes or best practices advocated by the existing global mechanisms are a function of the areas of expertise and focus of these institutions. Because the core competency of IMF is in macroeconomic and exchange rate policy, it has proposed standards on transparency in fiscal and monetary policies. Similarly, it has pushed for more comparable and accurate data, which are critical in surveillance work, at the national, regional and multilateral levels, through SDDS or GDDS. BIS, which is more concerned about the stability of banking systems and financial markets, promotes better prudential standards in bank supervision. IIF, on the other hand, is concerned with drawing up risk management standards for firms investing in emerging markets. It is also participating in drawing up best practices in transparency in concert with the other international financial institutions. IOSCO, IAIS and IASC are developing or revising standards in their respective areas. By working together, the nexus of agencies, both public and private, seem able to cover the gamut of issues where standards or codes are required at the present time. However, there is still a risk that some areas which can create global stress and shocks may be omitted unless vigilance is exercised in monitoring and in research and analysis and adequate coordination is achieved.

⁴¹ In general, it is easy to understand that financial systems can adjust more readily to gradual changes in premiums, capital flows etc. More destabilizing to systems are shocks such as abrupt and massive changes in prices or flows. As the saying goes, it is not speed that kills, but the sudden stop. If there are high levels of transparency in the system, points of vulnerability can be picked up earlier, before massive corrections occur.

To enhance the effectiveness of the codes and standards, it would appear that the following issues need to be addressed. At present, most of them are optional and not binding, even for the members of the organization devising the instrument. Hence, unless adequate incentives are created to encourage implementation, there is no assurance that countries will adhere to these codes or standards. Proper monitoring mechanisms should go beyond simply monitoring formal compliance with the standards. Rather, the methodology with which the data are collected and analysed, the degree of compliance and problem areas should be subject to monitoring as well. Given that financial markets are dynamic and not static, the types of data reported may also change through time. Hence, there is a need for international organizations to evaluate the appropriateness and relevancy of the existing reporting requirements constantly. Finally, it should be borne in mind that reporting and monitoring compliance of certain international benchmarks is not a panacea for crisis prevention.

Recent initiatives are marked by a greater reliance on market forces. Prior to the crisis, unless a country was subject to IMF conditionalities, there appeared to be little incentive to disclose information, especially by emerging markets. With the new, very public initiatives in the area of transparency, countries and firms alike are under greater pressure to disclose information for fear of being accused of having something to hide. When there are codes and standards, market participants will, in time, expect banks or countries to observe them. The markets can thus reward or punish firms or countries, by, say, applying a risk premium, based on their record of compliance.

There seems to be more cooperation among surveillance mechanisms in the aftermath of the Asian crisis. For instance, BIS, IMF, OECD and the World Bank have collaborated in setting up statistics on external debt. IMF and the World Bank likewise have participated with BIS in drafting a handbook on the methodology for assessing implementation of the Core Principles and in identifying areas in which further work could help countries achieve compliance. There is also a clearer distinction between the areas of competence as indicated by the codes and standards advocated by particular institutions. In time, because of the harmonization of international standards, it is likely that the problems of differences in the definition of data or indicators among different surveillance bodies will be resolved.

The Financial Stability Forum is a prime example of a cooperative arrangement among major global surveillance bodies, national authorities and other regulatory agencies. It is a consultative body consisting of representatives of the finance ministries and central banks of the G-7 countries, IMF, the World Bank, BIS, IOSCO, OECD and other agencies. This arrangement appears to be motivated by the need for a more coordinated response to the problems posed by the global financial system. The objectives of the Forum include pooling and sharing information on vulnerabilities in the international financial system among different bodies, and some kind of monitoring of the implementation of internationally agreed regulatory and supervisory standards and codes of conduct.⁴²

The Forum serves as a vehicle for identifying regulatory gaps and areas of vulnerability in the international financial system. It could become a significant force for effective policy responses, especially where coordination is necessary. However, it is not a representative body because emerging markets are not included. It is clear that the inclusion of the systemically important countries is crucial if the Forum is to achieve the minimum degree of representation and participation that is needed.⁴³ The Forum has a small secretariat in Basle and is chaired by the General Manager of BIS.

Lastly, there is greater interest in the area of managing the risk of globalization of financial markets. The Core Principles are focused primarily on risk management in banks. Financial stress testing exercises are being contemplated in the Financial Stability Forum where possible changes in liquidity conditions or exchange rate changes, for instance, are posited and the consequences are examined. Indeed, given that the costs of crises are so huge in a globalized setting, surveillance mechanisms are increasingly investing in risk management and prudential norms.

⁴² Yılmaz Akyüz and Andrew Cornford, "Capital flows to developing countries and the reform of the international financial system", paper presented for the World Institute for Development Economics Research (WIDER), project on New roles and functions for the UN and the Bretton Woods institutions (Geneva, UNCTAD, 1999).

⁴³ Montek S. Ahluwalia, "Key issues in reforming the global financial architecture", paper submitted to the Commonwealth Finance Ministers Meeting, Cayman Islands, 21-23 September, 1999.

PROGRESS IN STRENGTHENING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Proposal/action required

Action taken and progress made as of December 1999

Next steps

I. Transparency and accountability

A. IMF

Public Information Notices (PINs)

Executive Board took decision on new policy agreed earlier.

National authorities being actively encouraged to allow release of PINs following Article IV consultations.

Release PINs following Article IV consultations

PINs released for 80 per cent of Article IV consultations from January to August 1999. Lags shortened and number of modifications reduced.

IMF Executive Board's next review of PIN policy planned for March 2000.

Extend use of PINs to policy papers

Since March 1999, PINs released for policy discussions on SDDS reserve data, heavily indebted poor country initiative modifications, transparency initiatives, and monetary and exchange rate of euro area.

Article IV staff reports

Executive Board took decision on 3 June 1999 to implement an 18-month pilot programme for the voluntary release of Article IV staff reports. By 15 September 1999, 45 members had volunteered to participate. As of 4 February 2000, 31 staff reports had been published or authorized for publication.

National authorities are encouraged to volunteer for pilot programme.

Use of Fund resources
(i) Publish Chairman's statements after Board discussions in use of Fund resources cases; (ii) publish letter of intent, memoranda of economic and financial policies and policy framework papers; and (iii) voluntary release of use of Fund resources staff reports

In June 1999, the Executive Board took the decision to release: (i) letters of intent, memoranda of economic and financial policies and policy framework papers; and (ii) Chairman's statement in cases of use of Fund resources, on the understanding that the question of release of PINs and reports concerning use of Fund resources would be reconsidered in October 1999.

IMF Executive Board to review policies next year. In addition, issues may be reviewed in the light of experience gained in transparency in other areas.

National authorities are presumed to release letters of intent, memoranda of economic and financial policies and policy framework papers.

Allow accelerated public access to IMF archives

As of 9 September 1999, Executive Board implemented a new policy to shorten time limits from 30 to 5 years for access to Executive Board documents, and to 20 years for other archival documents.

IMF Executive Board to review policy in two years, with a view to possible liberalization.

(Continued on next page)

Proposal/action required

Action taken and progress made as of December 1999

Next steps

Enhanced systematic evaluation of IMF activities

A series of internal and external evaluations have been undertaken for Enhanced Structural Adjustment Facility supported programmes, and a preliminary assessment of IMF-supported programmes in Asia. IMF Executive Board took stock of the independent evaluation process towards the end of 1999.

The Board to consider proposals for an external review of the efficiency of IMF operating procedures in 2000.

External evaluation of IMF surveillance and economic research activities was issued in July 1999 and discussed by Executive Board in September 1999.

B. Private sector

Assess how operations of key financial market participants could be improved through, *inter alia*, greater disclosure requirements

Financial Stability Forum working groups on highly leveraged institutions, offshore financial centres and capital flows have commenced work, and draft status reports have been prepared.

National authorities and standard-setting bodies (BIS-based Committee, IAIS, IASC and IOSCO) to pursue ongoing work.

Financial Stability Forum working groups to report in early 2000.

Highly leveraged institutions

Reports by BIS-based Committee and IOSCO (February 1999) cover standards for banks' financial relations with highly leveraged institutions.

National authorities and standard-setting bodies to further develop and implement standards for banks' relations with highly leveraged institutions. Consideration of public data disclosure requirements for highly leveraged institutions.

Assess appropriate supervisory regulatory structure and disclosure to markets

Financial Stability Forum working group preparing report on systemic issues associated with highly leveraged institutions and their impact on small and medium-sized markets. The report is expected to be ready in early 2000.

II. Developing standards

A. SDDS

Strengthen SDDS prescriptions for: (i) international reserves and related items; and (ii) external debt and debt service

The second review of SDDS was completed in December 1998 with a decision to introduce a separate data category for external debt. In March 1999, the Executive Board agreed to strengthen SDDS prescriptions and approved the Data Template on International Reserves and Foreign Liquidity. IMF staff consulted with compilers on the debt transition period and will report to the Executive Board by March 2000.

IMF to carry out a third review of SDDS in March 2000.

SDDS subscribers to adhere to revised standards for reserves by March 31, 2000.

Proposal/action required

Action taken and progress made as of December 1999

Next steps

Procedures for monitoring observance of data standards were also established, to be reviewed by the Executive Board in March 2000.

Operational guidelines for the reserve template were reviewed in October 1999.

By end-December 1999, seven countries had started disseminating data on reserves in accordance with the template.

Consider inclusion of macro-prudential indicators of vulnerability in SDDS

B. GDDS

Approve and implement GDDS as framework for statistical development for countries not subscribing to SDDS.

The Board approved GDDS in December 1997. By end-1999, seminars had been held in many regions of the world in which most potential GDDS clients participated. Metadata have been prepared for 13-14 countries.

GDDS will move into its operational phase starting in 2000.

C. Code of Good Practices on Fiscal Transparency

Approval, endorsement and implementation of Code.

Code endorsed by Interim Committee in April 1998. Manual to assist implementation approved by the Board.

National authorities to aim at adhering to Code.

Countries are being encouraged to make self-assessments of fiscal transparency. For this purpose, manual, questionnaire and self-evaluation are posted on web site. Ten countries have completed questionnaires.

IMF staff working on pilot assessments of fiscal transparency.

D. Code of Good Practices on Transparency in Monetary and Financial Policies

Approval, endorsement and implementation of Code.

Code finalized after incorporating comments received from public and other institutions and approved by the Executive Board on 9 July 1999; adopted by the Interim Committee in September 1999.

IMF staff preparing, in cooperation with other international and national institutions, a supporting document to the Code to guide members in implementation.

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Proposal/action required	Action taken and progress made as of December 1999	Next steps
E. Banking supervision	<p>The Basle Committee established a working group devoted to review of the 1988 Capital Accord. The Committee issued a consultative paper on a "New Capital Adequacy Framework".</p> <p>In October 1999, the Basle Committee issued the Core Principles Methodology prepared by a working group, which included representatives of IMF and the World Bank, to assess implementation of the Basle Core Principles. IMF, independently and jointly with the World Bank, has undertaken several assessments of countries' compliance with the Core Principles.</p>	<p>IMF and others to provide comments on new framework by March 2000.</p> <p>IMF will continue, both independently and jointly with the World Bank, to assess countries' adherence to the Core Principles.</p>
F. Other standards	<p>Progress has been made in developing standards in the following areas: accounting, auditing, bankruptcy, corporate governance, insurance regulation, payment systems and securities market regulation.</p>	<p>Relevant standard-setting bodies to continue work.</p>
III. Surveillance	<p>First round of case studies prepared for Argentina, Australia and the United Kingdom, and released on IMF web site.</p> <p>Second round of case studies published for diverse group of countries: Bulgaria; Cameroon; Czech Republic; Hong Kong, China; Tunisia; Uganda; and Ukraine.</p> <p>Executive Board considered proposals on how to proceed based on experience from two rounds of experimental case studies and an outreach programme to private financial market participants and other standard-setting bodies.</p>	<p>IMF staff to continue experimenting with the modalities involved in preparing report on standards. Staff to conduct assessments for a range of countries. Comprehensive reports to be built up on a modular, standard-by-standard, basis. World Bank to consider what role it can play in preparing assessments outside the Fund's core operational concerns.</p> <p>The experience will be further reviewed in mid-2000.</p>
B. External evaluation of IMF surveillance	<p>Review is completed and preliminary discussion is undertaken by Executive Board.</p>	<p>Executive Board to return to issues during forthcoming internal review.</p>

Proposal/action required	Action taken and progress made as of December 1999	Next steps
<p>IV. Vulnerability assessment</p>		
<p>A. Comprehensive reporting on capital account</p>		
<p>Develop mechanisms for better assessing capital flows and external vulnerability</p>	<p>IMF staff have expanded reporting to Executive Board on financial market developments, and published reports on international capital market developments.</p> <p>Enhanced creditor-side data on external debt and internal system for disseminating detailed BIS data came online on Internet in March 1999. Work is ongoing to increase timeliness and quality of creditor-based data.</p> <p>Technical assistance is provided by IMF to members in improving data and monitoring systems.</p>	<p>IMF staff to continue work to implement detailed recommendations of task force.</p> <p>Efforts to strengthen data systems on external debt and reserves and further public dissemination of data (see SDDS) to be continued by national authorities.</p> <p>IMF to collaborate with international organizations to widen coverage of creditor data systems and to shorten publication lags.</p> <p>Financial Stability Forum expected to prepare report on short-term capital flows in early 2000.</p>
<p>B. High-frequency debt monitoring</p>		
<p>Develop systems to monitor short-term private debt on a high frequency basis</p>	<p>Systems to monitor inter-bank lines have been or are being established in Argentina, Brazil, Ecuador, Indonesia, Mexico, the Philippines, Republic of Korea, Thailand and Turkey. Other systems continue to be developed and upgraded.</p>	<p>Encourage other borrowers to implement systems. IMF to provide technical assistance as requested.</p>
<p>Improved debt assessment and management by countries</p> <p>Avoid excessive levels of short-term debt; maintain adequate reserves; limit use of put options in emerging market debt instruments; avoid rigid or inflexible debt structures; promote greater debtor-creditor risk sharing so that debt-service burden adjusts with borrower's capacity to service debt, as appropriate</p>	<p>IMF has begun assessing issues related to the external debt vulnerability in the course of Article IV and multilateral surveillance. Related efforts include joint FSAP with the World Bank and financial sector stability assessment reports. IMF staff to prepare paper on reserve adequacy by 1999.</p>	<p>International organizations are to continue to work with emerging market economies to promote best practices, and to develop an analytical basis for assessing vulnerability.</p> <p>IMF to continue to prepare papers in 2000 on debt and reserve-related indicators of external vulnerability.</p>
<p>C. Data provision to IMF</p>		
<p>Reach agreement on minimum standard for reporting of reserves and related items</p>	<p>Executive Board reached an agreement on minimum standards required for data reported by countries. IMF staff are developing a detailed reporting table based on SDDS reserves template. IMF Executive Board considered a paper on a minimum standard for reporting of reserves to IMF in November 1999.</p>	<p>IMF Executive Board to continue to prepare papers in 2000 on data provision by members to IMF.</p>

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Proposal/action required	Action taken and progress made as of December 1999	Next steps
<p>D. Early warning systems</p> <p>Develop and test empirical models to help predict balance-of-payments crises</p>	<p>IMF staff have developed and implemented, on an experimental basis, prototype enhanced models to predict crises for its internal use. Forecasts from these and existing private sector models have been presented to the Executive Board.</p>	<p>IMF staff to continue to use and assess performance of existing models and develop possible improvements. Results to be periodically presented to Executive Board, consistent with concerns regarding confidentiality and the uncertainty of the forecasts.</p>
<p>V. Strengthening financial systems</p>	<p>A. Financial market supervision and development</p> <p>Strengthen focus of IMF surveillance on vulnerabilities in financial sector. Enhanced technical assistance on a wide range of financial sector areas</p>	<p>FSLC will continue to coordinate the work of IMF and the World Bank in this area.</p>
<p>Joint IMF-World Bank FSAP initiated.</p>	<p>Joint IMF-World Bank FSAP initiated.</p>	<p>Pilot programme of FSAPs begun. Experience with FSAP under pilot programme will be reviewed by IMF Executive Board in early 2000.</p>

Source: IMF, *Statement and Report of the Managing Director to the Interim Committee on Progress in Strengthening the Architecture of the International Financial System* (Washington DC, September 1999), Annex, available at <<http://www.imf.org/external/np/exr/facts/arch.htm>> (12 January 2000), plus updated information provided by the staff of BIS and IMF.

Annex V.2.

INTERNATIONAL CODES AND STANDARDS FOR FINANCIAL MARKETS

Codes and standards of best practice arose out of the need to overcome informational asymmetry, help improve the functioning of markets and aid in monitoring performance. Their provision has in fact become an important element in the current debate on the new financial architecture. Since the advent of the Asian crisis, a number of international organizations and other bodies have either revised existing codes or standards or developed new ones for certain segments of the financial markets.

These codes and standards are expected to (i) give clarity to the roles and responsibilities of each participant in the market; (ii) increase the availability of information and reduce uncertainty, which fosters herd-like behaviour on the part of investors; (iii) increase the transparency and accountability of financial institutions as well as the governments; (iv) facilitate monitoring by improving the extent of comparability of performance across markets; and (v) establish international benchmarks or norms in various fields. It is strongly believed that the adoption of internationally recognized standards and codes of good practices can help improve economic policy-making and strengthen the international financial system.

Initiatives for developing codes and standards have been undertaken by different international organizations and agencies according to their focus or specialization. Adherence to these codes and standards is not compulsory, but based on a voluntary approach. Nevertheless, institutions like IMF and the World Bank encourage developing countries to comply with the standards proposed by themselves and other standard-setting bodies such as the Basle Committee, and offer technical assistance in implementing the codes. However, since many of the codes (for example, the Capital Accord) were developed for the situation in developed countries, there is the risk that the standards may not be equally relevant to the situation in the developing and least developed countries.

The following provides a brief overview of the features of the more important standards and codes of best practices relevant to financial markets.

Accounting. The International Accounting Standards Committee is an independent private sector body formed in 1973 with members from 142 professional accountancy organizations in 101 countries. The objective of IASC is to formulate and publish accounting standards for the private sector. It also aims to work

towards improving and harmonizing the different sets of regulations, procedures and accounting standards related to the reporting of the financial statements. It intends to achieve uniformity in the accounting principles used by the private sector for financial reporting across the world. Since 1974, IASC has published and updated series of 39 International Accounting Standards addressing specific topics such as the presentation of financial statements, business combinations, and financial instruments: recognition and measurement.^a

To illustrate its thrust to instil a harmonized reporting format, IASC suggests the following framework for the preparation and presentation of financial statements: (i) objective of the statement; (ii) underlying assumptions; (iii) qualitative characteristics of financial statements, such as relevance, reliability, and constraints on relevant and reliable information; (iv) elements of financial statements – asset, liability, equity, and income and expenditure; and (v) concepts of capital and capital maintenance. The set of core accounting standards is designed in such a way that private corporations could use them for cross-border offerings and listings in all global financial markets.

The International Federation of Accountants is formulating accounting standards which are based on the International Accounting Standards for the public sector. Work is expected to be completed by 2001.

IASC does not impose the use of its standards on its members – the adoption of standards remains the decision of national authorities, or self-regulatory organizations or enterprises. In some cases, stock exchanges require foreign issuers to present financial statements in accordance with the International Accounting Standards format as a precondition for listing on the exchange.

IMF has established contacts with IASC and IFAC. While accounting and auditing standards are not one of the core competencies of IMF, these standards are important for certain areas of its work. The adoption of international accounting standards in a country has become an element of recent stabilization programmes of IMF.

^a The list of published and updated series of the 39 IAS standards is available at <http://www.iasc.org.uk/frame/cen2_1.htm> (14 January 2000).

Auditing. The International Auditing Practices Committee is a committee of IFAC and its membership consists predominantly of national accountancy organizations. The objective of IAPC is to improve the degree of uniformity of auditing practices and related services throughout the world.

The majority of IFAC members use the IAPC International Standards on Auditing as a basis for developing their own national standards. However, these standards have no legal force. Members are simply expected to use their best efforts to see that IFAC and IASC principles and standards are applied in their domestic auditing systems.

The World Bank has supported both IASC and IFAC in developing harmonized accounting and auditing standards and, in fact, has provided funding from its Development Grant Facility to accelerate standard-setting in both bodies. It also participates as an observer in several committees and disseminates the auditing standards for use in the reporting of Bank-assisted project activities.

Banking supervision. The work on developing principles to promote prudential norms in banking is relatively advanced. The Committee on Banking Supervision was established at the end of 1974 in the wake of the failure of Bankhaus Herstatt in Germany. The first task of the Committee was to consider methods of improving early warning systems for banking crises. Subsequently, the Committee explored international cooperation for improving the quality of banking supervision worldwide, mainly by way of improving the exchange of information on national supervisory arrangements and enhancing the techniques for supervising international banking businesses and by setting minimum standards in areas where they are considered desirable. Among the significant outputs of the Committee are the Basle Capital Accord and the Basle Core Principles for Effective Banking Supervision.^b

The Basle Committee on Banking Supervision promulgated the Basle Capital Accord in July 1988, to ensure that internationally active banks maintain a level of capital commensurate with the risks they bear. The

^b For more details, see *BIS International Convergence of Capital Measurement and Capital Standards* (July 1988), available at <<http://www.bis.org/publ/bcbs04a.htm>> (18 January 2000) and *BIS Core Principles for Effective Banking Supervision (Basle Core Principles)*, available at <<http://www.bis.org/publ/bcbsc102.pdf>> (18 January 2000).

Accord laid down minimum capital adequacy requirements (8 per cent ratio of capital to weighted risk assets) based on relative levels of exposure to various forms of credit risk, both on and off balance sheet. By September 1993, all banks in G-10 countries with significant international operations were meeting or exceeding the minimum requirements.

Given the growing extensive dealings between corporate customers from two or more countries, the concept of country risk is expanding well beyond its traditional scope, which primarily encompassed only sovereign risk and transfer risk.^c The expansion of G-10 creditor claims against foreign commercial entities has forced banks to broaden their concept of credit risk management to incorporate the potential default of foreign private sector non-bank enterprises arising from country-specific economic factors. The Asian crisis, as well as other recent developments, has resulted in banks separately identifying individual foreign enterprises that are more exposed to local country conditions than others.

In response to the deterioration in the capital ratios of main international banks, as well as the growing risks of heavily indebted countries, the Basle Committee had resolved to increase the overall amount of capital in the banking system and work towards greater convergence in the measurement of capital adequacy. The Basle Accord is currently under review. A proposed new framework was issued in 1999 in the form of a consultation paper. Comments on this are to be made before March 2000. Its major features are as follows: (i) minimum capital requirements which seek to enhance the standardized rules in the 1988 Basle Accord; (ii) supervisory review of an institution's capital adequacy and internal assessment process; and (iii) market discipline as a lever to strengthen disclosure and encourage safe and sound banking practice.^d

The Board of the Basle Committee on Banking Supervision issued the Core Principles for Effective

^c This refers to the ability or willingness of a sovereign government to honour its cross-border debts and to make available foreign exchange so that otherwise viable local debtors could meet foreign-denominated cross-border claims.

^d The press release containing the main elements of the proposed framework is available at <<http://www.bis.org/press/p990603.htm>> (20 January 2000).

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Banking Supervision⁶ in 1997 in order to strengthen the supervisory systems of national financial markets. As minimum standards, the Core Principles comprise 25 basic principles that are considered essential for any supervisory systems to be effective. Broadly, these principles cover the following areas: pre-conditions for effective banking supervision; licensing and structure; prudential regulations and requirements; methods of ongoing banking supervision; information requirements; formal powers of supervisors; and cross-border banking. These principles reflect a significant development in at least four respects: (i) they are comprehensive and cover all aspects of banking; (ii) they provide a checklist of good practices for use by supervisors, international financial institutions, rating agencies and other market participants; (iii) they were drawn up with the active participation of non-G-10 supervisory authorities; and (iv) they apply to G-10 and non-G-10 countries alike.

The Basle Committee is continuing to develop standards in key risk areas such as credit risk management and disclosure. IMF and the World Bank use the Core Principles document to assist individual countries in strengthening their supervisory arrangements with the objective of promoting macroeconomic and financial stability. This document constitutes the main background material for the training offered at the Toronto Centre for Financial Sector Supervision set up by BIS, the Government of Canada and the World Bank.

Bankruptcy. Restructuring a financial system requires a system in which the assets of a failed entity can be priced and sold in a market in an efficient manner. In this way, resources that would otherwise have remained unused could be injected back into the real sector and converted into productive investment. Crisis resolution hinges, in no small measure, on the timely and efficient disposal of assets. However, the experience of the Asian crisis has shown that the process can be hindered by inadequacies in bankruptcy procedures and legislative guidelines. While the bulk of the institutional reforms pertaining to bankruptcy have to be implemented domestically, there have been a number of initiatives in addressing cross-border bankruptcy and insolvency issues.

Domestic bankruptcy systems vary considerably across countries, reflecting not only disparate legal traditions and practices but also different social and political

choices. Given these differences, regional and multi-lateral initiatives to harmonize domestic bankruptcy laws have made little progress. More success has been achieved in promoting the harmonization of treatment for cross-border bankruptcy problems. It should be noted that initiatives in this area do not attempt to harmonize domestic bankruptcy laws.

To illustrate, the European Union adopted the Convention on Insolvency Proceedings in 1995. This Convention sets the rules for the treatment of insolvencies where the debtor has establishments and assets in more than one EU member State. It would provide, *inter alia*, for the international distribution of jurisdiction, choice of law, cooperation between the courts of different EU member States, and recognition of foreign judicial decisions and orders. However, the Convention has not yet been ratified by all member States and the prospects for its entering into force are still in doubt.

The United Nations Commission on International Trade Law developed a Model Law on Cross-border Insolvency which was adopted by UNCITRAL members in May 1997. This law has the following objectives: (i) cooperation between the courts and competent authorities of States involved in cases of cross-border insolvency; (ii) greater legal certainty for trade and investment; (iii) fair and efficient administration of cross-border insolvencies that protects the interest of all creditors and other interested persons; (iv) protection and maximization of the value of the debtor's assets; and (v) facilitation of the rescue of financially troubled businesses. Furthermore, the model law is designed to provide greater predictability regarding the extent to which, for example, creditor action will be recognized by a local court. It also provides for the non-discrimination of foreign creditors. Adoption of the model law is under consideration in a number of countries.

Corporate governance. Corporate governance refers to the set of principles, rules and practices that define the agency relationship between the stakeholders (shareholders, lenders and, in some countries, employees) in a corporation and the persons entrusted with its management. By definition, corporate governance aims to ensure a proper discharge by managers of their duties to the corporation's constituents. In this respect, managers have the fiduciary duty to maximize the value that shareholders derive from their investment in the corporation, while at the same time respecting the rights of other stakeholders.

The fragility of the financial system in a number of affected economies can be traced partly to the overly risky positions taken by many interconnected firms.

⁶ Together with the Core Principles, the Committee released a compendium of existing Basle Committee recommendations, guidelines and standards, and has continued to update the compendium.

Private lenders in recent years have been underpricing risk. Competition in the financial area has increased markedly and, as profits have been harder to come by, pressure to maintain or even expand profit levels may have induced some financial institutions to engage in riskier endeavours.^f

In response to a request made at its 1998 Ministerial Meeting, OECD has established a task force to develop international guidelines to improve corporate governance practices among its member countries. It is also envisioned to serve as a reference point for non-member countries. With respect to financial institutions in particular, the OECD work on institutional investors stressed the need for developing a common understanding on risk management standards and risk accounting standards. The task force is led by the OECD Directorate of Financial, Fiscal and Enterprise Affairs, and includes members from securities regulatory agencies, stock exchanges, the private sector and relevant international organizations, including IMF and the World Bank.

The OECD Business Sector Advisory Group on Corporate Governance issued a report in April 1998 entitled "Corporate governance: improving competitiveness and access to capital in global markets",^g which seeks to identify principles of sound corporate governance. The report rejected the one-size-fits-all approach to corporate governance, but recognized the need for an international reference point and identified some fundamental parameters as a basis for initiatives to improve governance. These parameters include the following points: (i) increased acceptance of maximizing shareholder value as the primary corporate objective; (ii) acceptance of increased transparency and independent oversight of management by boards of directors; (iii) making a board's practice subject to voluntary adoption and evolution, taking into account global minimum standards; and (iv) the adoption of universal rules in certain areas (such as accounting) is preferable.

^f See the discussion in William R. White, "New strategies for dealing with the instability of financial markets", paper presented at the Conference on the Management of Global Financial Markets: Challenges and Policy Options for Emerging Economies, the EU and the International Institutions, Forum on Debt and Development at the National Bank of Hungary, Budapest, 24-25 June 1999.

^g A summary of this report is available at <<http://electrade.gfi.fr/cgi-bin/OECDBookShop.storefromt/1329864493/Search/Run>> (20 January 2000).

Apart from OECD, other international and regional institutions are promoting better corporate governance in various ways. For example, the World Bank supports reform of corporate governance in developing countries, and has undertaken corporate governance assessments in eight countries in cooperation with APEC. EBRD has also been active in developing sound business standards and corporate practices; EBRD borrowers and co-investors are expected to commit themselves to adhering to these standards and practices.

Finally, the Basle Committee also addresses corporate governance in the context of banking supervision. It issued a paper in September 1999 entitled *Enhancing Corporate Governance in Banking Organizations*, which provides guidance on corporate governance in banks, based on supervisory experience in banking organizations on governance problems, and suggests the types of practices that would help avoid such problems.

Data dissemination. The Special Data Dissemination Standard and the General Data Dissemination System were established by IMF in 1996 and 1997 respectively; they are intended to enhance the quality and integrity as well as the availability of timely and comprehensive economic and financial statistics, which in turn is expected to contribute to the pursuit of sound macroeconomic policies.

GDDS is meant to be a step towards subscription to SDDS for those countries which do not yet have sophisticated statistical systems. Participation in GDDS is voluntary. The implementation of GDDS is expected to be carried out in two phases over the next six to seven years. The first phase will focus on the education and training of member countries. In the second phase, IMF staff will work directly with member countries to assist them in assessing their current practices and developing plans for improvements.

SDDS is a best-practice standard against which a country's dissemination practices can be readily measured. Although subscription is voluntary, it entails a commitment by a subscribing member to observe the standard and provide information to IMF about its practices in disseminating economic and financial data. At present, 47 countries have subscribed to SDDS. It covers four sectors of the economy, real, fiscal, financial and external, and has four dimensions: the coverage, periodicity and timeliness of the data; access by the public to those data; the integrity of the data; and the quality of the data. For each of these dimensions, SDDS prescribes two to four monitorable elements: good practices that can be observed or monitored by the users of statistics, as reported in the table below.

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Summary of the Special Data Dissemination Standard

1. The data: coverage, periodicity, and timeliness

Comprehensive economic and financial data, disseminated on a timely basis, are essential to the transparency of macroeconomic performance and policy.

2. Access by the public

Dissemination of official statistics is an essential feature of statistics as a public good. Ready and equal access is a principal requirement for the public, including market participants.

3. Integrity

To fulfill the purpose of providing the public with information, official statistics must have the confidence of their users. In turn, confidence in the statistics ultimately becomes a matter of confidence in the objectivity and professionalism of the agency producing the statistics. Transparency of its practices and procedures is a key factor in creating this confidence.

4. Quality

A set of standards that deals with the coverage, periodicity and timeliness of data must also address the quality of statistics. Although quality is difficult to judge, monitorable proxies, designed to focus on information which the user needs to judge quality, can be useful.

Measure:

The dissemination of economic and financial data categories has to follow the prescriptions of IMF, with the components, periodicity and timeliness as indicated.

Measures:

- (a) Advance dissemination of release calendars.
- (b) Simultaneous release to all interested parties.

Measures:

- (a) Dissemination of the terms and conditions under which official statistics are produced, including those relating to the confidentiality of individually identifiable information.
- (b) Identification of internal government access to data before release.
- (c) Identification of ministerial commentary on the occasion of statistical releases.
- (d) Provision of information about revision and advance notice of major changes in methodology.

Measures:

- (a) Dissemination of documentation on methodology and sources used in preparing statistics.
- (b) Dissemination of component detail, reconciliation with related data, and statistical frameworks that support statistical cross-checks and provide assurance of reasonableness.

Source: IMF, Special data dissemination standards, *Dissemination Standards Bulletin Board*, available at <<http://dsbb.imf.org/overview.htm>> (20 January 2000).

Under SDDS, IMF is prescribing dissemination standards for 17 data categories covering the real, financial, fiscal and external sectors of the economy, as shown below:

Categories and components of data under the SDDS

<i>Categories</i>	<i>Components</i>
Real sector	
1. National accounts: nominal, real, and associated prices	GDP by major expenditure category and/or by productive sector
2. Production indices	Industrial, primary commodity, or sector, as relevant
3. Labour market	Employment, unemployment, and wages/earnings, as relevant
4. Price indices	Consumer prices and producer or wholesale prices

<i>Categories</i>	<i>Components</i>
Fiscal sector	
5. General government or public sector operations, as relevant	Revenue, expenditure, balance and domestic (bank and non-bank) and foreign financing
6. Central government operations	Budgetary accounts; revenue, expenditure, balance and domestic (bank and non-bank) foreign financing
7. Central government debt	Domestic and foreign, as relevant, with a breakdown by currency, as relevant, and a breakdown by maturity; debt guaranteed by central government, as relevant
Financial sector	
8. Analytical accounts of the banking sector	Money aggregates, domestic credit by public and private sector, external position
9. Analytical accounts of the central bank	Reserve money, domestic claims on public and private sector, external position
10. Interest rates	Short-term and long-term government security rates, policy variable rate
11. Stock market	Share price index, as relevant
External sector	
12. Balance of payments	Goods and services, net income flows, net current transfers, selected capital account items (including reserves)
13. International reserves	Gross official reserves (gold, foreign exchange, SDRs and fund position) denominated in US dollars
14. Merchandise trade	Exports and imports
15. International investment position	
16. Exchange rates	Spot rates and three- and six-month forward market rates, as relevant
17. Population	

Source: IMF, *SDDS Data Categories*, available at <<http://dsbb.imf.org/category.htm>> (20 January 2000).

The formal period for the implementation of the database system by the SDDS subscribers began in early 1996 and ended on December 1998. During that period, a member could subscribe to SDDS even if its dissemination practices were not fully in line with SDDS. A specified time was given for subscribers to adjust their practices according to the requirements.

A subscriber is expected to submit information about its data and dissemination practices (called metadata) to IMF for presentation on an electronic bulletin board maintained by the IMF Dissemination Standards Bulletin Board. The Board now provides hyperlinks between the SDDS metadata and actual country data, shown in a national summary data page, for 18 countries. It should be noted that the subscriber alone is responsible for the accuracy of the metadata and the actual economic and financial data.

IMF is encouraging SDDS subscribers to collect and release data on forward-looking indicators (for example, business surveys, orders), debt-service projec-

tions, FDI, and portfolio investment. The IMF Executive Board undertook a second review of experience with SDDS in December 1998. The review considered an extension of the data coverage of SDDS on international reserves and external debt.^h SDDS subscribers are obliged to provide information on the composition of reserve assets, other foreign assets held by the central bank and government, short-term foreign liabilities, and

^h The effort to improve data dissemination of international reserves and external debt underpins the Fund's increased focus on vulnerability assessment. Countries have begun enhanced disclosure of international reserves data based on the format of the SDDS International Reserves Template approved by the Executive Board on 23 March 1999. The countries which disseminate information on the foregoing data are Canada, France, Germany, the Netherlands, Switzerland and the United Kingdom.

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related activities that can lead to a drain of reserves (such as financial derivatives and government guarantees for private borrowing). Procedures for the monitoring of the observance of the standards were also established, as well as penalties such as removal from the Dissemination Standards Bulletin Board upon non-observance. However, to this date only six subscribers are reporting these data; none of them is a developing ESCAP member.

The Executive Board also agreed that the SDDS prescription should be for dissemination of full data corresponding to the new template on a monthly basis, with a lag of no more than one month, although data on total reserve assets would still be prescribed for dissemination on a monthly basis with a lag of no more than one week. The dissemination of data for the full template on a weekly basis, with a one-week lag, was to be encouraged. The new standards were started formally in August 1999, with Canada, France, Germany, Switzerland and the United Kingdom as the only participating members. The transition period for the observance of the new standards is through 31 March 2000, when all SDDS subscribers are required to disseminate data in line with the new SDDS template.

Fiscal transparency. In April 1998, the Interim Committee of IMF adopted the Code of Good Practices on Fiscal Transparencyⁱ to guide members seeking to increase fiscal transparency, and thereby to enhance the accountability and credibility of fiscal policy as a key component of good governance. The rationale for the Code is that providing better information to the public will make governments more accountable, and thereby strengthen fiscal policy credibility.

This Code rests on four principles. First, a government should clearly define its roles, responsibilities and activities which have an impact on the rest of the economy. This should be done within a clear legal and administrative framework. Second, it should make a commitment to provide comprehensive and reliable information, which includes its past, present and projected fiscal activity. Third, the process of budget preparation should be clear and should also include well-presented budget estimates that facilitate policy analysis and allow for international comparison, with clearly defined procedures of execution and monitoring. Lastly, the integrity of fiscal information should be capable of being counterchecked by a national auditing body.

Countries are encouraged to implement the code on a voluntary basis and no formal subscription process

ⁱ IMF, *Code of Good Practices on Fiscal Transparency – Declaration on Principles*, available at <<http://www.imf.org/external/np/fad/trans/code.htm>> (20 January 2000).

is currently envisaged. A manual on implementation of fiscal transparency has been prepared and approved by the Executive Board. The manual sets out the principles and practices in more detail, drawing on existing international standards and experiences of member countries to illustrate good practices.

Through technical assistance missions and other contacts with country authorities, IMF staff members have initiated discussion on fiscal transparency and have begun to direct technical assistance resources to help countries seeking to improve fiscal transparency. Efforts to encourage implementation of the Code have begun by focusing on a small group of countries in which a lack of fiscal transparency affects policy formulation and implementation directly. Work has also started on a pilot basis to undertake country-level assessments of fiscal policy.^j

Insurance regulations. The International Association of Insurance Supervisors is responsible for developing internationally accepted principles and standards on insurance supervision and training insurance supervisors from emerging market economies.^k Recommendations or principles produced by IAIS are meant to be advisory rather than binding for its members. In September 1997, IAIS issued two sets of standards: (i) insurance supervisory principles, addressing general issues such as licensing, ownership, change in shareholders control, off-site analysis, on-site examinations, information disclosure and supervisory powers; and (ii) principles applicable to the supervision of international insurers and insurance groups and their cross-border establishments, on-site and off-site supervision of cross-border entities, information and audit. Three additional standards were adopted in October 1998 relating to licensing, on-site inspection and supervision of derivatives. Future standards will cover solvency requirements and reinsurance. Progress in harmonizing solvency requirements will depend on having a uniform accounting standard in place. There is no uniform international standard of accounting for insurance companies, although IASC has begun a project aimed at achieving such a uniform standard by 2002.

In February 1999, the Executive committee of IAIS decided to establish a task force to elaborate a methodology of how best to assess the implementation of the IAIS principles and standards in the different jurisdictions. In addition, IAIS is responsible for training

^j IMF, *Experimental Case Studies on Transparency Practices* (Washington DC, April 1999), available at <<http://www.imf.org/external/np/exr/facts/transpar.htm>> (20 January 2000).

^k Detailed information on IAIS can be obtained at <<http://www.iaisweb.org/1/index.html>> (20 January 2000).

insurance supervisors from emerging economies. It has developed a self-assessment programme for its members and has solicited assistance from the World Bank in distributing the principles, standards and guidance notes to insurance supervisors.

Monetary and financial policies. The Interim Committee called on IMF to develop a code of transparency practices for monetary and financial policies, in cooperation with appropriate institutions. As a result, IMF, along with BIS, the World Bank, OECD etc., prepared a Code of Good Practices on Transparency in Monetary and Financial Policies which was adopted by the IMF Interim Committee in September 1999.¹ The Code identifies practices that would enhance the transparency of central banks in their conduct of monetary policy as well as other financial policies. The transparency practices listed are designed to meet the following objectives: (i) clarity of the roles, responsibilities and objectives of central banks and financial agencies; (ii) open process of formulating and reporting of monetary policy decisions by the central bank and of financial policies by financial agencies; (iii) public availability of information on monetary and financial policies, on the grounds that monetary and financial policies can be made more effective if the public knows the goals and instruments of policy and if the authorities make a credible commitment to meeting them; and (iv) accountability and assurances of integrity by the central banks and financial agencies. Good governance calls for central banks and financial agencies to be accountable, particularly in areas where monetary and financial authorities are granted a high degree of autonomy. A compendium of good practices and other material to provide guidance on the implementation of the Code is being prepared.

Securities market regulation. Regulation of national securities and futures markets is conducted through both government regulators and self-regulatory organizations, which include securities and futures exchanges. The International Organization of Securities Commissions^m is working to establish universal principles for securities regulation, which could be adopted by official regulators. Thirty principles of securities regulators have been set out, based on three objectives: to protect investors; to ensure that markets are fair, efficient and transparent; and to reduce systemic risk. The principles are divided into eight categories: the responsibilities of the regulator; self-regulation; enforcement of securities regulation; cooperation in regulation; issuers;

collective investment schemes; market intermediaries; and the secondary market. The document also provides securities regulators with a yardstick against which progress towards effective regulation can be measured. IOSCO has an extensive committee structure and produces recommendations that are meant to be advisory, rather than binding, on the membership.

IOSCO has also released a number of documents that spell out standards for various specific aspects of security trading. For instance, in March 1998, it released a consultative document entitled *Risk Management and Control Guidance for Securities Firms and their Supervisors*. The paper provides a benchmark by which both securities firms and their supervisors may assess risk management and control systems. A report, *Methodologies for Determining Minimum Capital Standards for Internationally Active Securities Firms Which Permit the Use of Models under Prescribed Conditions* was released in May 1998 advising supervisors that it was acceptable, subject to suitable safeguards, to incorporate the output of value-at-risk models in the calculation of regulatory capital for market risk for internationally active securities firms.

IOSCO and the Basle Committee have been issuing the annual survey on the *Trading and Derivatives Disclosures of Major G-10 Banks and Securities Firms* since November 1998. They also issued a joint paper in October 1999 outlining the revised recommendations on trading and derivatives disclosure. The IOSCO Technical Committee has collaborated with IASC to evaluate the proposed international accounting standards. This evaluation is focused on whether the Committee should recommend endorsement of the IASC core standards to its members for use by foreign issuers in cross-border listings and offerings.

Others. The BIS-based Committee on Payment and Settlement Systems is working towards improvements in the robustness of payments systems in three areas: the implementation of real time settlement payment systems; a shift to delivery versus payment settlement systems in securities markets; and the elimination of settlement lags in foreign exchange markets through the creation of a specialized bank. The BIS-based Committee on the Global Financial System is working to identify practices and structures that support deep and liquid forward markets. IMF has been working closely with the Committee on a disclosure template that would be consistent with the strengthening of the SDDS data category for reserves.

IIF has organized a series of working groups to identify best practices and develop standards in a number of areas. These include data standards for emerging market economies; best practices for financial firms to manage risk exposure to emerging market economies; common financial industry definition for non-performing loans; and criteria for loan classification.

¹ IMF, *Code of Good Practices on Transparency in Monetary and Financial Policies*, available at <<http://www.imf.org/external/np/mae/mft/index.htm>> (20 January 2000).

^m Information on the work of IOSCO is available at <<http://www.iosco.org/iosco.html>> (20 January 2000).

VI

IMPROVING AND COMPLEMENTING EXISTING SURVEILLANCE MECHANISMS

The Asian crisis was remarkable for the severity, breadth and rapidity with which it spread. It is also widely held that the crisis caught the markets, global and regional institutions, national authorities and society unawares. The perception that the Asian crisis was largely unanticipated has highlighted the urgency of improving and complementing economic and financial surveillance mechanisms.

The expanding literature on the Asian crisis indicates that crises are very complex phenomena. It is therefore very difficult to attribute the occurrence of crises solely to failures of crisis-prevention arrangements. For example, surveillance may have picked up the impending problems and given warnings to policy makers, but political factors prevented the warnings from being heeded. However, the fact that the crisis happened also indicates that there may be gaps in existing surveillance or monitoring mechanisms that need to be addressed in order to minimize the possibilities of recurrence.

This chapter attempts to identify areas for improvement in the existing surveillance mechanisms in the light of the Asian crisis. Such an identification of gaps provides a natural starting point for devising new instruments or more effective implementation modalities for existing instruments of crisis prevention. Tremendous efforts and resources are being poured into conceptualizing and substantiating a new international financial architecture by international financial institutions, regional development banks, investment banks, intergovernmental institutions and national authorities alike.¹ As discussed in the previous chapter, not only are new monitoring

instruments being employed but new forums and coordinating modalities are being formed in order to enhance crisis prevention. While the lead roles of IMF and BIS in particular are recognized in several of the initiatives to fill in the gaps of surveillance, there is also an understanding that they need to be complemented by initiatives closer to countries and to be supportive of all countries, especially the more vulnerable ones and not only the systemically important economies. Certainly, this is the case for the countries in Asia, where there is wide disparity in the economic development and state of sophistication in financial systems. The answer is clearly more multilateral cooperation. But of what kind? The second part of the chapter focuses on the ways in which the global surveillance and monitoring mechanisms can be complemented and supported at the regional or subregional levels in the Asian and Pacific region.

International cooperation, such as policy consultation and dialogue, cannot operate in a vacuum. Not only should there be an institutional framework that can guide the process towards attaining the desired outcomes, but there should also be a focus. In surveillance, indicators provide the focus for analysis, discussions and exchange of views. Thus, developing a set of indicators at the national level is a first step in building the capacity of countries to engage in meaningful international cooperation for crisis prevention. To this end, a number of basic indicators are proposed for adoption by countries in the region.

LESSONS ON SURVEILLANCE FROM THE ASIAN CRISIS

The Asian crisis provides several valuable lessons on how existing models of surveillance/monitoring can fail to signal an impending crisis or to induce pre-emptive responses. These are discussed in this section (some of them are drawn from the analysis of recent research in chapter IV, and others from actual experience in the crisis period).

¹ The new financial architecture aims to enhance crisis prevention, management and resolution. The diverse proposals under this heading cover a whole spectrum, which includes the setting of exchange rates, establishing standards and codes of best practices for financial institutions and corporate entities, strengthening the supervision of domestic financial sectors, the institution of an international lender of last resort, supervision and regulation of international capital flows, and devising a system of orderly debt work-outs (see *Survey* 1999).

First, surveillance can fail because countries do not disclose adequate information. Transparency refers to the process by which information about existing conditions, decisions and actions is made accessible, visible and understandable to all stakeholders. In the context of the Asian crisis, improved transparency might have helped prevent the build-up of financial and economic mismatches, and prompted swifter policy response and limited contagion; hence, the renewed call after the outbreak of the crisis to improve the quality of information concerning traditional and new key macroeconomic variables, as well as the financial reporting of banks, financial institutions and corporate entities.

The quality of information made available to monitoring agencies has an important bearing on the quality of surveillance. In an early warning system, more specifically, the timeliness and accuracy of information are very important. Often daily, weekly or monthly series are being proposed to provide the necessary lead-time for policy responses. Accuracy, on the other hand, is important for formulating the appropriate policy response. Unless these information problems are addressed, surveillance and early warning systems will be severely hampered.

Transparency helps to instil market discipline, which in turn makes the economic and financial systems more resilient to shocks. The implicit assumption appears to be that the markets and international monitoring bodies, when they have access to accurate and timely information, will perceive the deterioration of the financial and economic conditions of a country more easily. This is expected to trigger a gradual response by the markets, such as an increasing borrowing premium or a downgrading of credit ratings, thereby avoiding panics and creditor rush behaviour. In addition, the evils of crony capitalism, where long-term links between banks and corporations lead to overlending and investments in excessively risky areas, can be reduced when there is sufficient information about the true financial position of banks and corporate borrowers.

Transparency helps markets function better. A sudden loss of confidence in both financial firms and enterprises which prompts creditors to exit rapidly is due, in large part, to a lack of transparency on the part of firms as well as national authorities. In periods of financial stress, a lack of transparency tends to reinforce rather than dispel the rumours that form the basis of the unwillingness of creditors to deal with indebted parties. Thus, the provision of timely information can help mitigate the spectre of

contagion effects and stabilize expectations and market sentiments.

Because developing countries are more vulnerable to bouts of financial instability and contagion than developed economies, their making available good quality data in a timely manner is a concrete way to fill in the gap in existing international mechanisms.

Second, early warning may not operate because political pressure prevents a warning from being heeded. For example, in some instances IMF has advocated an adjustment of exchange rates, but the policy advice was ignored because of the perceived political importance of maintaining the peg.² In such cases, while surveillance was able to pick up an unsustainable policy, it was not successful in eliciting the necessary policy response to avert an impending crisis. This drives home the point that warnings through surveillance carry no guarantee of action; a political obstacle can lead to policy inertia until a crisis is actually triggered. On some occasions, by the time authorities turn to IMF for financial support and technical assistance, the situation is already too difficult for effective policy advice to matter. The loss of confidence is accentuated and the crisis deepened.

Heedful of political constraints, recent discussions on surveillance have emphasized regional peer pressure as one way of encouraging the adoption of appropriate policies.³ For this modality to be effective, a frank exchange of views among the members of a (regional) consultative body is imperative. Although such an exchange may not necessarily mean that a member will adopt the policies proposed by the others, it does allow the spillover considerations and the burden of dealing with them to be discussed openly. In order to motivate policy makers to adopt the needed policy response, taking into consideration the political cost of doing so, it is also necessary to have a significant sense of ownership of the process.

² See, for example, J. Crow, R. Arriazu and N. Thygesen, "External evaluation of surveillance report", in *External Evaluation of IMF Surveillance* (Washington DC, IMF, 1999), available at <<http://www.imf.org/external/pubs/ft/exev/surv/index/htm>> (26 January 2000).

³ See, for example, the executive summaries of the ADB Institute-sponsored workshops on regional surveillance in *Asia: Responding to Crisis* (Tokyo, ADB Institute, 1998), pp. 79-102.

A third possible reason for the failure of surveillance is that there are differences in the interpretation of the signals. When an indicator emits a signal, this may be viewed as issuing a warning by some but not by others, depending on the underlying hypotheses concerning the anticipated effects. For example, the rapidly rising level of short-term debt in several Asian countries before the crisis was evident and clearly signalled. However, this was not seen as a warning of an impending problem by the government authorities as they felt that the private sector, which had mainly incurred the debt, would be able to deal with the problem. However, the market interpreted the signal differently.

Fourth, it is possible that the model underlying the surveillance mechanism was not fully relevant, so that the indicators being monitored did not give adequate warning of potential problems or of their severity. Thus, the situation was not diagnosed correctly and important points of vulnerability were not noticed. Indeed, one criticism levelled at IMF during the Asian crisis is that its bilateral surveillance mechanism was not focusing on the problems of financial sectors, banks and debtors, that proved to be at the core of the loss of confidence in the region. Bilateral surveillance, at least during the pre-crisis period, tended to concentrate on macro-economic policies, and paid little attention to issues such as the volatility of capital inflows, the consequences of financial liberalization, maturity mismatches, build-up of fragility in the financial system and other capital account issues. Thus, it is alleged that there was an important gap in IMF surveillance in terms of not giving importance early enough to structural issues such as corporate governance, supervision and regulation.

It is increasingly recognized that the crises of the late 1990s were very different from the traditional balance-of-payments problems facing developing countries which usually arose from developments in the current account (such as terms-of-trade shocks). Rather, the Asian crisis emanated from the capital account, which calls for somewhat different responses in both crisis prevention and its resolution.⁴

⁴ See discussions in the *Report of the Commonwealth Expert Group on Protecting Countries Against Destabilizing Effects of Volatile Capital Flows* (Commonwealth Secretariat, September 1998); and R. Moreno, G. Pasadilla and E. Remolona, "Asia's financial crisis: lessons and policy responses", in *Asia: Responding to Crisis* (Tokyo, ADB Institute, 1998).

The crisis has shown the importance of including structural issues and capital account indicators in monitoring and resolving crises. Thus, partly in order to fill the aforementioned gap, IMF has tended over time to broaden its surveillance to cover all the policies that affect trade, capital movements, external adjustment and the effective functioning of the financial system. The areas covered now include structural policies (for example, market policy, privatization, industrial policy and competition policy), the financial sector (for example, capital account issues, banking supervision, deposit insurance and other financial sector regulations), and a number of other issues (for example, the environment and military spending).⁵ Further, IMF, as well as BIS and other relevant organizations, is starting to collect more information on the structure of external debt (both maturity and ownership), the availability of reserves and the contingent liabilities of governments as part of its template on reserves.

A fifth reason why surveillance can fail is that, even when diligent monitoring can pick up incoming shocks that may destabilize an economy and can issue warnings, it is often too late to do anything about it. For instance, the crisis in Thailand could have been taken as a harbinger of shocks or a warning for the other countries in the region. However, despite the warning, the weak financial systems in the other countries could not bear the reassessment of markets.⁶ The result was

⁵ Crow, Arriazu and Thygesen, "External valuation of surveillance report..."

⁶ There are a number of views on the timing and severity of the financial crisis in Asia. One view is that economies were inherently sound but a sudden change in market expectations triggered a panic and put a halt to funds flow. Another explanation is that the recent crisis stems directly from policies that encouraged imprudent lending or excessive risk-taking, making the economies vulnerable to shocks. As a result, the financial systems became very fragile over time. In principle, the build-up of vulnerabilities would not have happened had prudential regulation been working effectively. While prudential systems cannot prevent banks from failing, a strong regulatory system can provide a cushion to systemically risky banking practices and mismanagement. Asia liberalized its financial systems to a large extent, but did not put in place the requisite supervisory and regulatory institutions. As a consequence, these systems were not able to stem imprudent lending behaviour on the part of banks and over-investment in dubious areas on the part of corporate borrowers. The financial systems of the affected economies were very vulnerable, simply accidents waiting to happen. But for a while, rapid economic growth rates masked the weaknesses in the financial systems.

contagion. Thus, under these circumstances, even if policy makers in Indonesia and the Republic of Korea had been able to anticipate, through surveillance, that their economies were highly vulnerable following the initial disturbance in Thailand in July 1997, their ability to respond effectively was probably constrained by weaknesses in their financial sectors that had persisted for years. In contrast, though not insulated from the regional turmoil, Singapore's robust financial sector absorbed the shocks without the severe interruptions in financial flows that hit the most affected economies.⁷

Sixth, surveillance, particularly at the national level, may not function well because the authorities may be unsure of what the actual problem really is. This incapacity to diagnose a problem can come from the lack of technical resources for effective surveillance. International financial institutions and the private sector, on the other hand, spend large amounts on analysts and expensive databases in order to produce high-quality monitoring outputs. In this regard, there is considerable scope for international cooperation between countries and international financial institutions. Certainly, technical assistance to enhance the capacity of national authorities to perform good surveillance work is a step in filling this gap.

Lastly, contagion was largely unanticipated by existing surveillance mechanisms such as IMF partly because of the lack of a regional perspective in these mechanisms. It is useful to recall that IMF traditionally performs surveillance at two levels, bilateral and multilateral. Concentrating on domestic macroeconomic development (as is done in bilateral surveillance) would tend to ignore regional linkages or channels for the transmission of disturbances. Inasmuch as contagion effects have become more pronounced as a result of globalization and deeper economic interdependencies, insufficient focus on the regional spillover dimensions of crises would tend to diminish the effectiveness of a purely nationally based surveillance mechanism. On the other hand, multilateral surveillance can be too broad and could easily miss regional dynamics, especially those that affect countries which are not systemically important.

In order to address this problem, there is a suggestion⁸ that IMF should bring international and regional considerations and experience to bear when giving advice about domestic policies as a part of Article IV consultations. This suggestion is motivated by the fact that the impact of developments in the international environment is becoming more powerful owing to increasing private capital flows and the greater openness of countries. In fact, one of the intentions behind the IMF presentations to the now twice-a-year meetings of the Manila Framework members is to respond to the need for taking into account international developments at the regional level.

The gap in the form of a lack of a regional perspective is very closely tied up with the phenomenon of contagion, which tends to have strong regional characteristics. Because of contagion and the increasingly swift escalation of crises, there is an observed need to have a regional or subregional surveillance and monitoring system as a complement to domestic and global ones. It has been generally recognized that countries which suffer from currency and/or financial crises have similar structural weaknesses, such as currency and maturity mismatches, financial sector weaknesses and weakness in general supervision. Furthermore, the spillover of policy responses often has more severe effects on countries that belong to the same subregion, owing to their substantial financial, investment and trade linkages. The existing mechanisms focus too much on the effects of policies of major industrial countries (which tend to have a global orientation), or on the country level, and so do not sufficiently cover regional concerns until after the fact.

REGIONAL MODALITIES FOR COMPLEMENTING GLOBAL SURVEILLANCE MECHANISMS

The Asian crisis exposed gaps, of varying levels of seriousness, in the existing global and national surveillance mechanisms. Taken in this sense, the crisis can be considered a wake-up call for initiatives to fill these gaps, including efforts to include explicitly a regional dimension in measures

⁷ G. Manzano and R. Moreno, "Supporting regional consultations: the roles of research, policy analysis and surveillance", in *Asia: Responding to Crisis* (Tokyo, ADB Institute, 1998).

⁸ Crow, Arriazu and Thygesen, "External valuation of surveillance report..."

to preempt crises. This section discusses a few modalities for how global efforts to improve crisis prevention can be supported or complemented by efforts among countries in the Asian and Pacific region.

Why initiatives at the regional level? The first consideration is that the economies in the region have become much more interdependent in terms of both trade and investment over the last decade. They are increasingly being considered as belonging to one region (or subregion) and investors tend to treat the countries as having the same characteristics. The financial crisis has highlighted the fact that the stake of each one in the growth and orderly development of the others is growing. In other words, precisely because spillover effects in the region are very insidious, there is a pressing need to engage in regional cooperation. It should be stressed that the action to forestall a crisis has largely to be undertaken at the national level. However, given the dynamics of open markets and systems which link the economies closer with each other, there are many possibilities for regional cooperation and these may help encourage and reinforce action at the national level.

Four modalities of increasing degrees of formality are discussed here. In this regard, as noted in chapter IV, there are increasingly complex forms of cooperation.⁹ Perhaps the simplest form is the adoption of common standards or definitions (such as accounting terms, format for data preparation etc.). Another form is a rules-based framework in which countries continue to make decisions autonomously but follow the same rules. Or it can involve a structured exchange of information which would not take place unless there was an institutional mechanism. The deepest (and the most difficult) form is joint decision-making by countries. Different levels of international cooperation obviously entail different costs and benefits in economic resources as well as political capital. Depending on

the political dispositions of countries, there are thus a number of ways in which they can interact at the regional level to enhance crisis prevention. It should be noted that these modalities are not mutually exclusive but rather form a continuum of increasing degrees of regional cooperation in which countries may wish to engage, depending on their past experience with cooperation and their motivation, which is itself a reflection of the degree of their involvement in the regional and global economies.

Informal exchanges of experience

As one obvious problem in national surveillance is the difficulty faced by authorities in diagnosing correctly the points of vulnerability of their economy, a natural starting point for filling the gaps in existing surveillance mechanisms is for countries to engage in informal workshops or seminars on selected topics, such as financial sector development, data requirements (collection, definitions), selection and use of indicators, exchange rate policies, governance issues, and supervisory or regulatory issues, without any hint of policy coordination. Such exchange of experience with others who have faced similar situations can promote more resilient economic and financial systems in the region through inducing improvements in the capacity of national authorities to formulate sound policies.

For example, regional or subregional informal meetings can provide a good medium for in-depth discussions on the selection of indicators, data collection methods and issues so that countries can acquire a feel for how to develop their national early warning systems better, taking into account the structure and peculiarities of their own situation while being alert to the relevant international or regional dimensions. There appears to be a significant need for such interaction on indicators as most support to date has been at the level of developing more comprehensive databases such as SDDS or GDDS, and not on the selection of a limited number of appropriate leading indicators. ADB is providing some limited support in this area to ASEAN members through in-house training. However, exchange of experience among responsible officials would clearly help.

⁹ See also Richard Cooper, "Panel discussion: the prospects for international economic policy coordination", in W. Buiter and R. Marston, eds., *International Economic Policy Coordination* (National Bureau of Economic Research, 1985), pp. 366-372.

Further, an analysis of the individual responses by authorities to financial sector problems and the subsequent reaction of markets can provide valuable lessons on how to manage financial liberalization adequately, as well as how to avoid policy mistakes. In a sense this was the purpose of establishing SAARCFINANCE, which groups the central banks and finance ministries of the SAARC countries. To date, three seminars or workshops have been held on specialized topics in the finance area, the last, in November 1999 being on the Asian crisis and its implications for SAARC countries. These are sponsored by one of the member central banks (each central bank has a SAARCFINANCE cell responsible for coordinating with the other cells) with participants from other central banks or ministries of finance paying their own travel costs. Each country attending presents at least one paper on the topic relating to its experience. These are interactive seminars which spread information and increase contacts among the staff of the participating institutions. They have also involved resource persons from outside international or regional organizations.

There is also an annual South East Asian Central Banks (SEACEN)¹⁰ Governors Conference to discuss current economic and financial developments in the region. SEACEN is the cooperative arrangement among South-East Asian central banks, started in 1966, which also has an annual meeting of Directors of Supervision and another of Directors of Research and Training (as well as a Research and Training Centre). These meetings provide a good forum for interactive exchanges.

Informal consultations can help highlight, for the benefit of the policy makers, the nuances of the environment within which their economies interact, and explore new ways of dealing with developments and turmoil in financial markets. The recent financial crisis has shown how the markets react to policy responses (or their lack) in the midst of contagion. In addition, policy makers can work towards an analytic framework for assessing the international impact of the policies of neighbouring countries. Different countries have different approaches to

policy-making and financial regimes (for example, Thailand is using a market-based loan restructuring approach, whereas the approach of the Republic of Korea is more government-driven). The differences have implications for the behaviour of capital flows and vulnerability to shocks. Greater appreciation of these differences can help countries assess the impact of their policies in the region.

One advantage of engaging in regional or subregional seminars or informal meetings is that they provide the opportunity for countries, especially those which are not systemically important (of which there are quite a number in the Asian and Pacific region), to have their views heard on the impact of certain policies pursued by their neighbours. These considerations can go a long way in building the confidence of countries within the region to fit into the post-crisis international order.

ESCAP has a long history of conducting expert group meetings for selected groups of countries to promote exchange of experiences. Often these meetings have been specifically for the least developed countries (among recent ones were seminars on the topics of overcoming institutional constraints to implementing macroeconomic policies and options for exchange rate policy in least developed countries) with case studies on selected, more advanced economies as background material. Sometimes they have been directed at a wider grouping (for example, the seminar on improved management of the financial sector, and the high-level seminar on managing capital flows: national and international dimensions). These workshops involve not only country case studies but a comparative analysis and policy lessons, and can lead to the adoption of some non-binding conclusions and recommendations for the consideration of national decision makers. As they involve experts and are conducted in an informal manner, there is little constraint of political sensitivity, and frank exchanges take place.

Meetings under the aegis of global surveillance institutions

In the field of global surveillance and monitoring, international financial institutions such as BIS, IMF and the World Bank have taken the lead in devising new instruments, processes, codes and standards, policy analysis and options, geared to minimize the risk of new crises as a part of the broader framework of the new financial architecture.

¹⁰ Members of SEACEN are Indonesia, Malaysia, Mongolia, Myanmar, Nepal, Philippines, Republic of Korea, Singapore, Sri Lanka, Taiwan Province of China and Thailand. There are six observers (Cambodia, Fiji, Lao People's Democratic Republic, Papua New Guinea, Tonga and Viet Nam).

The task of disseminating the findings, policy studies or new processes presents several avenues for regional cooperation between the countries of Asia and the Pacific and these institutions.

One modality for complementing the new initiatives of multilateral institutions is to engage them in smaller meetings with groups of interested countries in the region. This arrangement would facilitate enhanced interaction between the institutions which draw up the blueprints for new processes such as codes and standards etc. and the target audience in the emerging markets. It would present a very good opportunity for the international financial institutions to disseminate new initiatives as well as receive feedback from developing countries. The modality for such meetings could be holding seminars at the fringes of regular meetings of the institutions at their headquarters, or conducting seminars in the region with the active involvement of their headquarters or regional offices. For instance, SDDS is currently the best practice system for gathering data and information. However, it imposes considerable demands on human, financial and technical resources in developing countries. The proposed modality could be considered an avenue for exchanging information among users and IMF on problems and potential solutions.

Another example concerns BIS. While IMF and the World Bank are currently promoting BIS Core Principles for Effective Banking Supervision, it would seem useful to have more direct interaction between BIS on its thinking and research, and representatives of countries not party to its deliberations. Meetings could be organized between BIS and regulators in the region focusing on regulatory issues and taking into account regional viewpoints and features.¹¹ Further, as BIS has long experience in conducting discussions on surveillance, it could assist by holding demonstration discussions among countries in the region, illustrating their procedures, inputs and outputs.

If it is desirable for the developing economies to be actively involved and integrated into the evolving new structure, then why not simply engage these developing economies directly in the regular processes of the institutions beyond IMF and the World Bank? For example, why not encourage central banks from developing countries to become members of BIS? There are at least two major difficulties with such a proposal. One is that the conditions and costs of membership may not be within the realm of feasibility or not generate sufficient return for many developing countries. Second, as the membership of an institution increases, the process of informal consultation becomes more unwieldy and points of conflict are magnified; there is a tendency for the frank exchange of views to be stymied as the number of participants increases. Thus there is a need for another formula to find a balance between not expanding the membership and increasing the degree of involvement of developing countries.

The above is important because the danger of not engaging the emerging markets in the formulation of crisis-prevention initiatives is weak ownership. The emerging markets (which presumably are more crisis-prone than other developing countries that are less well integrated into the global economic and financial system) are not adequately represented in the decision-making processes of the existing mechanisms. Hence, there is generally weak ownership by their concerned authorities. For instance, most of the activities of BIS are concentrated on the G-10. The inclusion of emerging countries and areas such as Brazil; China; Hong Kong, China; India; Mexico; Republic of Korea; Russian Federation; Saudi Arabia; and Singapore into BIS in 1996 was a step towards recognizing the importance of developing economies in the global financial system. It is not clear, however, how influential these new members are in the decision-making process. For instance, there is no representative of the emerging markets on the Board of Directors. A general concern arising from this governing structure is that specific regional concerns (which involve mainly developing economies) may not be adequately considered by international institutions.

The impact of this situation is likely to rebound on the policy decisions of the authorities. Weak ownership of the process can compromise the

¹¹ There is a similar proposal in Stephany Griffith-Jones with Kenny Kimmis, "The BIS and its role in international financial governance", in UNCTAD, *International Monetary and Financial Issues for the 1990s*, vol. XI (United Nations publication, Sales No. E.99.II.D.25), pp. 27-49.

quality of cooperation of the parties concerned. This has repercussions on the timely and accurate provision of data as well the willingness of the policy makers of a region to engage in a frank exchange of views and opinions. Their qualitative judgements are important; it is generally accepted that a good reading of the prospects depends crucially on qualitative assessments, not simply on quantitative templates.

Yet, it is important for countries to be aware of the transparency requirements they need to meet; to be familiar with and not afraid of the international standards and how to meet them; how to use data in order to construct measures of their degree of vulnerability as well as that of their neighbours; to know the range of policy options available in the presence of shocks; and to be conversant with new technologies in surveillance and monitoring. These can be regarded as support that can be drawn from the considerable core expertise of international financial institutions. In effect, the proposed meetings could provide an effective and efficient modality for emerging markets to take advantage of the research and policy analysis capacity and outputs that these institutions possess.

The building of modern and robust economic and financial systems in developing countries is a daunting task. Effective regional consultations on the progress would benefit from quality policy and analytical support. Even the G-7 consultation mechanism, which is rather informal, involves careful preparation and draws on the expertise of IMF, BIS and OECD, apart from the policy analysis capabilities of the developed countries themselves. To be of any value, policy support must accomplish two things. First, it must improve the ability of policy makers to identify the policies that will make their economies more resilient against shocks and suggest ways and means of identifying and responding to shocks in an appropriate and timely fashion. Second, it must encourage the policy makers to make the hard choices necessary to make the financial and economic systems more robust.¹² The proposed meetings potentially can highlight the policy support that the interna-

tional financial institutions could extend. This modality fits quite well within the format of the Bretton Woods and United Nations institutions; in addition, BIS has informally signalled its willingness to be involved in the type of process described above. It would be a natural follow-up to the regional conference which it organized in Asia.

There exists at present at least one concrete example of this modality: the Manila Framework meetings. There are now biannual meetings among the concerned officials of the Manila Framework group to discuss informally the regional economic situation, progress in reform and recovery and any other topic of interest. IMF has been backstopping this process and ADB is also now involved. As this process involves both developed and developing countries and is focused on Asia, it can be considered a useful new approach to surveillance. However, it involves only a limited number of the economies of the region and its inputs and outputs are not made public, apart from an agreed press release after the meeting.

An interesting variation of this modality has been tried by IIF as a way of involving the private sector. This approach involves replicating the holding of private-official dialogues in which briefings were given by senior Finance Ministry and Central Bank officials of Mexico (and other countries) for representatives of foreign banks, equity investors, asset managers, pension funds etc. in order to inform them about the most recent economic and financial developments and to engage in an informal exchange of views. Building on this experience, IIF has suggested that developing economies that have a significant involvement with international financial markets should undertake such interaction on a more systematic basis.¹³ The aim would be to build up foreign private sector confidence in a developing economy, which is important for stimulating investment as well as maintaining financial stability.

¹² Manzano and Moreno, "Supporting regional consultations..."

¹³ Montek S. Ahluwalia, "Key issues in reforming the global financial architecture", paper submitted to the Commonwealth Finance Ministers Meeting, Commonwealth Secretariat, Cayman Islands, 21-23 September 1999.

Use of country assessment exercises

IMF conduct of bilateral surveillance culminates in a document based on Article IV consultations, which is written by the Fund staff. Because such documents are generally of high quality, they can be a very good source of information for the markets and the international community and their release could allow markets to work more smoothly. However, there are problems of confidentiality because, during the consultation process, governments provide the Fund with sensitive and confidential information and engage the Fund in a frank exchange of views over economic developments and policy options. Because the Fund assessment can be politically sensitive, there is a great deal of caution on the part of national authorities in disclosing the report. While it was agreed that the reports could voluntarily be made public by September 1999, and 45 members of IMF had so agreed, only 16 reports have in fact been released or authorized for publication.¹⁴

Lately, the PINs that sum up the Board deliberations of the Article IV consultations have been released to the public domain, again with the consent of the relevant national authorities. It is noted that 80 per cent of the PINs in the period January to August 1999 have been released.¹⁵ This should improve considerably the amount of information about the state of economic health of various countries.

Regional or subregional consultations under the first two modalities outlined above, especially if they are kept confidential and informal, could be enhanced if their dialogues were based not only on the papers produced by the countries themselves but also on the Article IV reports. The use of these reports in regular consultations in the region would help focus on the problems which concern international investors and which could therefore affect investor perception of the region as a whole.

¹⁴ See IMF, *Progress in Strengthening the Architecture of the International Financial System*, Statement and Report of the Managing Director to the Interim Committee, IMF advance copy (Washington DC, September 1999) pp. 10-12.

¹⁵ *Ibid.*

Furthermore, simply by discussing the consultation reports among themselves, the policy makers in the region could gain better understanding of the constraints and difficulties that their neighbouring countries face. More importantly, policy makers would have a better appreciation of the spillover effects of their policies on other countries, and therefore, they would internalize spillover effects whenever they deliberate on policy moves.

The background papers for consultations need not be confined to Article IV reports. Another proposal is that the members of the regional process conduct voluntarily an IMF-style transparency assessment or a financial sector stability assessment (see chapter V) and use such assessments as background papers. These exercises could be helpful in building confidence as well as enhancing the capacity of national authorities in surveillance work.

Formal regional surveillance process: the ASEAN surveillance mechanism

A fourth modality by which the regional economies in the Asian and Pacific region can complement global surveillance and monitoring is formally to set up a regional or subregional surveillance mechanism supported by a technical unit. The idea of establishing a regional surveillance and monitoring mechanism was first enunciated during the Manila Framework meeting in November 1997. This meeting, in which 14 economies¹⁶ participated, was one of the earliest gatherings convened with the overriding purpose of crafting a concerted regional response to the Asian crisis.¹⁷ Among the agreed

¹⁶ Australia; Brunei Darussalam; Canada; China; Hong Kong, China; Indonesia; Japan; Malaysia; New Zealand; Philippines; Republic of Korea; Singapore; Thailand; and the United States.

¹⁷ This is not the first time that policy makers in Asia had consulted on financial matters. The first governor-level Executives' Meeting of East Asia-Pacific Central Banks, held in Tokyo in July 1996 concentrated on possible cooperation in foreign currency markets, and on installing regional mechanisms to defend currencies against speculative attacks. In fact, this Executives' Meeting can be considered the predecessor arrangement to the Manila Framework.

four-point regional response was the establishment of a regional surveillance mechanism to complement global surveillance by IMF.¹⁸

At present, the regional surveillance mechanism is focused on the subregional group of 10 South-East Asian countries, ASEAN. This group has traditionally dealt with security and trade issues. The crisis, however, raised the imperative of engaging in cooperation in financial matters to foster systemic stability. This led to the establishment of the Finance Ministers process. The ASEAN Finance Ministers endorsed the early implementation of the Manila Framework recommendations soon after they were adopted and, in February 1998, decided that an ASEAN economic monitoring mechanism would be established as a complement to the global framework of IMF.¹⁹ This mechanism was deemed to be an integral part of anticipating crises and taking preventive efforts to avoid the emergence of risks that would precipitate a crisis.

This process is to be run and managed by ASEAN itself. Therefore, the ASEAN Finance and Central Bank Deputies, composed of senior officials of the ASEAN central banks/monetary authorities and finance ministries/departments, will form the core of the mutual surveillance process. The ASEAN Surveillance Coordinating Unit, based in the ASEAN secretariat in Jakarta, will provide technical and coordination support for the process. During the set-up period (first two years), ADB is providing technical assistance in capacity-building and is housing the ASEAN Surveillance Technical Support Unit to which ASEAN central bank and finance officials are being seconded for training on surveillance matters. (Box VI.1 provides details on ADB involvement with the follow-up to the Manila Framework.)

¹⁸ The other points are (a) enhanced economic and technical cooperation, particularly in strengthening domestic financial systems and regulatory capacity; (b) measures to strengthen the capacity of IMF to respond to financial crises; and (c) a cooperative financing arrangement that would supplement IMF resources.

¹⁹ Background material for the ASEAN surveillance mechanism has been culled from the discussions held in the Workshops of the Peer Assistance and Review Task Force of PECC Sydney, 20-21 April 1999; and the Workshop on Economic Monitoring of Financial Systems in East and South-East Asia under ADB, the ADB Institute and PECC Manila, 25-26 June 1998.

One of the objectives of the ASEAN surveillance process is to provide a monitoring and early warning system for its members. Because it is closer to the source of a crisis, it is expected to provide a quicker diagnosis and response. A second objective is to monitor and discuss, through peer review, global economic and financial developments and similar developments of member countries. It is hoped that by providing an institutional backdrop for policy consultations, the spillover effects of individual country policies on the region could be internalized in the decision-making process of the relevant countries. The sharing of experience could provide lessons on and insights into the effectiveness of specific policy responses, and therefore enhance the policy formulation process at the country level. This exercise could mitigate the pursuit of inappropriate and unsustainable policies in ASEAN. Finally, the process would provide the institutional framework within which possible unilateral or collective policy options are agreed jointly by ASEAN members in their attempt to avoid future crises.

The underlying principles that were seen to animate the ASEAN surveillance process proceed from the ASEAN way of conducting business, which is based on consensus, that is, participation by all. ASEAN is inclined towards informal processes in which on a member's behaviour may be influenced by peer pressure. Thus, the main mode of crisis prevention in this mechanism is the peer review and policy consultation component. It is envisioned that the process will provide an institutional setting in which the frank exchange of views on policy directions among ASEAN policy makers will take place. While this may seem to depart from the policy of non-interference in domestic affairs, increasingly ASEAN policy makers have come to grips with the necessity of constructive engagement, especially in financial matters, where the contagion effects are only too real.

The ASEAN Surveillance Coordinating Unit is responsible for coordinating all surveillance-related matters, including preparing the draft surveillance report. The report is very critical to the process, as it provides the analytical inputs on which the policy dialogues will focus. In preparing the report, the Unit will gather the economic and financial data from ASEAN members according to an agreed template, and occasionally provide studies on special issues which are of particular relevance to the stability

Box VI.1. The role of the Asian Development Bank in economic monitoring after the crisis^a

ADB has been an integral part of the regional response to the economic and financial crisis. Besides its loan programmes to address financial, economic and social problems in the affected countries, it has contributed to the development of economic and social monitoring. The Bank participated in the Manila Framework process and, as a result, established the Regional Economic Monitoring Unit within its secretariat to act as a focal point for monitoring exercises. This Unit, whose work is supported by technical assistance projects, has three main responsibilities.

The Unit was designated to provide substantive assistance and capacity-building for the ASEAN surveillance process for the first two years of its existence. The Unit provides inputs to the ASEAN surveillance reports, which are presented to meetings of Deputy Ministers before the actual surveillance meetings occur; conducts studies on specialized topics on request; and offers in-house training to ASEAN officials on surveillance-related matters. So far, three-month on-the-job training has been given to officials from Indonesia, Myanmar and Thailand, and another group from the Philippines and Viet Nam started in December 1999. The intention of this training is to build the capacity in the relevant ministries in each ASEAN member country to undertake surveillance work.

The Unit is also responsible for the development and implementation of the Asia Recovery Information Center (ARIC). This project, being implemented with financial assistance from AusAID, grew out of a proposal from the Government of Australia made in March 1999 on how to meet the need for accurate and timely information on the economic and social impacts of the crisis and on the state of progress of the recovery. ARIC is an Internet-based web site^b which was launched

on 9 November 1999. It contains, at the initial stage, information on the five crisis-hit countries (Indonesia, Malaysia, Philippines, Republic of Korea and Thailand) under seven sections: recovery watch, social dimensions, international assistance, country focus, ARIC indicators, meetings and conferences and key hyperlinks. The ARIC high-frequency indicators include 60-70 key variables for each country under five categories: performance indicators, policy indicators, market indicators, prudential indicators and social indicators. The data are drawn from national sources through a contact in each country, from international sources such as IMF or BIS, or from private information providers such as Bloomberg. They are to be updated on a regular monthly, quarterly and annual basis, depending on the reporting frequency of the underlying data series. The Center has an advisory board with representatives of ADB, APEC, ASEAN, AusAID, IMF, UNDP and the World Bank. The intention is to widen the country coverage at a later stage once the system is running smoothly and its utility to governments, both donors and developing countries, researchers, NGOs etc. can be assessed.

Partly as a result of the above two initiatives, and in the light of the Bank's experience with preparing Asian Development Outlook on an annual basis, the Bank is now preparing a regional monitoring/surveillance report twice a year which is to be used as a background document for the Manila Framework meetings; the first one is to be presented in Hong Kong, China in February 2000. The idea is that the Bank will take more of a regional perspective than IMF does in its paper prepared for these meetings, which covers global and country-level developments, and thus the two complement each other.

The Regional Economic Monitoring Unit reports directly to the President of ADB. This signals the importance the Bank places on these new activities. However, the Bank has limited resources for data collection and processing activities and the related analysis and yet the work is heavily resource-intensive. There will be questions about the sustainability of ARIC once the current projects are completed.

^a Information drawn from the ADB brochure on the Regional Economic Monitoring Unit (autumn 1999) and an interview with the Head of the Unit (November 1999).

^b The web site can be accessed at <<http://aric.adb.org>> or through <<http://www.adb.org>> (31 January 2000).

of the region. The Unit is being supported by ASEAN Surveillance Technical Support Unit. Because ASEAN surveillance is meant to complement, not substitute for the global surveillance of IMF, the Fund will be asked to provide inputs on the global macroeconomic outlook. The surveillance reports of

other international financial institutions will also be used in the drafting of the surveillance report.

The draft surveillance report will be fed into the ASEAN Finance and Central Bank Deputies Meeting. The officials will discuss and, where

applicable, modify the draft and produce the final draft surveillance report. The ASEAN Finance Ministers will then discuss the report and exercise a peer review. The ASEAN Finance Ministers Meeting is usually conducted in an informal manner. However, it should be noted that the surveillance report, which discusses relevant trends and policy issues and arrays of response options, drives the deliberations of the surveillance process. The end product of the peer review process could be regional or national measures or policies, which would find expression in a joint ministerial statement.

The peer review mechanism in the ASEAN process essentially involves the exchange of information and frank discussions on the economic situation and outlook of members. The various country outlook papers provide suitable material for the discussion. Considering that the concern at the present conjuncture is how to sustain the recovery in the region, the discussions tend to revolve around measures taken by member countries to revive their economies. The inputs of international financial institutions, particularly IMF, will be used in assessing the downside and external risks to the ASEAN recovery, such as possible turmoil and the state of economic health of the United States, Japan and other major markets of ASEAN exports. As the peer review begins to take root in the ASEAN process, the natural progression towards deeper cooperation is policy coordination. The ASEAN surveillance process provides a good test bed for such a future arrangement. So far, however, there is consensus on the process, but not so much on the technical aspects.

The second meeting on the ASEAN surveillance process took place in late November 1999 during the meeting of Heads of State of ASEAN in Manila. There were proposals to involve China, Japan and the Republic of Korea in the process in a more formal manner. Whether this happens or not, the process is at least going forward as a review and monitoring initiative.

Such an arrangement could be envisaged for other subregional country groupings such as ECO, the South Pacific Forum, North-East Asia or SAARC, if the member countries so desired. In this regard it is suggested that a peer review process could cover discussions on the following types of topics: how to expedite economic and financial restructuring; ways of enhancing subregional economic and financial

integration; the pursuit of monetary and fiscal policies to manage domestic demand and provide safeguards for the poor; coordination on the monitoring of capital flows; and modalities for playing a more proactive role in international forums, such as crafting a common position on the international financial architecture.

In principle, for any subregional arrangement, the surveillance report should contain all the technical material, including the variables that will form part of the indicator series, which feed into the surveillance process. The country outlook papers could be expected to feature discussions and data on the following areas for each member country: GDP growth performance; functioning of the foreign exchange markets; current account balances and movements in foreign reserves; movements in domestic interest rates; extent of inflationary pressures; stock market behaviour; consumer sentiment; and industrial production. A discussion of the possible downside and external risks could include the following areas: threat of rising protectionism in advanced countries; a sharp reversal of a major foreign stock market; prolonged weakness of a major export market; possibility of exchange rate misalignments of major currencies; uncertainty of external financial flows; and lack of progress in economic and financial restructuring in developing economies.

While the full template of the data required of each member economy is still under discussion in the ASEAN case, any surveillance arrangement was likely to monitor at least the following standard indicators:

Macroeconomic indicators: GDP growth, unemployment rates, exchange rates, interest rates and inflation

Performance indicators: foreign direct investment flows, trade flows, consumer spending and industrial production output

Financial position indicators: current account balance, balance of payments, reserve levels, aggregate commercial bank lending and aggregate non-performing loan ratios

For the ASEAN or any other surveillance process to work, the provision of timely, reliable, accurate and comparable macroeconomic and financial data is absolutely critical. Without such

information, the policy dialogues would merely be generalities and as such would not be persuasive enough to influence country behaviour. The members thus need to make sure that data are made available. Lastly, a good balance needs to be struck between confidentiality and transparency with regard to disclosure.

Supporting regional initiatives in surveillance

The four modalities proposed above are not mutually exclusive, but variations which could be followed depending on the suitability, resources and interests of countries or groups of countries. This section explores possible regional initiatives in monitoring that can be set up within the subregional groupings of the larger Asian and Pacific region. Especially in the more structured modality, such as the ASEAN type, there are certain institutional requirements that are important for the success of any regional initiative. These are also discussed in this section.

As ASEAN has its own process and several of its members are participating in BIS, there does not seem to be a need for a new proposal for this group, but rather to support and strengthen what has been started. There are some indications that the countries of North-East Asia may wish to consider a similar initiative, or for some of them to be associated with the ASEAN one. As SAARC has started some informal contact on the financial system, there is a need to consolidate this process, to support it through the provision of resource persons and information and to foster it in the direction of more monitoring. The South Pacific Forum could be used similarly for the Pacific island countries, with suitable external assistance. As many Pacific island countries are very small economies and do not have their own central banks, it might be more feasible and realistic to initiate the process among the members of the Melanesian Spearhead Group (Fiji, Papua New Guinea, Solomon Islands and Vanuatu, with New Caledonia as an observer) as they have growing cooperation in the trade area and are relatively larger economies. The Central Asian economies could be drawn in through ECO at a later date, if there was interest in this body in pursuing some monitoring-type activities, or alternatively through an initiative under SPECA. If any of these subregional

groupings did decide to pursue the ASEAN-style approach, they would need to consider the implications for their secretariats. At a minimum, a technical support unit would be needed to develop the indicators and produce surveillance reports and so support the exercise. Some outside substantive assistance would also probably be necessary.

It should be noted, however, that subregional groups do not necessarily meet all the concerns of countries, particularly when the economies within a group are at very different stages of development and integration with the international financial marketplace. It may be more suitable to think of some more homogeneous groupings, such as least developed countries, or those in a geographic area that are not considered systemically important, as the basis for consultations.

Another consideration for the success of a surveillance process relates to the appropriateness of the participants from countries. One of the reasons why the BIS process works is that all participants are from central banks or supervisory agencies, institutions which are directly concerned with macro/financial stability and relatively independent of political pressures. They would seem to make an ideal target group for subregional surveillance processes. Participants from finance ministries could also be included, as in the ASEAN process.

Whatever modality countries may wish to adopt in enhancing surveillance at the regional or subregional level, it should be understood that the process is evolutionary. What could start as informal and ad hoc meetings among groups of countries could progress into a more structured surveillance process at some time in the future. As the experience of ASEAN shows, it is important to build comfort or confidence levels among those participating in surveillance. As the confidence level increases, the exchange of information and scope of cooperation could become deeper.

Regional surveillance cannot operate in a vacuum; to make the regional surveillance process meaningful, analytical support of the highest quality is critical. As discussed earlier, technical support should enhance the ability of policy makers to draft policies that will help to spot shocks, react to them promptly and withstand shocks. Such support should also encourage them in making the hard choices needed to strengthen the financial sectors

and economic management. It can be organized through a special unit in a subregional secretariat or through cooperative arrangements with regional bodies such as ADB or ESCAP. A staple function for such a support unit is to conduct research and the monitoring of indicators. However, it should go beyond pure surveillance and look into more long-term issues aimed at ensuring the robustness or resilience of economies to shocks. For instance, it could seek to detect areas of weakness and sources of risks, and indicate how these vulnerabilities might contribute to the spread of a crisis. Research may uncover the characteristics that make financial systems susceptible to the crisis, as well as ways of eliminating these weaknesses. This requirement is being taken into account in the case of the ASEAN regional surveillance process, with ADB, *inter alia*, providing technical assistance to ASEAN for the preparation of issue papers (see box VI.1).

Apart from technical policy analysis and support, another requirement for a successful surveillance and policy consultation is frank exchange of views. Unless this takes place, it is very difficult to have the concerns over policy spillovers internalized by those participating in the consultation. The fear that officials will desist from engaging in frank exchange of views is especially acute in the Asian context because of the perceived political sensitivities arising from attribution. One possible way of supporting the official consultation process is to establish a parallel unofficial forum²⁰ composed of academics, financial market participants, business leaders and international financial institutions. Since these people need not be constrained by diplomatic protocol, they can conduct open and frank discussions which can then be used as inputs into the official process of surveillance and consultation.

Regionwide monitoring

At the present time, there are two main channels for regionwide reviews of economic developments over the short term through ADB and ESCAP (see chapter V). The *Economic and Social Survey of Asia and the Pacific* is recognized as the main background document for the annual review of recent socio-economic developments by ministers at the

annual Commission sessions of ESCAP; the ADB *Asian Development Outlook* is used as a background report for the meeting of its Board of Governors. There may be room to use either or both of these as a vehicle for more systematic regional monitoring. This could be done by requesting the secretariats to monitor on an annual basis a consistent group of indicators for their members and to comment on their evolution in terms of warnings of vulnerabilities and implications for the region, and then to have the ministers/governors address the analyses at the Commission session or the Board meeting: having both undertake a more systematic surveillance role would increase the richness of the results. However, at present, there is more substantive debate at the Commission session than at the ADB Board meeting, which is more like a shareholders' meeting of an enterprise. While any such exercise would also obviously not be a substitute for more frequent and intense monitoring and surveillance exercises, it could at least give a clear regional focus and involve a wide range of countries in the review and discussion.

CHOICE OF LEADING INDICATORS

It is not humanly possible, or necessary, to monitor everything. Collecting and analysing data is costly in both financial and human terms. Therefore, countries participating in monitoring exercises on their own or regionally have to select a limited number of indicators to monitor. The choice is not obvious. Every economy is unique, with its own peculiar characteristics; some economies are relatively open, while others are closed. Some economies are exporters of primary commodities, while others are exporters of manufactured goods. The financial systems may be advanced in some economies and less so in others. Yet, while economies can differ in a myriad of ways, most modern economies are structured around markets and so share considerable commonalities. This suggests that, although the set of indicators will necessarily differ from country to country, there may be a core set of indicators.

One could identify such core indicators by either using the economic theory of how market economies operate, or from empirical analysis. One could argue that if a core set of indicators does exist, then these indicators should test as significant

²⁰ Manzano and Moreno, "Supporting regional consultations:"

in empirical studies covering a wide range of countries. A fair starting point for selecting core indicators in the latter approach is the study of Kaminsky, Lizondo and Reinhart reviewed in chapter IV. This provides a fairly comprehensive tally of indicators used in the literature on early warning systems. A wide range of countries and time periods is covered in the papers. All the indicators were tabulated according to the number of papers in which each indicator was used and the number in which the indicator was found to be significant. For the purpose of proposing an initial set of indicators, only those indicators found significant in a majority (more than half) of the papers were included. A shortened version of the results of this work is reported in table VI.1. (Table IV.2 gives the list of indicators used by Kaminsky and others in their own research).

The above list of variables accords well with what economic theory would suggest. The high frequency with which some variables are included in the surveyed studies is noteworthy (real exchange rate, international reserves, credit growth, inflation, real GDP, fiscal deficit). Moreover, the real exchange rate and international reserves indicators have a very high incidence of significance in the statistical tests. Not surprisingly, many of the variables are financial and/or related to the external accounts. However, indicators of the real sector (including the fiscal sector) also figure prominently.

Since the authors culled these indicators from papers that covered a wide cross section of countries, the indicators can be considered to be a common or core set. No doubt individual economies

Table VI.1. Significant leading indicators

<i>Variables^a</i>	<i>Number of studies considered</i>	<i>Statistically significant results</i>
International reserves	12	11
Foreign direct investment	2	2
Share of commercial bank loans in total debt	1	2
Share of concessional loans in total debt	2	2
Real exchange rate	14	12
Trade balance	3	2
Exports	3	2
Terms of trade	3	2
Real interest rates	1	1
Credit growth	7	5
Money multiplier	1	1
Parallel market premium	1	1
Position of exchange rate within the band	1	1
Money demand/supply gap	1	1
Central bank credit to banks	1	1
Money growth	3	2
M2/international reserves	3	3
Inflation	5	5
Real GDP growth or level	9	5
Output gap	1	1
Employment/unemployment	3	2
Change in stock prices	1	1
Fiscal deficit	5	3
Government consumption	1	1
Credit to public sector	3	3
Months spent on exchange rate peg	1	1

Source: Graciela Kaminsky, Saul Lizondo, and Carmen Reinhart, "Leading indicators of currency crises", *IMF Staff Papers*, vol. 45, No. 1 (March 1998), table A4, p. 45.

^a Some indicators are not practical as the object of a monitoring exercise, for example, a dummy variable for the presence of crisis elsewhere, or a past foreign exchange market crisis, and have been excluded from the above-shortened list. Other indicators dropped are those with definitions that were not obvious, those indicating political events and those that do not lend themselves easily to quantitative measurement.

have unique characteristics and require the addition of other specific indicators or the removal of non-relevant ones. For instance, commodity prices may be important in the case of some countries, for example, oil prices for oil-producing countries, or the stock market may be inconsequential in other economies and therefore changes in stock prices would be dropped. Individual economies may have to conduct their own studies to modify the list. It should also be noted that several of the indicators have not really been tested very rigorously in that they have been used in only one study.

Economic theory can also suggest possible indicators. One possible set of indicators is that proposed by Dominick Salvatore, which was also reviewed in chapter IV (Salvatore's starting point for these indicators is the familiar open economy equilibrium condition). His list is much shorter and comprises only eight indicators: savings rate, budget deficit to GDP, current account deficit to GDP, foreign debt to GDP, short-term debt to GDP, current account deficit less FDI, debt service to exports, and months of import cover. This list has the advantage of being easier to monitor and digest. It is skewed towards the external accounts, especially foreign debt, but the other components, such as budget deficit, savings rate and current account deficit to GDP, are sufficiently broad to catch domestic stress factors.

In the light of the Asian crisis, additional indicators could focus on the financial solvency and liquidity of the banking system and corporations. A recent paper²¹ suggests that the main warning indicators in the case of Asia are variables which proxy the vulnerability of the banking and corporate sector. Towards this end, other potential indicators could include private sector financial deficit; risk management measures; prudential management measures (regulatory framework, enforcement and quality of bank supervision); capital adequacy; classification and provisioning for non-performing loans; minimum liquidity requirements; measures of property and creditor's rights; measures of transparency; number of bankruptcies resolved; insider lending limits; and degree of independence of central bank.

²¹ Daniel C. Hardy and Ceyla Payarbasoglu, "Leading indicators of banking crises; was Asia different?", in *IMF Working Paper*, No. 91 (Washington DC, June 1998).

Alternatively, the list of indicators could be classified according to the locus of stress (originating in the four sectors that any economy will have): domestic macroeconomic stress, external stress, financial stress and institutional stress. Such a classification could be most useful to policy makers. The list that follows is by no means to be regarded as comprehensive.

Domestic macroeconomic stress

This type of stress relates to those imbalances that affect the economy as a whole, among which are the following:

Fiscal deficit. Large fiscal deficits could lead to excessive domestic credit expansion in order to sustain them. Under a fixed exchange rate regime, this may lead to a loss of international reserves and, if reserves go below a critical level, may precipitate a speculative attack on the currency. This, in fact, is the argument of Paul Krugman mentioned in chapter IV.

Inflation. Excessive inflation without adjustment in exchange rates causes a considerable loss of international competitiveness and can worsen the current account deficit. If exports continue to deteriorate or imports continue to rise, then over time the current account deficit will put pressure on the exchange rate. Alternatively, a boom-and-bust pattern of growth could bring with it the phenomenon of asset inflation. High asset inflation with overvalued exchange rates is symptomatic of a bubble. Asset inflation and high collateral value could in turn feed further expansion of loans. When the bubble bursts, asset values plunge and could cause a crisis in the financial system.

Low real GDP growth. Low real GDP growth, or the more serious case of a recession, can precipitate a financial crisis. Firms may have more difficulty servicing loans in a recession and this may weaken the financial system and lead to a crisis.

Savings-investment gap. A large gap indicates that the economy will have to rely on external resources to support investment. This is not necessarily a vulnerability if the inflow of external resources leads to increases in productivity and the ability to earn foreign currency to service the external liabilities. If not, the flow of new external resources may stop, servicing of current liabilities may become problematic and a crisis can emerge.

Unemployment/underemployment. To a certain extent, this might be subsumed under low real GDP growth or the presence of a recession, as they will usually go together. Additionally, in an export-oriented economy, if the increase in unemployment is due to a decline in exports and has been persistent, it may be a signal that the exchange rate policy will need to be adjusted, failing which a crisis can occur.

Financial markets indices (stock and bond markets). One interpretation is that the stock market index is an expectations variable (the index is theoretically the discounted stream of earnings of a stock). As a proxy for market expectations, a booming stock market is indicative of a rosy economic outlook in the eyes of investors and vice versa for a bearish market. However, excessively high stock market indices can be indicative of irrational investors' euphoria that could be subject to sharp corrections (or crisis), as occurred in some Asian economies.

Government consumption. The level of consumption by a government is a proxy for the size of the government sector in an economy. A high or rising level may indicate a non-productive use of the resources of an economy and so signal a potential problem for sustaining the level of economic growth.

External stress

External stress relates to the imbalances in the sectors of an economy which are involved in foreign trade and investment. The stress may originate in the following:

International reserves. This is an indicator of a country's liquidity; a low level indicates that the country is ill-prepared to service the foreign exchange needs of the economy. An illiquid country is most likely to run into problems when the flow of capital reverses; it will also find it difficult to defend its exchange rate. Speculators being aware of this could exert pressure, leading to a sharp correction and a crisis.

Foreign investment. The composition of investment, whether long-term (FDI) or short-term (portfolio), is important in assessing financial stability. Short-term capital flows are often referred to as "hot money". A country with foreign investment dominated by these flows is very much hostage to changes in investor sentiments. Contagion effects

are more serious for countries with this type of flows. There are also trade-offs involved in attracting portfolio flows; they are usually determined by differential interest rates. An emerging economy can attract portfolio investment through high interest rates, but these imply a greater cost of financing investment from domestic sources and may crowd out domestic investment flows.

Exchange rate. This is actually a policy variable under a pegged or managed float system and, if set at an unrealistic level, may lead to crisis. In fact, currency crises are commonly defined as a very sharp devaluation, possibly accompanied by high interest rates and a significant drawdown on reserves. Unwarranted appreciation of real exchange rates can suggest a loss of export competitiveness and contribute to expectations of subsequent devaluation and speculation. In many instances, the presence of a parallel market and a significant premium in the black market price for foreign exchange precedes a crisis. Moreover, an overvalued exchange rate makes foreign liabilities look cheap and may lead to overreliance on external financing. Sharp devaluation also increases the local burden of paying foreign debt by governments, banks and corporations, contributing further to stresses in the domestic financial system and economy.

Trade balance. A growing and persistent current account deficit may be indicative of an overvalued exchange rate (detering exports and promoting imports). Unless foreigners are willing to finance the deficit by holding on to local assets, the current account deficit will be unsustainable and can prompt a strong correction (which can lead to a currency crisis).

Prices of major exports and imports (terms of trade). Deterioration in export prices reduces foreign currency earnings, with an obvious impact on reserves and the ability of an economy to service external liabilities. This is especially important for resource-based economies. On the other hand, sharp changes in import prices can have adverse implications for reserves and also presage inflation.

OECD growth. This variable proxies the demand for export products of developing countries, as OECD arguably constitutes the major market for these countries. The higher OECD growth, presumably the more positive is the outlook for developing countries.

Financial stress

Financial stress relates to financial markets; examples of possible stress include:

Composition of foreign capital inflows. This mirrors the rationale noted under the composition of foreign investment because banks use foreign capital inflows to relend in the domestic market. Mismatches in the maturity of the debt instruments should be highlighted to help assess vulnerability.

Interest rates. Once again, this is a policy variable that involves trade-offs. Low interest rates facilitate local debt payments. Higher interest rates, on the other hand, increases the burden of paying debts (and lead to non-performing loan problems) but can attract portfolio investments or increase the attractiveness of local assets that yield interest income. It can be recessionary through the effect on investment. Excessively high interest rates may lead to adverse selection in lending operations, leading to poor loan quality and problems with non-performing loans. Whether the interest rate is a positive or a negative indicator will depend on the actual conditions of a country (level of debt, non-performing loans etc.).

Credit growth. Banking crises have often been preceded by high credit growth rates. High credit growth puts stress on the credit quality. There may be moral hazard elements (that is, loans were not extended on the basis of business criteria, but rather on that of political connections). With regard to credit to the private sector, the Asian crisis has demonstrated that high private sector debt can be debilitating.

Money supply. This indicator is related to the inflation variable as well as the financing of the fiscal deficit. M1 and M2 are often used as measures of money supply, M2 being a more comprehensive measure.

M2/international reserves. This is an indicator of the pressure on the exchange rate as it measures the domestic money supply in relation to the international liquidity available.

Parallel financial market premium. The higher the premium, the larger will be the unmet credit needs of the economy. A high level indicates an

inefficient or underdeveloped banking system and thus stress on the formal financial sector.

Central bank credit (to banks or to the public sector). Again, moral hazard considerations exist. If the exposure of the central bank to government/private sector banks is huge, the central bank may feel constrained to raise interest rates as part of monetary policy designed to maintain systemic stability, due to the increased costs to the government

Private sector debt. The rationale is very similar to that for excessive credit growth. The Asian crisis was a case where private sector debt had got out of hand. Because the exchange rate was pegged in some economies, it made foreign currency look cheap and encouraged the private sector to increase foreign currency debt.

Institutional stress

This kind of stress relates to the pressures that arise from institutions/practices, albeit these factors may not always be easily quantifiable:

Exchange rate system. Pegged exchange rates are subject to speculation; almost always, the resources of individual governments will not be enough to defend their pegs against serious market pressures.

Risk management measures. Does the financial system have markets for risk? If not, then this is indicative of vulnerability. Globalization of financial/capital markets entails the challenge of developing markets for risk management. The number of players, market turnover etc., are the indicators of the relative robustness of the markets for risk.

Prudential measures. These are qualitative indicators of institutions that govern or regulate financial systems. The presence of these indicators does not imply that they will work, but their effective enforcement is likely to make an economy less vulnerable.

Capital adequacy provisions. This has to do with solvency of banks and can also be considered an example of a prudential measure. Limitations on the extent to which bank capital is tied up with loans prevents bank owners from taking on too much risk in lending.

Level of non-performing loans. This indicates how weak the banking system is; the higher the non-performing loans, the lesser will be the capacity of the banks to lend. This can also be an indicator of the financial vulnerability of banks.

Measures of transparency. These can help prevent the build-up of vulnerabilities and contribute to the proper conduct of corporate governance. Problems of moral hazard are also prevented when the true state of bank or corporate finances is known. Monitoring banks by supervisors will only be meaningful when there is accurate, current, comprehensive and transparent information about the banks' solvency and liquidity as well as the creditworthiness of their clients. Thus, the presence of such measures will minimize the possibility of crises.

Central bank independence. Independence is important for the objective conduct of monetary policy and supervision of the financial system (less susceptible to be influenced by politics, fewer possibilities for bailing out cronies, mitigates moral hazard problems somewhat).

Measures of creditor and property rights. The existence of bankruptcy procedures (which can be proxied by the proportion of bankruptcies resolved) and property laws, and their timely and effective enforcement are indicators of the institutional robustness of an economy.

Table VI.2 summarizes the foregoing discussion into a set of proposed indicators under their respective stress headings. The indicators can be used as they are or combined with other indicators to form new indicators or ratios. Some of the indicators are qualitative; proxy variables may have to be used to quantify them, supplemented by detailed qualitative analysis.

Each country can and should carry out its own empirical investigation of the predictive ability of these indicators, deleting those that test insignificant. Moreover, a country may include additional indicators that the unique characteristics of its economy may suggest.

In summary, indicators can help policy makers feel the pulse of the economy. One should not set too high an expectation for them (for example, to be able to predict the timing of a crisis). They can, however, provide a useful guide for assessing vulnerability. Signs of vulnerability shown by indicators should be accompanied by detailed policy analysis, including the potential for exposure to contagion. As has been noted, there is ample scope for refining the indicators. This can be fertile ground for informal regional consultations, exchange of experience and technical assistance for capacity-building.

Table VI.2. Indicators under a stress classification

<i>Macroeconomic stress</i>	<i>External stress</i>	<i>Financial stress</i>	<i>Institutional stress</i>
Fiscal deficit	International reserves	Composition of foreign capital flows	Exchange rate system
Inflation rate	Foreign investment	Interest rates	Risk management measures
Real GDP growth or level	Exchange rate	Credit growth	Prudential measures (regulatory framework, enforcement and quality of bank and financial market supervision)
Savings-investment gap	Trade balance	Money supply	Capital adequacy provisions
Employment/unemployment	Terms of trade	M2/international reserves	Level of non-performing loans
Financial market indices		Parallel financial market premium	Measures of transparency
Government consumption	OECD growth	Central bank credit to banks/public sector	Independence of central bank
		Private sector debt	Measures of creditor and property rights

FINAL REMARKS

The philosophical basis for advocating regional/subregional arrangements is the principle of subsidiarity. This principle demands that what a subordinate or local organization can do more effectively should not be taken over by a dominant central organization. In crisis prevention, for instance, this takes the form of deploying at the regional level the same measures and instruments that are being developed at the global level. It means that such measures might be more effectively implemented through stronger regional institutions or mechanisms in which many more countries can participate more meaningfully than they can in a global forum. A regional mechanism could be a more natural disciplinarian as the countries that make up the region are likely to have a common stake in maintaining

economic and financial stability and presumably would have the greatest incentive for implementing mutually beneficial policies. Moreover, the "psychic distance" between policy makers among countries in a region is likely to be small. Regional arrangements can, therefore, facilitate more meaningful dialogue and cooperation in formulating policy responses. Such responses are also likely to enjoy a greater degree of ownership and hence stand a better chance of being implemented.

Regional arrangements are a mezzanine level, between national measures and global (for example, IMF and BIS) mechanisms to undertake monitoring and surveillance and early warning. The last two are not sufficient by themselves. All these mechanisms should be implemented in a coordinated manner and should support each other in order to build robust economic and financial systems in the region.

The Asian crisis in 1997 and subsequent ones in Brazil and the Russian Federation highlighted the changed world economic and financial environment within which nation states and enterprises operate today and exposed the limitations of the existing international financial order. They demonstrated very clearly that financial integration, and more broadly, globalization, is a two-edged sword. Integration allows economic agents from economies with liberalized financial sectors to tap into the world's savings; but it also exposes such economies, particularly if they have underdeveloped institutions (both markets and supervisory agencies), to the vagaries of market volatility, largely as a result of sudden shifts in investor expectations. Of course, the factors that lead to instability in financial markets are not all externally driven. Inappropriate policies, such as the maintenance of overvalued exchange rates and poor sequencing of the capital account liberalization, which are determined at the national level, also play an important role. In addition, poor corporate governance and inadequate financial system supervision can contribute to the build-up of vulnerabilities.

In the aftermath of the recent crises, there is a growing consensus in the international community that a review of the international financial order is needed. In essence, this call for reform is motivated by the problems arising from the incongruence of the operations of rapidly globalizing markets with policy-making, which is still being conducted at the national level. Within the context of a new financial architecture, the proposals aim to enhance the functioning of markets as well as improve the modalities for crisis prevention, management and resolution. The proposals emanating from various forums cover a wide spectrum: from changes in exchange rate regimes to instituting an international lender of last resort and establishing and enforcing international standards and codes of best practices. As the new financial architecture means different things to different people, the diverse and sometimes contradictory proposals on reforming the system are still under debate.

One of the areas within this general scheme on which there is considerable convergence of views is the need for enhanced surveillance, which includes increased international cooperation in monitoring, sharing of information and early warning. It is the task of the surveillance function to detect and give clear signals of sources of economic and financial vulnerability and instability and to provide analysis of and guidance on the appropriate policy response and corrective actions needed. At the national level, the link between early warning and corrective policy measures is quite direct and under the control of the authorities. At the international level, it is less so, owing to sovereignty issues. In this regard, international cooperation is central to effect the necessary policy changes needed to avert or minimize the severity of crises and their contagion effects.

The preceding chapters reviewed the existing global surveillance mechanisms and identified gaps therein. Because the Asian crisis was largely unanticipated, despite the surveillance efforts at the global level, there is an observed need to evaluate, and where appropriate, improve and complement the existing arrangements. The major international financial institutions responsible for conducting surveillance, particularly IMF and BIS, have in fact taken the lead in enhancing surveillance within the context of the new financial architecture at the global level. As illustrated in chapter V, these institutions have made improvements concerning the quality, quantity and timeliness of the data to be provided to them and in their analyses, and have emphasized the need to develop and encourage adherence to internationally accepted standards and codes of good practices in many areas affecting financial markets. In chapter VI, the case was made for complementing and supporting these global initiatives through action at the regional level and four, increasingly formal, modalities for so doing were suggested. As requested in Commission resolution 55/2 of 28 April 1999 on economic and financial monitoring and surveillance in the ESCAP region, this chapter explores avenues in which regional institutions, in particular ESCAP, can play a role in supporting and complementing global surveillance mechanisms.

ROLE FOR ESCAP IN CONTRIBUTING TO MONITORING AND SURVEILLANCE MECHANISMS

The ways in which ESCAP could contribute to and complement the global monitoring and surveillance mechanisms can be analysed at two levels: at the level of its member States and at the level of ESCAP as an international organization.

Of course, ESCAP is not the only organization in the Asian and Pacific region that can make a contribution, though it may have some special attributes which facilitate the activities suggested below. As noted in chapter VI, ADB is already involved in supporting regional monitoring through its Regional Economic Monitoring Unit and has been requested by both the ASEAN members and the Manila Framework group to provide inputs into their surveillance processes. It has a fledgling database system, but this does not appear to have a defined set of leading indicators or very wide country coverage. In any event, cooperation in this area between ESCAP and ADB is a *sine qua non*. There is already an informal understanding between the offices involved on sharing information and undertaking joint activities when and where appropriate. IMF has a regional training institute in Singapore and BIS a regional office in Hong Kong, China. This regional presence should facilitate cooperation and coordination between them and the regional institutions, and some discussions to this effect have already been undertaken.

Action agenda for ESCAP members

There is very little in the area of surveillance that an international organization can do by itself beyond conducting its own analysis of some indicators or of emerging issues. Most of the actions require active initiative and commitment by national governments, either individually or collectively, to request support. It would appear from the foregoing that the actions that developing members can pursue are threefold: participating in consultative activities according to the four modalities outlined in chapter VI; strengthening the technical aspects of surveillance at the national level; and becoming actively engaged in the ongoing process of developing the new financial architecture. Individual member countries or groups of members in the region can pursue

these initiatives themselves, through their existing subregional arrangements or through arranging meetings of like-minded countries on an ad hoc basis.

Elements that comprise the first area of action, which essentially follow the proposals of chapter VI, are as follows:

- Request, help organize, sponsor and actively participate in informal meetings among groups of relevant parties on monitoring processes, leading indicators and data requirements
- Participate actively with other countries in the region in cooperation with BIS, IMF, ADB and/or ESCAP to review recent developments of concern to the grouping of countries
- Request, help organize, sponsor and participate actively in meetings among interested member States to consider issues of mutual concern on the basis of PIN reports or other assessment reports
- Participate in setting up more formal arrangements similar to the ASEAN surveillance process within subregional groups

The second area for action by ESCAP members entails strengthening the technical capacity of national surveillance systems. This can be partly accomplished by upgrading the analytical skills (human resources development) and improving the data collection and management systems. Of course, there is considerable scope for technical assistance in this area. Some avenues for action are as follows:

- Develop a national list of leading indicators and collect the data for the calculation of these indicators on a regular basis
- Request technical assistance for this activity as required
- Develop the requisite human resources through in-house training, attachment training and participation in training courses offered by ADB, BIS and IMF

The experience of the Asian crisis has highlighted the need to step up the level of financial regulation to international standards for prudential purposes; there is little choice for countries that wish

to participate in the international financial system but to adopt or abide by international regulatory rules and practices. It is thus in the interest of member States to monitor progress in the new financial architecture and participate actively in its development. To this end they could:

- Participate in the development of new codes and standards for financial systems and apply them at the domestic level
- Participate actively in assessments of the compliance with these codes and standards, including undertaking a transparency report and a financial sector stability assessment, and in the review and amendment of these codes and standards
- Seek membership in BIS or other relevant global bodies, especially if the concerned states are active in the international financial markets

Action agenda for ESCAP

Discerning the role of the ESCAP secretariat in contributing to, complementing or supporting the national and global surveillance mechanisms depends critically on its comparative advantage and the value added it could potentially bring to the surveillance processes. One of the comparative advantages of ESCAP is that it has a truly regional perspective. It has as members more than 50 developing countries or areas throughout the Asian and Pacific region, far more than any other institution in the region. Among its unique characteristics is its formal relationship with subregional groupings, including ASEAN, ECO, the South Pacific Forum and SAARC. It also has a long tradition of convening and providing substantive backstopping for workshops and seminars in which groups of countries can exchange experience and draw policy lessons from each other. Often these meetings are among groups of countries at differing levels of development and are a vehicle for involving the less advanced countries (the least developed, the economies in transition and the Pacific island countries). By virtue of the breadth of its membership and its network with subregional groupings, as well as modalities for activities, ESCAP is in a favourable position to take the lead in convening seminars for exchange of experience. More concretely, ESCAP could do the following, upon the request of its members:

- Convening and substantive backstopping exchange of experience among groups of interested member States on issues related to the identification, construction and interpretation of leading indicators
- Convening and substantive backstopping exchange of experience among groups of interested member States on issues related to international financial system developments and international surveillance modalities, in cooperation with other relevant international organizations, such as BIS, IMF and ADB
- Convening and substantive backstopping exchange of experience among groups of interested member States on issues related to assessment reports, such as PINs, transparency reports or financial sector stability assessments, in cooperation with other relevant international organizations, such as BIS, IMF and ADB

Furthermore, it can promote cooperation and informal discussions on monitoring and surveillance among the members of different subregional organizations, not only among members of one such organization. The ASEAN surveillance process could be used as the model and could provide the nucleus for this proposal. Given this consideration, ESCAP can backstop and provide resource persons for other seminars and workshops, similar to those organized by subregional groups such as SAARCFINANCE and ASEAN on topics related to monitoring and surveillance, identification, construction and interpretation of leading indicators, standards and codes, transparency initiatives etc. It can thus be a catalyst for any initiatives which these subregional groups might wish to take to develop their own surveillance process, no matter how formal or informal.

ESCAP has been responsible for conducting training workshops for its members for many years. It has developed its own training materials and has run courses with the cooperation of other institutions. In the surveillance area, ESCAP would be uniquely placed to develop joint courses with other institutions such as BIS, IMF, IIF and the World Bank in the various areas of concern, such as leading indicators, codes and standards and banking supervision. These could be run at the national level or for a few countries in close proximity. For example, while BIS

has, through its Financial Stability Institute and the Toronto International Leadership Centre for Financial Sector Supervision, courses on offer to supervisory authorities, these are quite expensive and remote so that only one or two individuals from the developing countries in the region are able to participate. Similarly, the IMF Training Institute in Singapore can cope with only a limited number of participants in a year. The IMF and World Bank courses in Washington are of excellent quality but again are only able to train a limited number of the target cadres in any one year. As the demand for courses on various aspects of financial markets is almost limitless at present, and as in-country courses could reach a larger number of the target audience, there is certainly room for ESCAP to organize such collaborative courses in the interests of financial sector stability in the region.

Another comparative advantage of ESCAP lies in its long history and track record in offering technical advice and assistance to its members on an individual basis. Over the years, ESCAP has dealt extensively with the least developed countries, the economies in transition, the Pacific island countries and other systemically unimportant markets but which suffer from contagion just the same. Although ESCAP does not, strictly speaking, engage in high frequency surveillance, it is well positioned, by virtue of its familiarity with its members, to provide advice and analysis in matters related to the surveillance, monitoring and construction of leading indicators for such countries. ESCAP can also extend assistance on basic data collection (in terms of content, timeliness and frequency) to these countries.

A further comparative advantage that augurs well for the advice-giving function of ESCAP lies in its reputation for neutrality. Being a regional commission of the United Nations, ESCAP is perceived to be relatively unbiased in its assessment of policy options. Because political acceptance of policy advice is critical in crisis prevention, this feature of ESCAP could be put to good use. Among the activities that ESCAP can carry out upon request of its members are the provision of advisory services

on the interpretation of leading indicators; on the advantages and constraints involved in participation in different monitoring modalities and systems; and on the implications of developments in the global financial system, the new financial architecture and proposed monitoring systems.

ESCAP can play a role in the region in providing inputs into the global surveillance mechanisms by providing a regional perspective on events and developments in the Asian and Pacific region. For instance, ESCAP can look into the applicability of and constraints on applying international codes and standards in developing economies. Among the initiatives that ESCAP can take on its own are continuing to provide independent and critical analyses of (a) economic developments in the region; (b) changes in monitoring systems and their implications for member States; (c) developments in new financial architecture and their implications for member States; and (d) experiences in other parts of the developing world. Although ESCAP is already covering some of this ground through its annual *Economic and Social Survey of Asia and the Pacific*, it could put more emphasis on issues of greater relevance to surveillance.

Global surveillance institutions have been hard put to catch up with the demands of globalization. While there is no dearth of initiatives to reform the international financial architecture, there appears to be relatively less discussion on what can be done at the regional level. Addressing this issue is important because, to be effective, the global surveillance mechanisms should be complemented at the regional level. Chapter VI explores a number of modalities and the present chapter highlights the different ways and means in which ESCAP can add value to the surveillance process in the region. Although no one can guarantee that there will be no crises in the future, investments in the surveillance process, including at the regional level, are worthwhile in order to minimize the probability of a crisis or limit its severity if one occurs. The challenge, as always, is how to muster the necessary support for ESCAP to put these recommendations into effect.

VIII

SOURCE MATERIAL FOR ECONOMIC AND FINANCIAL MONITORING AND SURVEILLANCE

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