The international environment

This article discusses developments in the international environment since the November 1997 Quarterly Bulletin. *The financial and economic crisis in Asia has widened and deepened during 1997 and into 1998. There have been signs of contagion in other emerging markets. These developments are discussed separately in the note on page 26. The other main news*[1] *is:*

- *Growth in the United States remained strong in the third quarter of 1997, but the Japanese economy has continued to slow.*
- *The recoveries in Germany and France have strengthened. Activity in Germany remained dependent on net exports, while domestic demand strengthened in France.*
- *By December 1997, most major equity indices had recovered from the correction in October 1997. In Japan, equity prices fell steadily in the second half of 1997, but have strengthened in January 1998.*
- *Measured inflation remains low throughout the major six (M6)*[2] *overseas economies.*
- *A majority of EU countries are expected to have fiscal deficits of 3% of GDP or less for 1997.*
- *Official interest rates were stable in most industrial countries, but bond yields have fallen.*

GDP[3] *in the M6 overseas economies grew by 0.8% in the third quarter, up from 0.1% in the second quarter. Growth in the United States remains strong, but activity in Japan has slowed.*

Table A
Quarterly contributions to US GDP growth[a]

Percentage points

	1996	1997		
	Q4	Q1	Q2	Q3
Domestic demand	**0.6**	**1.5**	**1.0**	**1.1**
Private consumption	0.6	0.9	0.2	1.0
Investment	0.1	0.2	0.5	0.5
Government consumption	0.0	0.0	0.1	0.0
Stockbuilding	-0.1	0.4	0.2	-0.4
Net exports	**0.5**	**-0.3**	**-0.1**	**-0.4**
GDP	**1.1**	**1.2**	**0.8**	**0.8**

(a) Contributions may not sum because of rounding.

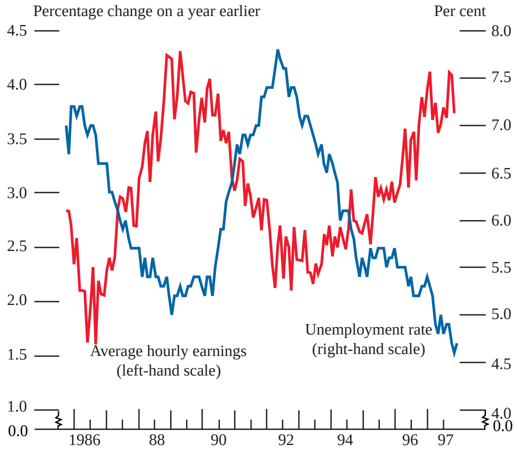
US GDP rose by 0.8% in the third quarter of 1997, to a level 3.9% higher than a year earlier. This followed growth of 1.2% and 0.8% in the first and second quarters respectively (see Table A). Growth in the third quarter was driven mainly by private consumption. As in the previous two quarters, net exports fell, reflecting the continued rise in the dollar effective exchange rate and the strength of US domestic demand relative to its major trading partners.

In Q4, nominal retail sales were 3.9% higher than a year earlier. This was slower than in Q3, but consumer confidence remains at historic highs. Consumption was also supported by strong growth in both nominal and real income. Industrial production remained strong, rising by an average annual growth rate of 5.8% in Q4.

The US labour market tightened in the fourth quarter; non-farm payrolls, the main measure of employment, rose by a monthly average of 358,000. For 1997 as a whole, payrolls grew at a monthly average of 267,000, up from 212,000 in the year before. The US unemployment rate fell to a historic low (see Chart 1), averaging 4.7% in Q4, its lowest quarterly average since 1970 Q1.

(1) Based on data up to 28 January 1998.
(2) The M6 comprises the G7 countries minus the United Kingdom, ie the United States, Japan, Germany, France, Italy and Canada.
(3) UK trade-weighted.

Chart 1
US labour market



Wage pressures appear to be building; average hourly earnings rose by 4.3% annualised in the fourth quarter, up from 4% in Q3. The Employment Cost Index, a more comprehensive measure of labour costs, has also been accelerating. It rose by 1% in Q4, compared with 0.8% in the previous quarter.

By contrast with the United States, the Japanese economy has slowed. Preliminary data indicate that Japanese GDP rose by 0.8% in the third quarter of 1997, so that the level of output was barely higher than a year earlier. The main contributor to Q3 growth was private consumption (see Table B), suggesting some recovery from the effects of the April tax rise. The prospects for consumption in Q4, however, are subdued. Retail sales fell in the fourth quarter, car sales have been weak and activity in the housing sector has been lacklustre.

Table B
Quarterly contributions to Japanese GDP growth(a)

Percentage points

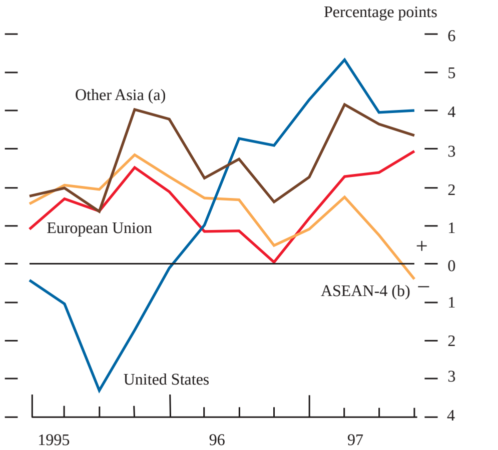
	1996	1997		
	Q4	Q1	Q2	Q3
Domestic demand	**0.7**	**1.9**	**-3.8**	**0.9**
Private consumption	0.6	2.3	-3.2	0.9
Investment	0.1	-0.4	-0.8	-0.1
Government consumption	0.1	0.1	-0.1	0.1
Stockbuilding	-0.1	0.0	0.3	0.0
Net exports	**0.4**	**0.1**	**1.0**	**-0.1**
GDP	**1.1**	**2.0**	**-2.8**	**0.8**

Source: Economic Planning Agency.

(a) Contributions may not sum because of rounding.

Net exports, which have been the main engine for growth in the current cycle, may be losing momentum—they fell in the third quarter. And data for the fourth quarter released so far show evidence of some adverse impact from the financial crisis elsewhere in Asia. Exports to Indonesia, the Philippines, Thailand and Malaysia (the ASEAN-4), which accounted for just over 10% of Japan's exports during 1997, fell by 6.9% in Q4 relative to Q3. By contrast, exports to the European Union (18% share) and the United States (28% share) rose by 16.9% and 7.6% in the same period, more than offsetting the deterioration with the ASEAN-4 (see Chart 2).

Chart 2
Japan: contributions to annual export growth(a)



(a) Nominal terms. Not seasonally adjusted.
(b) Other Asia includes: South Korea, People's Republic of China, Taiwan, Hong Kong and Singapore.
(c) The ASEAN-4 are: Thailand, Malaysia, the Philippines and Indonesia.

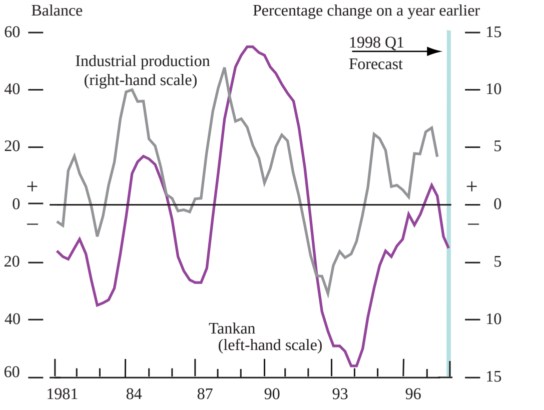
Industrial production weakened as manufacturers reduced unwanted inventories. Business sentiment also deteriorated, according to the Bank of Japan's Tankan Survey for the fourth quarter (see Chart 3). The business conditions diffusion index for major manufacturers, which had been +3 in September, fell to -11, its first negative value for a year. Confidence in other business sectors, which has been significantly weaker than in large-scale manufacturing, also deteriorated in the December quarter, as did the lending attitude of financial institutions.

The signs of increasing financial fragility, with the closure of Yamaichi Securities and Hokkaido Takushoku Bank in the fourth quarter, together with weakening economic prospects, led the authorities to loosen fiscal policy. A supplementary budget was announced, comprising tax cuts and a one-off income tax rebate, as well as a programme of public works. The total ¥5 trillion package (1% of GDP) partly reverses the consumption and income tax increases in April 1997. The Japanese government also announced measures to stabilise the financial system, involving a ¥30 trillion guarantee (equivalent to 6% of GDP) to the Deposit Insurance Corporation. The funds are to be used for recapitalising the banking sector and depositor protection.

Since the November *Quarterly Bulletin*, considerable attention has focused on the prospects for countries in East Asia, and the potential spillover of the financial crisis to other countries. The note on page 26 describes recent developments. The *Inflation Report* analyses their likely effect on the world economy and on the UK economy in particular.(1)

(1) Financial market developments are also analysed in the 'Markets and operations' article on pages 5–19.

Chart 3
Japan: Tankan Survey(a) and industrial production



(a) Major manufacturers' view of business conditions.

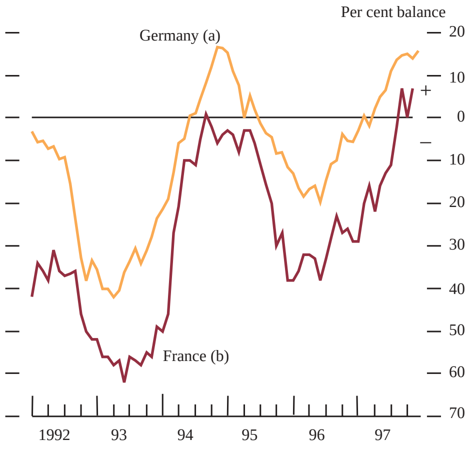
Table C
Quarterly contributions to German GDP growth(a)

Percentage points

	1996 Q4	1997 Q1	Q2	Q3
Domestic demand	**0.3**	**0.3**	**0.2**	**0.1**
Private consumption	-0.2	-0.1	0.7	-0.6
Investment	0.1	-0.5	0.1	0.1
Government consumption	-0.4	0.3	0.1	0.1
Stockbuilding	0.9	0.6	-0.6	0.5
Net exports	**-0.1**	**0.0**	**0.8**	**0.7**
GDP	**0.2**	**0.3**	**1.0**	**0.8**

(a) Contributions may not sum because of rounding.

Chart 4
Industrial confidence



(a) IFO: manufacturing climate.
(b) INSEE: industrialists' opinion on total demand.

Table D
Quarterly contributions to French GDP growth(a)

Percentage points

	1996 Q4	1997 Q1	Q2	Q3
Domestic demand	**0.1**	**-0.4**	**0.5**	**1.2**
Private consumption	-0.3	0.1	0.1	0.7
Investment	0.0	-0.3	0.1	0.3
Government consumption	0.1	0.1	0.1	0.1
Stockbuilding	0.3	-0.3	0.3	0.2
Net exports	**0.3**	**0.7**	**0.7**	**-0.3**
GDP	**0.3**	**0.3**	**1.1**	**0.9**

(a) Contributions may not sum because of rounding.

Growth in the large continental European economies moderated in the third quarter. The recovery in Germany continues to be export-dependent, whereas domestic demand in France has recently strengthened.

German GDP grew by 0.8% in the third quarter, to a level 2.3% higher than a year earlier. The strongest contribution came from net exports, as in the previous quarter (see Table C). Investment rose by 0.4%, reflecting a marked recovery in machinery and equipment expenditure, which outweighed the contraction of the construction sector. In Q4, business confidence in western Germany was little changed from its level in the previous quarter, though it remained stronger than a year previously (see Chart 4). Sentiment about the current economic situation reached its most positive since early 1992 in December. But expectations of business conditions deteriorated slightly during Q4, albeit from a high level, which may indicate concerns about the impact on net exports of the Asian slowdown.

Private consumption was weak in the third quarter, partly reflecting the high level of unemployment and its effect on disposable income. The unemployment rate in Germany overall reached 11.9% in December, up from 11.6% in August. Unemployment in western Germany remained broadly stable in the three months to December, but continued to increase quickly in eastern Germany. The unemployment rate is now almost twice as high in eastern Germany (19.8%) as in western Germany. But consumer confidence, though volatile from month to month, has been steadily increasing. Consumers' expenditure in 1998 is expected by the OECD and IMF to grow at close to its trend rate, which has been around 2.3% during the past decade (after adjusting for the effects of reunification).

The manufacturing sector continued its recent strength in the third quarter, spurred by extremely strong export orders. But industrial production data released so far for the fourth quarter suggest that the growth rate of manufacturing has slowed slightly.

In France, GDP grew by 0.9% in Q3, to a level 2.6% higher than a year earlier (see Table D). Growth in the third quarter was a little lower than in the previous quarter, which had been slightly inflated by a working-day effect. Whereas in previous quarters the main stimulus to demand had been net exports, growth in the third quarter was driven mainly by stronger private consumption. Net exports fell for the first time since 1996 Q2.

The prospects for consumption have improved, with strengthening consumer confidence and a pick-up in labour demand. Employment rose by 0.7% in the year to Q3, nudging the unemployment rate down to 12.4% in November, its lowest since August 1996. The number of vacancies has also begun to grow more rapidly. Investment has strengthened recently and, together with stronger consumption, offset the fall in net exports in the third quarter. The outlook for net exports in coming quarters has been dimmed by the impact of the Asian crisis, and by the prospects for import growth as consumption strengthens.

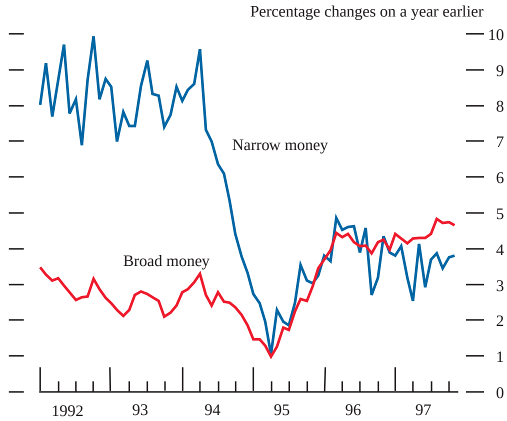
In Italy, the recovery appears to be strengthening gradually. Output rose by 0.4% in the third quarter of 1997, and by 2.1% on a year earlier. The quarterly pattern of output growth has been distorted both by working-day effects, as in France, and by a car-purchase incentive scheme. GDP growth for 1997 as a whole is now widely expected slightly to exceed the Government's forecast of 1.2%, partly because of downward revisions to GDP in 1996. But this better-than-expected growth rate for 1997 is still substantially below trend. Unemployment remained high, at 11.7%, in the third quarter.

Elsewhere in Europe, growth has been strong in the Netherlands, Finland, Denmark and Ireland. Growth in 1997 strengthened in Spain and Portugal. The OECD estimates that output in the European Union rose by some 2½% in 1997, compared with 1¾% in 1996.

Narrow and broad money growth in the M6

On a GDP-weighted basis, the average growth of narrow and broad money in the M6 economies rose slightly in the third quarter of 1997 (see Chart 5). The annual growth rate of narrow money in the M6 was 3.8% in November, up from 2.7% at the end of Q2. In real terms, narrow money grew by 1.4% in September. In November, annual narrow money growth rose in the United States and France, but fell sharply in Germany and Canada in Q3. In contrast, Canadian M1 continued to grow strongly. In Japan, the annual growth rate of M1 rose from 8% in Q3 to 8.7% in Q4. This may partly reflect a shift in individuals' preferences towards holding cash at a time of financial fragility.

Chart 5
Average narrow and broad money growth in the M6 economies

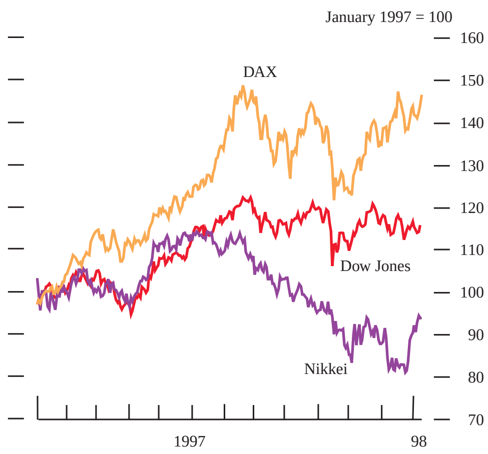


Nominal broad money in the M6 economies has grown by more than 4% annually during the past two years, and by 4.5% in October. Real broad money growth in the M6 has been strong, rising by 2.3% in the year to September.

US M2 growth rose almost continuously in 1997, to an annual growth rate of 5.2% in December, above its monitoring range of 1%–5%. But broad money in Germany slowed throughout the year, and M3 growth has been within its target range of 3.5%–6.5% since June. M3 rose at an annualised rate of 4.7% in November (relative to its average level in 1996 Q4); October's rise in the repo rate appears to have brought monetary growth below the 5% midpoint of the Bundesbank's target range for the first time this year. The new target range for 1998 was lowered to 3%–6%, to take into account the existing large supply of liquidity in the economy.

The weakness of the Japanese economy was reflected in continued broad money growth rates of around 3% in Q3, which picked up to 3.8% in December, reflecting monetary operations by the Bank of Japan to improve liquidity. Italian broad money remained strong, at an annual growth rate of 9.4% in November. French annual broad money growth, which had been negative since July 1996, turned positive again, and was 1% in November.

Chart 6
Equity markets(a)



(a) In local currencies.

Most major equity markets were buoyant in 1997, quickly recovering from losses when prices fell in October last year. In Japan, equity prices fell steadily in the second half of 1997, but have recovered some of their losses in recent weeks.

Equity markets proved buoyant in 1997 in most industrialised countries, with the major exception of Japan (see Chart 6). Prices were more volatile in the second half of 1997 than in the first half,

Chart 7
US consumer and producer price inflation

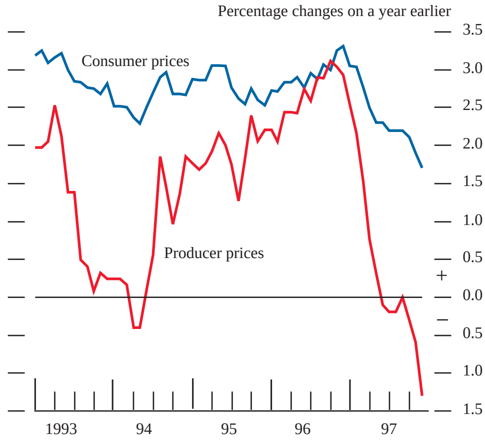


Chart 8
EU3 consumer price inflation

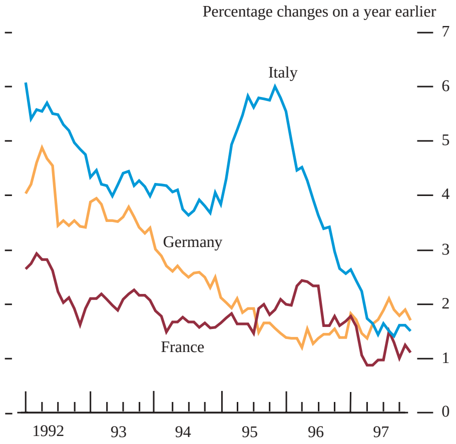


Table E
Harmonised index of consumer prices (HICP)

Percentage changes on a year earlier

	1997 Aug.	Sept.	Oct.	Nov.
Austria	1.3	1.1	1.1	1.1
Belgium	1.7	1.6	1.2	1.3
Denmark	2.0	1.9	1.6	1.4
Finland	1.6	1.6	1.6	1.7
France	1.6	1.5	1.1	1.4
Germany	1.7	1.6	1.4	1.4
Greece	5.6	4.9	4.8	5.0
Netherlands	2.5	2.6	2.4	2.6
Ireland	0.6	0.6	0.8	1.1
Italy	1.6	1.6	1.9	1.8
Luxembourg	1.4	1.7	1.7	1.5
Portugal	1.6	1.5	1.6	1.9
Spain	1.7	1.9	1.8	1.9
Sweden	2.1	2.6	2.7	2.7
United Kingdom	2.0	1.8	1.9	2.0

with sharp corrections in a number of markets. In the industrialised countries, the falls in October were quickly reversed, with most of the losses recouped by early December.

US equity prices were about 25% higher at the end of 1997 than a year earlier. In Japan, equity prices fell by around 25% between their most recent peak at the end of July 1997 and the end of December 1997. This reflects the considerable slowdown in activity, the expected negative impact of the Asian currency turmoil, and continuing concerns about the general health of the financial system. In January, Japanese equity prices have strengthened, rising by around 12% since the end of December. In Germany, the DAX rose by around 50% during 1997.

Inflationary pressures remain subdued in all major economies.

In the United States, the pick-up in wages growth has not fed through to either wholesale or retail prices. US producer prices fell by 0.2% in December to a level 1.2% lower than a year earlier, while consumer prices rose by 1.7% during the same period (see Chart 7). 'Core' measures of consumer and producer prices have also been subdued. Price pressures have been reduced not only by a stronger dollar, but also by weakening commodity prices in the second half of 1997.

After allowing for the impact of the consumption tax rise in April, Japanese inflation rates also remain low. Annual consumer price inflation has been around 2% since the tax rise, which largely reflects the one-off tax-induced change to the price level, the effect of which should drop out after a year. Wholesale prices have increased even less quickly, rising by 1.5% in November on a year earlier. Annual import price inflation fell from rates above 15% in the first few months of 1997 to around 5% in the third quarter.

Weak domestic demand has helped to moderate inflation in the EU3 (see Chart 8). In Germany, annual consumer price inflation was 1.8% in December, down from its recent peak of 2.1% in August. In France, annual consumer price inflation was 1.1% in December. In both countries, producer price inflation was similarly muted. In Italy, annual consumer price inflation was 1.5% in December. There appears to be considerable consumer resistance to price rises: inflation did not pick up substantially in response to the increase in VAT in October. If passed on fully, this would have added 0.7 percentage points to annual inflation for a year.

In the European Union, inflation rates based on harmonised indices of consumer prices converged during the year (see Table E). The range between the highest and narrowest rates was 3.9 percentage points in November, the lowest since 1996, when these data were first available for all countries. The unweighted average inflation rate (excluding Greece) was 1.7% in November.

A majority of EU countries are expected to have fiscal deficits of 3% of GDP or less for 1997.

The latest European Commission (EC), OECD and IMF forecasts indicate that a majority of the EU countries are expected to have fiscal budget deficits at or below 3% of GDP in 1997 (see Table F). In particular, the OECD forecasts, which are the most recent, indicate that only France and Greece will exceed that level—

Table F
Forecasts of 1997 fiscal deficits(a)(b)

	EC (c)	IMF (c)	OECD (d)
Austria	-2.8	-2.5	-2.9
Belgium	-2.6	-2.8	-2.5
Denmark	1.3	0.5	0.5
Finland	-1.4	-1.9	-1.3
France	-3.1	-3.2	-3.1
Germany	-3.0	-3.1	-3.0
Greece	-4.2	-4.7	-5.0
Ireland	0.6	-0.8	-0.2
Italy	-3.0	-3.2	-3.0
Luxembourg	1.6	-0.1	n.a.
Netherlands	-2.1	-2.1	-2.0
Portugal	-2.7	-2.9	-2.9
Spain	-2.9	-3.0	-2.9
Sweden	-1.9	-2.1	-1.5
United Kingdom	-2.0	-2.0	-2.3

n.a. = not available.

(a) Percentage of GDP; negative indicates a deficit.
(b) General government (Maastricht definition).
(c) October 1997.
(d) December 1997.

France by just 0.1 percentage point. The EC forecasts tell a similar story. But the IMF forecasts suggest that four countries will have deficits that exceed 3% of GDP.

Most EU countries will have had public debt ratios in excess of 60% of GDP in 1997. According to IMF and OECD forecasts there will be only four exceptions—France, Luxembourg, Finland and the United Kingdom—but the EC forecast that Germany and Portugal will also have debt ratios of 60% or less in 1997. All three organisations expect the debt positions of most EU countries to improve in 1998. In particular, the OECD and EC forecast that the debt/GDP ratios of all EU countries except France will rise (the IMF also projects a rise in the German ratio); all three organisations expect debt/GDP ratios in Belgium, Greece and Italy to remain above 100% in 1998.

Official interest rates have remained stable in most industrialised economies.

US official interest rates were unchanged by the Federal Open Market Committee in Q4, as they have been since March 1997. The long end of the US yield curve has fallen progressively during the past five months, partly reflecting the growing perception that domestic inflationary pressures have subsided. Official short-term rates within the European Exchange Rate Mechanism countries have converged. Official rates were raised by 30 basis points in Germany in October, followed by increases in rates in Belgium, France and the Netherlands; official rates were cut in Italy, Spain and Portugal. Official interest rates were increased in Canada in November and December.(1)

(1) More details of interest rate changes are given in the 'Markets and operations' article on pages 5–19.

Developments in East Asia

Global economic developments in the second half of 1997 were dominated by the financial crisis in East Asia, initially concentrated in Thailand, Malaysia, Indonesia and the Philippines (the ASEAN-4). These countries were forced to abandon their exchange rate pegs to the US dollar and have seen substantial falls in their stock markets. The crisis affected a number of other emerging markets, and Korea was seriously affected towards the end of 1997.

Background

Although the precise economic situation differed among the ASEAN-4 countries, there were a number of broad similarities (see Table 1). All had experienced rapid, investment-dominated growth in recent years. Though this was accompanied by generally moderate inflation, there were increasing signs of overheating, particularly evident in widening current account deficits. There were also large foreign capital inflows, attracted by the higher returns available at a time when yields in industrial countries were falling. In 1996, net private capital inflows to the ASEAN-4 were between 6%–10% of GDP, exceeding the size of their current account deficits. Since exchange rates were not allowed to adjust, there was a build-up of foreign exchange reserves. These reserve increases were not fully sterilised, resulting in rapid increases in the money supply.

Table 1
Selected economic indicators

1996 levels as a percentage of GDP unless otherwise stated

	ASEAN-4				
	Indonesia	Malaysia	Philippines	Thailand	Korea
GDP growth (a)	7.9	9.0	4.9	7.9	8.2
Inflation (b)	8.6	3.5	8.5	5.6	5.2
Domestic saving	28.8	36.7	19.7	33.1	33.3
Fixed capital formation	28.1	42.2	23.2	40.8	36.8
General government balance	1.4	4.2	-0.4	1.6	0.0
Current account balance	-3.3	-4.9	-4.7	-7.9	-4.9
Net private capital inflows	6.3	9.6	9.8	9.3	4.9
External debt	53.4	43.9	67.8	53.2	29.3

Sources: IMF *World Economic Outlook* and Institute of International Finance.

(a) Average annual growth for 1993–96.

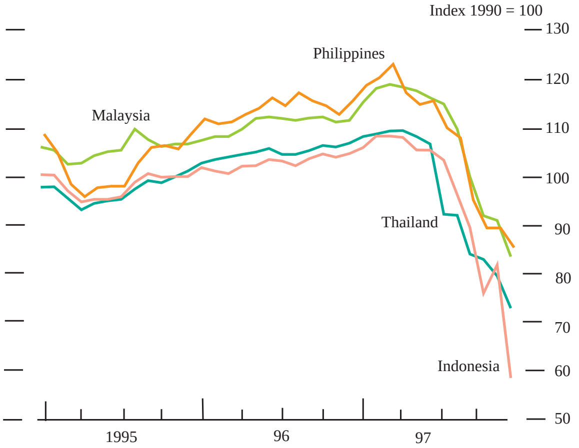
A problem facing all these countries was weak financial infrastructure. The limited experience of their financial institutions in the pricing of risk, combined with underdeveloped banking supervision systems, lax controls on lending criteria and political interference, all contributed towards imprudent lending. This left the banking systems vulnerable to adverse economic developments.

Private sector credit growth rose in the ASEAN-4 to rates in excess of 20% in 1995. In Malaysia, the credit growth was primarily domestic, fuelling a property price bubble, though there was also a large amount of net direct investment from overseas. Elsewhere, the capital inflows included large volumes of foreign currency borrowing by the corporate sector, both from domestic and foreign banks (particularly Japanese banks), encouraged by foreign interest rates that tended to be lower than domestic ones. These funds supported high levels of investment. In some countries, notably Thailand and to a lesser extent Indonesia, the investment was increasingly in real estate, where there were property price bubbles.

The foreign currency borrowings were predominately short term and typically unhedged, in the expectation that exchange rate pegs would be maintained. According to statistics from the Bank for International Settlements on foreign bank lending to these regions, the share of short-term loans outstanding by June 1997 was highest in Korea (68%), followed by Thailand (66%), Indonesia (59%) and Malaysia (56%).(1) This compares with a share of 52% in Latin America and 51% in Eastern Europe. The reliance on short-term, private sector capital left the Asian countries vulnerable to changes in investor sentiment.

A combination of factors led up to the crisis itself. The export performance of the ASEAN-4 weakened in 1995–96, as their trading partners' activity slowed, and excess supply in the electronics market led to sharp falls in revenue from electronics exports. These developments were exacerbated by a loss of competitiveness in the ASEAN-4 countries: their real effective exchange rates appreciated steadily during 1995–96 (see Chart A). This partly reflected higher rates of inflation relative to their trading partners. But it was also

Chart A
ASEAN-4: real effective exchange rates

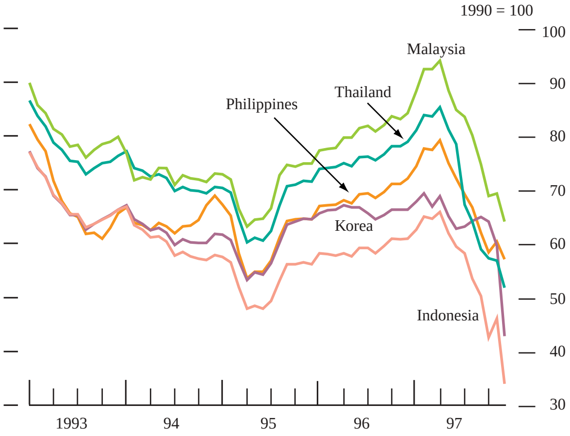


Source: J P Morgan.

(1) Short-term is defined as 'up to and including one year'. These data cover lending from banks in the G10 countries plus Austria, Denmark, Finland, Ireland, Luxembourg, Norway and Spain, and foreign affiliates of these banks. For precise definitions see *The maturity, sectoral and nationality distribution of international bank lending*, BIS, January 1998.

caused by the appreciation of the US dollar in this period, particularly against the yen, making the ASEAN-4 less competitive against Japan, their largest or second-largest trading partner (see Chart B).[1]

Chart B
Bilateral yen exchange rates



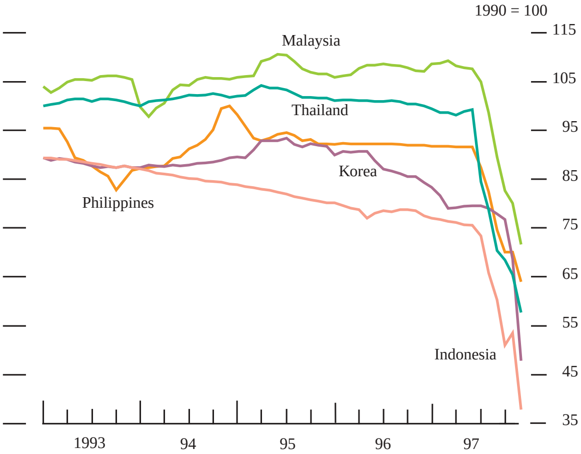
Domestic developments—most notably asset price falls and rising corporate bankruptcies—clearly warranted lower interest rates, but these were maintained at high levels to offset pressures on the exchange rate, as international investors were increasingly questioning the sustainability of the exchange rate pegs.

The ASEAN-4

There were periodic attacks on the Thai baht during 1996, which became more persistent and aggressive from May 1997. Having raised interest rates and intervened extensively on the foreign exchange market, the Thai authorities allowed the exchange rate to float on 2 July, in the face of large capital outflows. The Thai baht depreciated by about 20% against the US dollar in the first month, and by about 40% by the end of October (see Chart C). From July, the currency turbulence spread to the Philippines, Malaysia and Indonesia, as investors became concerned about the sustainability of their exchange rate arrangements. In the Philippines, the authorities abandoned the *de facto* peg of the peso to the US dollar on 11 July; the peso depreciated by 10% against the dollar in the first month of floating. The Malaysian ringgit also came under pressure, and the authorities allowed the currency to depreciate—by around 10% against the dollar between the end of July and the end of August. Pressures on the Indonesian rupiah caused the authorities to widen the intervention band to 12% on 11 July, having widened it on three occasions during 1996, but after further exchange rate pressures, the authorities decided to float the currency on 14 August.

China remained relatively unscathed by the crisis in the surrounding region. Chinese competitiveness improved after the unification of its official and swap exchange rates

Chart C
Bilateral US dollar exchange rates



in 1994, when the yuan depreciated.[2] Since then, China has had a current account surplus, which reached an estimated 2.5% of GDP in 1997; its reserves have risen to a level far higher than in any other emerging country in the region (around US$140 billion at the end of 1997), its external debt is lower than most other countries in the region (14.3% of GDP in 1996), and it maintains controls on international capital flows.

But other Asian currencies came under pressure, such as the Hong Kong dollar, which is pegged against the US dollar in a currency board arrangement. The Hong Kong authorities' commitment to maintain the current peg necessitated sharp increases in interest rates (three-month rates peaked at more than 40% on 23 October). The Singapore dollar and New Taiwan dollar also came under pressure in July. There were sharp falls in most equity markets in Asia (see Table 2 and Chart D).

Table 2
Currency and stock market movements in Asia

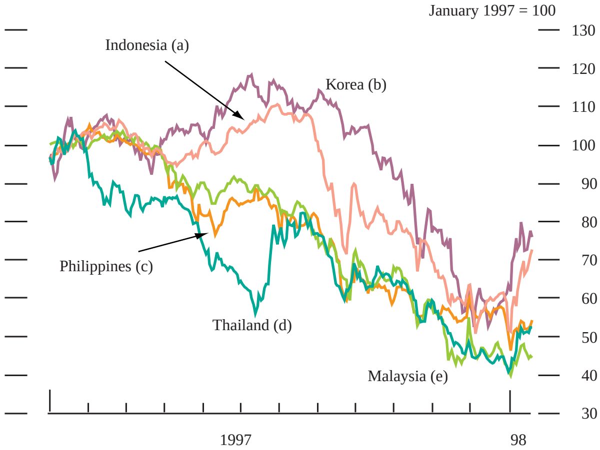
	Percentage change between start January 1997 and end October 1997		Percentage change between end October 1997 and end January 1998	
	Equity market (a)	Exchange rate (b)	Equity market (a)	Exchange rate (b)
Japan	-15	-4	+3	-4
Hong Kong	-19	0	-12	0
Korea	-28	-13	+10	-38
Singapore	-29	-11	-19	-8
Taiwan	+12	-11	+6	-9
Thailand	-44	-37	-3	-24
Malaysia	-46	-24	-14	-24
Philippines	-43	-25	-2	-16
Indonesia	-22	-35	-3	-71

(a) Major indices expressed in local currencies: Nikkei 225; Hang Seng; Korean composite; Straits Times Industrial; Taiwan Stock Exchange; Thai Set; Malaysian Kuala Lumpur composite; Philippines composite; Jakarta composite.
(b) Nominal rate against US dollar.

Two rescue packages were announced by the IMF: US$17 billion for Thailand on 11 August, and US$23 billion for Indonesia on 31 October. Both stipulated conditions for structural economic changes and financial reform. Having seemingly stabilised, the situation worsened, particularly in Korea.

(1) The dollar appreciated against the yen by 37% between April 1995 and June 1997.
(2) While the yuan depreciated by some 50% against the US dollar from the previous official rate, the effective depreciation was less than this, because a large proportion of transactions were conducted at the swap rate. For more details, see IMF *World Economic Outlook*, Interim Assessment, December 1997.

Chart D
Asian stock exchange indices



In local currencies:
(a) Jakarta composite.
(b) Korean composite.
(c) Philippines composite.
(d) Thai Set index.
(e) Malaysian Kuala Lumpur composite.

Korea

Until the end of October, Korea appeared to be avoiding contagion effects, partly because it already had a more flexible exchange rate. The won had depreciated against the US dollar by around 10% during 1996, insulating it to some extent from the loss of competitiveness against the yen experienced by the ASEAN-4 (see Chart C).

The economic problems in Korea were rather different in nature from those experienced in the other Asian countries, and were more closely linked with a loss of confidence in the banking system. In Korea, the banking sector is heavily dependent on the fortunes of *chaebol* (large conglomerates), which dominate the industrial structure. The *chaebol* tended to concentrate on market share rather than profitability, resulting in overinvestment in some sectors, notably steel and automobiles. Weaknesses in the domestic financial system exacerbated these problems, with lending decisions, especially to firms in financial difficulty, often politically influenced. These firms had become highly leveraged, borrowing increasing amounts of foreign currency, predominantly at short maturity. Because this debt was typically unhedged, it left the Korean economy vulnerable to shifts in international investor sentiment.

It should be recognised, however, that all banking systems are vulnerable to changes in sentiment. This is why governments have tended to support banks with liquidity problems, reinforcing the view that lending to banks carries low risks. At the international level, this 'moral hazard' has increased the size of capital flows, reduced the monitoring of the profitability of the borrowers by lenders, and encouraged speculative investment by borrowers. If further crises are to be avoided in future, ways must be found to reduce the extent of moral hazard in international capital flows.

A record number of bankruptcies during 1997 among the *chaebol* severely weakened the financial sector.(1) Initially, the extent of the difficulties was not clear because of a lack of reliable data. The trigger for the crisis occurred when several commercial banks admitted having difficulties in meeting their short-term debt obligations. The stock market fell by 17% in the last week of October, and by a further 19% by 3 December. The won also came under pressure, falling against the US dollar by an average of 1% a day between the end of October and the start of December.

An IMF-supported rescue package of US$57 billion was announced on 3 December, initially meeting with a positive market reaction. In the first couple of days after the announcement, the Korean stock market rose by 15% and the won appreciated by around 5%. But the improvement in sentiment was short-lived. During the following week, concerns increased about Korea's ability to repay its short-term debt, amid doubts about the government's commitment to structural reform, concerns about the impact of higher interest rates on the corporate sector, and increasing evidence that the problems were more serious than previously thought.(2)

Since then, the Korean authorities have received part of the rescue funding ahead of schedule, and they have accelerated and reaffirmed their commitment to the IMF reforms. Various steps have been undertaken to help instil confidence, including suspending 19 insolvent merchant banks, taking measures to liberalise the capital account, raising the ceiling on interest rates and removing the exchange rate band.

Spillovers to emerging markets

There were spillovers to currency and equity markets in a number of emerging markets throughout 1997. At about the same time as the attacks on the Thai baht, the Czech Republic was becoming vulnerable because of its widening current account deficit. The authorities abandoned their target band for the koruna in late May 1997, after trying to defend the currency with higher interest rates and intervention in foreign exchange markets. The Slovak koruna came under similar pressure at this time.

Most of the pressures on exchange rates in emerging markets occurred in late October. In Brazil, pressure on the real prompted the authorities to double interest rates and tighten fiscal policy. The Argentinian and Mexican pesos also came under pressure, as did the currencies in Greece, Russia and the Ukraine. Interest rates were increased sharply in these countries.

There were falls in a number of equity markets. In Brazil, the Bovespa Stock index fell by around 40% between the last week in October and mid November; though the index was still more than 40% higher in domestic currency terms (around 30% in US dollar terms) at the end of 1997 than at the start of the year. There were also corrections in Russia and Hungary.

(1) By 6 December, seven of the top 30 *chaebol* had failed. More than 15,000 companies filed for bankruptcy in 1997.
(2) Money-market interest rates were increased from 15%–19% at the beginning of December to 25% on 13 December.

The outlook

Assessing the impact of the Asian crisis on world growth is made more difficult by the rapidly changing economic and financial situations of many of these countries. It is also unclear how far the effects may be mitigated by policy adjustments in other countries. Between October and December 1997, the IMF revised down its forecasts for world growth in 1998 from 4.3% to 3.5%.[(1)] This compares with world growth of around 4% in 1996 and 1997, but is considerably stronger than the global slowdown in 1990–93, when world output was rising at an annual rate of around $1^3/_4$%–$2^3/_4$%.

Growth projections by the IMF have been revised down for all regions, but mainly for Asia. Forecasts of growth in 1998 in the newly industrialised Asian economies (Korea, Taiwan, Hong Kong and Singapore) have been reduced most—from 6% to $3^1/_2$%—with the largest adjustment for Korea. The 1998 forecast for Japan has also been revised down, from around 2% to 1%. Revisions to forecasts elsewhere—notably for the United States and European Union—are fairly minor, reflecting smaller shares of trade with Asia and the recent stronger-than-expected growth in these countries. Though considerable uncertainty surrounds these estimates, the risks are predominantly on the downside, especially given that the crisis has deepened since December.

The OECD also revised its forecasts, but these were concluded in November 1997, before the more recent deterioration in Korea and worsening prospects in Japan. Moreover, they forecast OECD, rather than world, growth, and so do not include the ASEAN-4 countries. They expect GDP growth for the OECD region to be 2.9% in 1998. This is higher than their forecast in June of 2.7%, and principally reflects faster growth expected in the United States. Given the events in Korea and Japan that have occurred since the publication of these forecasts, growth in the OECD region in 1998 is likely to be lower than their initial estimate.

(1) The new forecasts, included in the IMF *op cit*, were based on developments up to mid December 1997. The OECD's new forecasts in the *Economic Outlook*, December 1997, were based on information available up to 10 November 1997.