EXTERNAL SECTOR

Global financial markets have come under unprecedented tension as a fall out of the crisis that erupted in East Asia in July 1997, and which continued to deepen and broaden in 1998. The turbulence has spread rapidly from one part of the world to another, principally arising from the "herd behaviour" of international capital that led to a swift reassessment of emerging markets as investment destinations. The economies most affected directly by the East Asian crisis experienced drying up of private foreign financing, together with large currency depreciation and precipitous decline in asset prices. This, in turn, exposed and exacerbated financial sector fragility in these countries, especially Thailand, S. Korea and Indonesia. The crisis has resulted in a sharp contraction in domestic demand in these countries, with large declines in real GDP and lowering of near-term growth prospects. In Japan, which is the market for about one sixth of the exports of the ASEAN-4 and S. Korea, the economic recession continues with severe and mounting problems in its huge financial sector. In August 1998 the crisis spread to Russia with severe consequences for the economy.

2. The East Asian crisis has had a profound impact on normal international financial flows. In 1997, net private capital flows to developing countries, countries in transition and newly industrialised Asian economies fell by about 45 per cent from the record level of U.S.$ 215 billion in 1996. In 1998, net private capital flows are estimated to decline by a further 40 per cent over 1997 to about U.S.$ 68 billion, with the developing countries in Asia accounting for most of the decline. Moreover, reversal of market sentiments in the industralised world and heightened risk aversion by international capital has affected external viability for other emerging economies, including Brazil. Reduced availability of foreign financing, increased interest spreads on foreign borrowing, and policy tightening to reduce vulnerability to disruptive changes in market sentiment have generally weakened growth prospects for almost all emerging economies, including India. The seriousness of global developments is also reflected in the adverse impact of the crisis on world stock markets (reflecting increasing risk aversion towards equity), profitability of western banks and the resultant response recently by leading central banks to make significant cuts in interest rates.

3. The considerable deterioration in international economic and financial conditions has, since the beginning of 1998, necessitated

TABLE 6.1
External Environment

(per cent change)

	1997	1998^{e}	1999*	2000*
Output				
World total	3.2	1.8	1.9	2.7
OECD countries	2.7	1.9	1.6	2.2
East Asian crisis countries	4.5	-8.0	0.1	3.2
South Asia	5.0	4.6	4.9	5.6
Trade in Goods (In volume terms)	9.5	5.3	5.7	6.2
	1997	**1998^{e}**	**1999-2000***	
Price indices (U.S. $)				
G-5 export unit value of Manufactures	-5.1	-3.8	1.9	
Petroleum price	-1.1	-25.7	7.7	
Non-fuel commodity price	5.0	-14.6	-0.4	

e : Estimates. *** : Projections.**
Source : Global Economic Prospects, World Bank, December 1998

periodic downward revisions in global growth projections. There was a sharp deceleration in world real GDP growth in 1998 to 1.8 percent and, more worryingly, no recovery is forecast for 1999 (Table 6.1). There is, in fact, a substantial risk that, in 1999, the world economy may stagnate. Concomitantly, a marked slowdown in world trade has also come about. In volume terms, the growth of world trade in goods in 1998 is estimated to be only 5.3 per cent, compared to 9.5 per cent in 1997 and, furthermore, no significant recovery is expected in 1999. The impact of the crisis is also being felt through weaker commodity prices, including oil. For developing countries that are net importers of these products, there will be a helpful terms of trade gain, but for many countries that are net exporters there will be significant negative impact on growth, current account and fiscal positions.