

Global Economic Prospects

and the Developing Countries



2000

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Contents

Foreword	vii
Summary	ix
Abbreviations, Acronyms, and Data Notes	xv
Chapter 1 Prospects for Growth and Poverty Reduction in Developing Countries	1
The external environment for developing countries is improving	3
The outlook for developing countries in 1999–2001 suggests significant acceleration	17
Projections for growth in developing countries in the long term are lower	22
Recent trends and prospects for poverty in developing countries	28
Risks to the forecast and a low-case scenario	36
Notes	42
References	44
Chapter 2 External Shocks, Financial Crises, and Poverty in Developing Countries	47
External shocks and poverty in developing countries	48
Income poverty and inequality during the East Asian crisis	51
Beyond current income effects of the East Asian crisis	62
Fostering sustained growth and reducing the social costs of volatility and crises	65
Notes	67
References	68
Chapter 3 Asian Restructuring: From Cyclical Recovery to Sustainable Growth	73
The uneven recovery	74
The focal point of restructuring: the financial sector	84
Corporate restructuring: some progress, but a long way to go	91
Notes	98
References	99
Chapter 4 Managing the Recent Commodity Price Cycle	103
Key issues confronting primary commodity exporters	104
The savings response to commodity price cycles	108

The savings response by oil exporting countries to the recent swing in oil prices	110
The savings response by non-oil commodity exporting countries of Sub-Saharan Africa	119
Notes	127
References	130

Appendix 1 Regional Economic Prospects 133

Appendix 2 Global Economic Indicators 151

Classification of Economies 169

Figures

1.1	World industrial production	4
1.2	U.S private savings rate and current account balance	6
1.3	G-3 consumer prices, 1997–99	8
1.4	Short-term interest rates, 1998–99	9
1.5	World import volume growth	10
1.6	Spreads on Brady bonds	15
1.7	Real GDP growth for developing countries	17
1.8	Index of financial conditions since June 1997	18
1.9	Growth of U.S. employment and productivity in manufacturing	22
1.10	Long-term trends in commodity prices, 1990–2008	25
2.1	Terms of trade and GDP growth volatility, 1961–97	49
2.2	Unemployment in East Asia during the crisis	59
2.3	Poverty and spending on social safety nets in East Asia, 1996–98	60
2.4	Change in gross domestic savings, 1997–98	62
2.5	Relative price of foods during the crisis	63
3.1	Nontradable production before and after crises	75
3.2	Industrial production before and after crises	76
3.3	Production index in Korea by industry	77
3.4	Thai nonperforming loans and interest rates, June 1998–September 1999	79
3.5	Change in bank deposits and lending to the private sector, December 1998–July 1999	81
3.6	Total investment in East Asia	81
3.7	Cross-border mergers and acquisitions, Q1 1997–Q2 1999	95
4.1	Primary commodity prices versus manufactures unit value index, 1960–98	105
4.2	The decline in commodity prices due to the East Asian crisis	108
4.3	Current and previous price declines of nonenergy commodities	109
4.4	Mexico’s current account, 1970–82	115
4.5	Shares of merchandise exports of Sub-Saharan Africa non-oil commodity exporters, 1990–97	119
4.6	Agricultural exporters’ trade prices, 1993–98	120
4.7	Metals and minerals exporters’ trade prices, 1993–98	121
4.8	Real income, savings, and aid during booms	125
4.9	Change in savings rates during boom compared with base periods	126

Tables

1.1	Global conditions affecting growth in developing countries, 1998–2001	2
1.2	World output growth, 1998–2001	5
1.3	Contributions to world import growth	10
1.4	U.S. import prices of manufactured goods, 1999	11
1.5	Annual percentage change in oil and non-oil commodity prices	14
1.6	Average monthly gross capital market flows to developing countries	14
1.7	World growth, 1981–2008	23
1.8a	Population living below \$1 per day in developing and transition economies, 1987–98	29
1.8b	Population living below \$2 per day in developing and transition economies, 1987–98	29
1.9	Projected growth rates in real per capita private consumption and changes in Gini coefficients for 1998–2008	30
1.10a	Population living below \$1 per day in developing and transition economies for 1998–2008 under scenarios of slow growth and rising inequality (Scenario A) and inclusive growth (Scenario B)	33
1.10b	Population living below \$2 per day in developing and transition economies for 1998–2008 under scenarios of slow growth and rising inequality (Scenario A) and inclusive growth (Scenario B)	33
1.11	Population estimates and projections, 1998 and 2008	35
1.12	World, industrial, and developing countries in the low-case scenario	37
2.1	Growth, poverty rates, and Gini coefficients in East Asia, 1996–98	53
2.2	Employment and real wages in East Asia during the crisis	57
2.3	Public spending on health and education	64
3.1	Financial distress, past and projected, 1995–2002	77
3.2	Ration of nonperforming loans to total loans, December 1998–September 1999	78
3.3	Public debt and recapitalization costs as share of GDP, 1998	84
3.4	Institutional arrangements for corporate and financial restructuring	85
3.5	Structural changes in the financial system	85
3.6	Estimated recapitalization costs for commercial banks, mid-October 1999	87
3.7	Restructuring: out-of-court and in-court progress, August 1999	91
3.8	Illustrative postcrisis policy reforms in crisis countries	96
3.9	FDI flows in East Asia, 1992–99	97
4.1	Savings, investment, and real income changes, selected country groups, 1996–97	111
4.2	Capital flows to oil exporters and energy prices, 1970–97	114
4.3	Ratios of public and private savings to GDP, 1996–98	115
4.4	Economic performance of major oil exporters and other countries, 1980–97	117
4.5	Share of oil and non-oil commodities in merchandise exports, 1980 and most recent year	118
4.6	Policy performance and GDP, savings, and real income during boom periods	122
4.7	Exports and terms-of-trade changes, boom compared to base period	123
4.8	Changes in savings and real income relative to base periods	123
4.9	Economic performance	126
4.10	Decomposition of real income changes	127

Boxes

- 1.1 Sectoral and regional effects of the East Asian crisis 12–13
- 1.2 Prospects for a new round of multilateral trade negotiations 26–27
- 1.3 Technical discussion of assumptions 34
- 1.4 Can the international development target for reducing income poverty be achieved? 37
- 1.5 Failing to forecast the severity of the East Asian crisis 38–39
- 1.6 The possible impact of the Y2K bug on developing countries 40–41
- 2.1 Volatility, growth, and poverty 51
- 2.2 External shocks and fluctuations in poverty in Mexico 52–53
- 3.1 Why distress can persist 80
- 3.2 Redeployment of assets: lessons from Japan 92–93
- 4.1 Counterfactual scenarios 112
- 4.2 Public sector expenditures during the oil price boom 116
- 4.3 Fiscal adjustment in Saudi Arabia and Venezuela 117
- 4.4 Savings and real incomes during the commodity price cycle 124
- 4.5 Real incomes in Benin during the commodity price cycle 127

Foreword

Developing countries are now recovering from the worst ravages of the financial crisis of 1997–98. But the recovery is uneven and fragile. Growth remains well below the precrisis trends in many countries, so much so that the average per capita income of developing countries outside of Asia is expected to fall in 1999. Long-term projections for growth in developing countries (excluding the transition economies) suggest that it is likely to be lower in 2002–2008 than in the precrisis 1990s. The experience of the past year has underscored how financial volatility can increase poverty significantly in the short to medium term. As a result, there is a growing consensus that in order to maximize the positive effects of growth that can come with openness, the international community must find ways to reduce the frequency and severity of economic crises.

For the first time, this year's *Global Economic Prospects* analyzes the trends in poverty levels in developing countries. Progress on poverty reduction in many developing countries is likely to remain slow and below poverty-reduction targets recently adopted by the international community.

This year's report also considers three areas where the crisis has had a major impact on growth and welfare in the developing world.

First, the crisis has increased poverty in the East Asian crisis countries, Brazil, and Russia. Not only has the increase in poverty been significant, whether measured by levels of income or consumption, but the crisis has engendered large costly movements of populations and sharp declines in standards of living for the middle classes. Urban poverty increased in all countries, particularly the Republic of Korea. Although efforts were made to maintain spending on social services, real public expenditures on health and education fell in the crisis countries, with a particularly severe impact on access to services in Indonesia.

Second, though the East Asian crisis countries are experiencing a cyclical recovery, severe structural problems remain. The level of nonperforming loans remains high, and a large share of firms are insolvent. Weak firms have operated on thin margins and their inability to pay interest, following the onset of the crisis, has added to their debt burden. Such firms constitute a significant portion of each of the crisis economies and the appetite to invest in them is extremely limited. They will continue to act as a drag on investment and growth until such time as the financial claims on them are resolved and either their operations return to adequate profitability or their assets are redeployed. Without vigorous corporate and financial restructuring, the return to a sustainable growth path will likely take longer, the costs of the crisis could rise, and these economies will remain vulnerable to new external and internal shocks.

Finally, the exchange rate depreciations and declines in demand in East Asia have exacerbated the fall in primary commodity prices that began in 1996. Countries that depend on primary commodities have faced an enormous challenge in smoothing consumption in the face of booms and busts in commodity prices during the 1990s. Some commodity-dependent countries

cope with the wide swings in commodity prices more successfully than others. In the oil exporting countries, weak policy environments led to mixed savings performance and lower investment over the oil price cycle. These countries have generally been unsuccessful in reducing their dependence on oil revenues, and the fall in investment will further impede progress. By contrast, the commodity price cycle of the 1990s does not appear to have adversely affected the prospects for growth in the non-oil exporting countries of Sub-Saharan Africa. Changes in real incomes were generally smaller than in the oil exporting countries, and improvements in policies in several countries enabled them to increase savings and investment rates during both commodity-price booms and busts.

Overall, then, *Global Economic Prospects 2000* shows a mixed picture, with a number of extraordinary challenges confronting developing countries in their efforts to further economic progress and reduce poverty. We hope that this report will serve both to sharpen the World Bank's work in supporting our clients, and to inform the international community about the critical development issues of the day.

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This report was prepared by the Development Prospects Group, and drew from resources throughout the Development Economics Vice Presidency, the Poverty Reduction Board, the East Asia Regional Vice Presidency, and other World Bank regions. The principal author of the report was Mustapha Nabli, assisted by William Shaw, with direction by Uri Dadush. The chapter authors were Mick Riordan (chapter 1), Mustapha Nabli (chapter 2), Ashoka Mody (chapter 3), and William Shaw (chapter 4). The report was prepared under the general direction of Joseph Stiglitz.

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Summary

DEVELOPING COUNTRIES ARE NOW RECOVERING from the worst ravages of the financial crisis of 1997–98. The East Asian economies are rebounding from last year’s collapse in output. Improved prospects and an easing of monetary conditions in many parts of the developing world have boosted emerging equity markets and reduced interest rates from the sky-high levels of mid-1998. Developing countries also are benefiting from the acceleration of growth and interest rate reductions in industrial countries.

However, the recovery is both uneven and fragile, and many countries continue to struggle in the aftermath of the crisis. Several countries in Africa, Latin America, and Eastern Europe face declines in output in 1999, and outside of Asia developing countries’ per capita income is expected to fall. Continued imbalances in industrial countries markedly increase the risks presented by the international economic environment. Furthermore, the cyclical recovery in East Asia has not addressed severe difficulties that were either caused or exacerbated by the crisis. In addition to a review of international economic developments and prospects, *Global Economic Prospects 2000* considers three areas where the crisis has had a major impact on growth and welfare in the developing world.

First, the crisis has increased poverty in the East Asian crisis countries, Brazil, and the Russian Federation, and elsewhere. Chapter 2 reviews the evidence on the crisis’ social impact on East Asia and other developing countries and addresses the broader issue of the impact of external shocks on poverty in developing countries.

Second, though the East Asian crisis countries are experiencing a strong cyclical recovery, severe structural problems remain, notably the banking systems’ high levels of nonperforming loans and the large share of insolvent firms. Chapter 3 outlines the depth of the problems faced by the corporate and financial sectors of these economies, analyzes the challenges facing the restructuring process, and discusses the appropriate role of government in supporting restructuring and reducing systemic risk.

Third, exchange rate depreciations and declines in demand in East Asia exacerbated the fall in primary commodity prices that began in 1996. Countries that depend on primary commodities have faced an enormous challenge in smoothing consumption in the face of booms and busts in commodity prices and adjusting to the secular decline in commodity prices relative to manufactures. Chapter 4 examines how the most commodity-dependent economies in the world—the major oil exporting countries and the non-oil exporters of Sub-Saharan Africa—have adjusted to the commodity price cycle.

Prospects for growth and poverty reduction in developing countries

The effects of the crises of 1997–99, from East Asia to Russia and Brazil, persist in many aspects. In most developing countries growth remains weak and well below the precrisis trends. Social dislocations are severe and progress in poverty reduction has stalled. At the same time, recent developments in the global economy have been largely encourag-

ing, with signs of strong initial recovery in the East Asian crisis economies and continued expansion in the industrial countries leading to a bottoming-out of world industrial production and trade.

Recent events have confirmed the importance of the factors identified in *Global Development Finance* (March 1999) as shaping the global recovery, notably the easing of macroeconomic policies in industrial countries, early signs of recovery in the East Asian crisis countries, and easier financial conditions in developing countries. But the magnitude of these effects has been much larger than anticipated, and recent evidence has yielded some surprising developments: adjustment in some of the worst-hit countries, such as Russia and Brazil, has been much more favorable than expected in March, and a sharp increase in oil prices, following the decision of the Organization of Petroleum Exporting Countries (OPEC) in April 1999 to curtail oil supplies, has benefited developing countries that depend heavily on oil exports.

The positive evidence has been strong enough to support an upward revision of the March projections for growth. Growth for the G-7 countries this year is likely to register 2.6 percent, 0.9 percentage points higher than the forecast made six months ago. Continued strong growth in the United States is the principal factor in the revision, but Japan's performance in the first half of 1999 (3.2 percent annualized GDP growth), which was much better than anticipated, also contributes to the change. Europe, which had been hampered by inventory overhang, is now showing signs of a strong revival. Reflecting these developments, world industrial production appears to be on an accelerating path. For developing countries, GDP growth for 1999 is expected to be 2.7 percent—a revision of 1.2 percentage points from the March forecasts—and the outlook for 2000 has been upgraded by 0.5 percentage points.

Positive as these revisions are, they mask the considerable fragility of developing countries, which have yet to recover fully from the

financial crises of 1997–99, nor do they reflect the markedly different patterns of growth and recovery among regions. Except for East Asia and South Asia (regions bolstered by growth in China and India), aggregate real per capita incomes in 1999 are expected to decline or stagnate in several developing regions. Further, the news since March has not been all good. The tightening of oil supply has meant higher import bills for many developing and industrial countries. And the favorable financial conditions have not made international investors less risk-averse, as shown by the high levels of interest rate spreads. International capital flows to developing countries have fallen much more sharply than anticipated.

Although improving, the external environment for developing countries remains subject to a high degree of uncertainty.

The underpinnings of growth, especially in the developing countries, remain fragile. Capital flows to emerging markets continue to be scarce and expensive. In such an environment, the prospective unwinding of large imbalances in the industrial countries presents potential risks for these projections. Chief among these risks are the consumption boom (driven by the stock market) and widening external deficit in the United States, and the uncertain outlook for Japan.

One potential scenario assumes a tightening of monetary policy in the United States (in response to signs of increased inflation), which sharply reduces equity prices, resulting in slow growth in the United States and Europe and a relapse into recession in Japan. For developing countries, effects are transmitted through a further slowing in export market growth, declines in oil and non-oil commodity prices because of deteriorating demand conditions, and increased risk aversion in financial markets. Although policy responses to these external circumstances would vary widely across developing countries depending on current conditions, most countries would be obliged to adjust through a compression of domestic demand and imports. An assumed

closure of the financing gap on the demand side (almost \$100 billion) results in a loss of 2 percentage points of growth for developing countries as a group in both 2000 and 2001, implying a loss of nominal GDP of some \$260 billion.

Long-term projections for growth in developing countries have been downgraded by some 0.3 percentage points, suggesting that growth for the group (excluding the transition economies) in 2002–2008 is likely to be lower than in the precrisis 1990s.

This estimate reflects several factors, including a somewhat less favorable external environment and, importantly, prospects for a protracted work-out of structural weaknesses in developing countries—particularly in financial systems and fiscal positions—which have become more apparent in the wake of the crisis. One implication of lower long-term projections is that progress on poverty reduction will be slower. For some regions, including Sub-Saharan Africa and Latin America and the Caribbean, reductions in poverty are likely to remain below the targets recently adopted by the international community. Effective policy actions to encourage rapid and equitable growth are essential to reduce poverty.

External shocks, financial crises, and poverty in developing countries

The financial crisis has underlined how globalization, especially financial integration, exposes developing countries to external shocks.

External shocks can reduce the gains in poverty reduction from openness and increase poverty significantly in the short to medium term. This fact underscores the importance of addressing the issue of volatility in order to maximize the positive effects of growth on poverty reduction. The countries most affected by the East Asian crisis illustrate the asymmetric impact of changes in per capita income on poverty and the negative effects of volatility on growth.

Any development strategy for stable and sustainable growth must include both adequate safety nets and appropriate policies and institutions designed to prevent financial crises, and to respond when crises occur. Prospects for poverty reduction depend not only on future growth but also on countries' capacity to manage volatility and reduce growth fluctuations.

Though less dramatic than early predictions suggested and very heterogeneous, the negative social impact of the East Asian crisis and consequent crises in Russia and Brazil has been enormous.

The increase in income or consumption poverty has been significant. In addition, the crisis has engendered costly, large reallocations of people and sharp declines in middle-class standards of living. Unlike the situation in Latin America, where income inequality increased significantly during crises, in East Asia the effects on income distribution have been small and highly differentiated. The extent of these effects depends on the country's income level and the impact of the crisis on different economic sectors.

Urban poverty increased in all countries, particularly Korea, where total employment declined and open unemployment grew more than in other countries in the region. Falling real wages in the urban formal sector affected mostly high-income groups. In Thailand the impact was felt mostly in rural areas because of the large inflows of workers from urban areas and the relatively small increases in agricultural prices.

The severity of the crisis in Indonesia is reflected in the strong responses of households to increase consumption as a share of income, adjust their asset holdings, and increase the share of staple foods in their consumption baskets. In Korea and Malaysia the response of households was to increase the savings rate. The composition of consumption expenditures changed significantly. Households spent more, primarily on essential items such as food, fuel, housing, health, and education.

The crisis demonstrated the flexibility of labor markets in developing countries. These

markets help absorb the effects of shocks through reduced wages and labor mobility within and between urban and rural areas.

Wages fell sharply during the East Asian crisis, with particularly spectacular declines in Indonesia. Wage declines moderated the impact of the recession on employment. Thus the decline in total employment in Thailand and Malaysia was limited, and employment actually rose in Indonesia. Labor was reallocated from the formal (urban) sector to other activities, particularly the informal sector and agriculture, where exchange rate depreciations improved incentives.

Real public expenditures on education and health fell in the crisis countries, although efforts were made to increase spending on safety nets.

The extent to which households were able to adjust their spending to offset this decline varied across countries as well as income groups. In Thailand, families and government programs acted to cushion the impact of the crisis in order to avoid declines in school enrollment rates or in access to health services. In Indonesia, however, the severity of the crisis led to significant declines in poor households' access to both education and health services, particularly in urban areas. Such setbacks can have irreversible effects on human development.

Even where public spending on safety nets increased significantly, the impact on poverty was limited for several reasons. These included the absence of safety nets before the crisis, response lags, institutional problems, and low levels of spending relative to the scale of poverty. In some cases, evidence suggests that well-functioning programs were underfunded relative to the potential impact of shocks on poverty.

Asian restructuring: from recovery to sustainable growth

The aftereffects of the externally triggered liquidity crisis in Indonesia, Korea, Malaysia, and Thailand indiscriminately sub-

merged both strong and weak producers and financiers. The rising tide is lifting the strong, but the financially weak continue to struggle because of both crisis-induced and longstanding vulnerabilities.

Since the onset of the East Asian crisis more than two years ago, the corporate sectors and financial systems in the crisis economies have remained in severe distress. The banking systems' nonperforming loans have skyrocketed to unprecedented levels: nonperforming loans range between approximately 30 percent of GDP for Korea and Malaysia to 60 percent of GDP for Thailand. In contrast, nonperforming loans in other major emerging market crises (Chile in the early 1980s and Mexico in 1995) were less than 20 percent of GDP. In the Scandinavian banking crises during the early 1990s, nonperforming loans amounted to approximately 5 percent of GDP.

East Asia's heavy reliance on bank-based financial systems and the high debt-equity ratios of corporations have made the economic distress especially acute. Weak firms in East Asia operated on thin margins in the years leading up to the crisis, and their inability to pay interest following the onset of the crisis has added to their debt burden. Such firms constitute a significant portion of the corporate sector in each of the crisis economies, and the appetite to invest in them is extremely limited. They will continue to act as a drag on investment and growth until the financial claims on them are resolved, and either their operations return to adequate profitability or their assets are redeployed.

Without vigorous corporate and financial restructuring, the return to sustainable growth will likely take longer, the fiscal costs of the crisis could rise, and the economies will remain vulnerable to new external and internal shocks.

Recognizing the urgency, East Asian governments were quick to create an institutional structure for corporate and financial restructuring; they also earmarked funds for bank recapitalization. The political momentum for

reform has, however, slowed down, in part because the deeper structural problems now need to be addressed. Experience from other economies, including Japan's, shows that a slackening of the reform effort can undo progress.

Government restructuring policies need to be guided by two principal considerations: limiting the likelihood of systemic disruption while also containing fiscal costs; and clarifying financial claims and building an environment conducive to asset reallocation. Based on these two principles, fiscal costs come principally from the government's social contract to protect bank depositors and to prevent systemic failure. Government funds are not required for corporate restructuring.

Bank restructuring is important because it contributes to both policy objectives. Expediently restoring the health of the banking system is required, but the process of restructuring itself can be disruptive.

Restructuring is necessary because a poorly capitalized banking sector creates continued systemic risks and growing fiscal liabilities for governments. Healthy banks are also best positioned to enforce claims and to pursue corporate restructuring. But restructuring should be undertaken in a manner that ensures the integrity and the organizational capital of the financial system so that prudent lending to businesses and households may continue. Achieving this objective requires making difficult choices. Having provided implicit or explicit guarantees, governments can either move ahead rapidly by taking fiscal responsibility for the costs of the crisis, or they can encourage private resolution of the distress while applying regulatory forbearance. Waiting to resolve problems is likely to make them worse. However, expeditious and transparent action should be accompanied by market-based measures to recoup fiscal costs and to signal a credible commitment to severely restrict guarantees and bailouts in the future.

Corporate restructuring needs to deal first with the delineation and allocation of losses.

Improvements in accounting standards and bankruptcy regimes can help support this process. However, in the absence of effective bankruptcy procedures, out-of-court procedures offer a mechanism for resolution. Once financial claims are resolved, corporate restructuring can be expected to occur through natural market forces, except where a major impediment prevents such forces from working. Governments can facilitate asset mobility by creating the framework for effective domestic and cross-border mergers and acquisitions. The Japanese experience cautions that, without an adequate infrastructure for resolving claims and for fostering asset mobility, fundamental corporate restructuring can be interminably deferred at a high economic cost even in a sophisticated economy.

Managing the recent commodity price cycle

Primary commodity prices have undergone a pronounced cycle since the mid-1990s, driven by both temporary and secular factors.

Primary commodity prices continue to be more volatile than the prices of manufactures. Energy prices have been especially volatile. Crude oil prices rose 74 percent from early 1994 through the end of 1996, then fell 56 percent by the end of 1998, and in 1999 recovered nearly the entire decline of the previous two years. Average non-oil commodity prices rose by 46 percent from the monthly low in mid-1993 to mid-1997, and then dropped 30 percent by late 1999. The cycle in primary commodity prices was driven by changes in global demand, weather-related supply shocks, supply responses to the high prices of the early 1990s, technological innovations that have reduced production costs, and exchange rate depreciations among large commodity exporters linked to the East Asian crisis.

Such volatility poses real challenges to developing countries that depend on primary commodities for a substantial share of their export revenues. Countries where consump-

tion rises with real incomes during commodity price booms may face either painful reductions in consumption or declines in investment that reduce long-term growth when prices fall. Countries' savings and investment behavior differed markedly over the recent commodity price cycle; these differences primarily reflected the quality of policies rather than shifts in the terms of trade.

In the oil exporting countries weak policy environments led to mixed savings performance and lower investment over the oil price cycle. On average, countries allocated to increased consumption about half of the average 5 percent of GDP improvement in real incomes during the upswing in oil prices (1996–97). During the 1998 drop in oil prices, however, consumption did not decline, implying that savings fell by the full amount of the decline in real incomes. Countries' performances varied greatly, depending on their specific political and economic circumstances.

Oil exporting countries' investment fell relative to output over the commodity price cycle. The decline in investment was actually greater than the decline in domestic savings, so the current account deficit fell. The major oil exporting countries have generally failed to reduce their dependence on oil revenues, and the fall in investment will further impede progress. At the same time, several of these

countries face high levels of unemployment, continued slow growth, and rapidly expanding populations. They need to strengthen their policies to encourage greater private sector (and non-oil) activities and to improve the institutional environment.

The commodity price cycle of the 1990s does not appear to have adversely affected the prospects for growth in the non-oil exporting countries of Sub-Saharan Africa. Changes in real incomes were generally smaller than in the oil exporting countries because the price of their commodity exports changed by less than the price of oil, and the losses from declining export prices were partially offset by gains from lower import prices, particularly energy prices. More important, however, improvements in policies in several countries enabled them to increase savings and investment rates during both commodity price booms and busts. Many countries cut their fiscal deficits in an effort to rein in the growth of debt and to reduce inflation, while private savings rose in response to improved policies that increased the return to investment, particularly in export sectors. Countries with better policies, as measured by the World Bank, achieved larger increases in savings and higher growth of GDP than countries with worse policies, despite smaller increases in real incomes in the former group.

Abbreviations, Acronyms, and Data Notes

ASEAN	Association of Southeast Asian Nations
ASEAN-4	Indonesia, Malaysia, Philippines, and Thailand
BIS	Bank for International Settlements
CFA	Communauté Financière Africaine
CIS	Commonwealth of Independent States
CPI	Consumer price index
East Asia-5	Indonesia, Malaysia, the Philippines, the Republic of Korea, and Thailand
ECB	European Central Bank
ECLAC	United Nations: Economic Commission for Latin America and the Caribbean
EMU	European Monetary Union
ERM	Exchange rate mechanism
EU	European Union (formerly the EC)
EU-4	France, Germany, Italy, and the United Kingdom
EU-12	Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom
EU-15	Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom
FDI	Foreign direct investment
G-3	Germany, Japan, and the United States
G-5	France, Germany, Japan, the United Kingdom, and the United States
G-7	Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States
G-8	Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States
G-10	Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States (and sometimes Switzerland is involved)
G-22	Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong (China), India, Indonesia, Italy, Japan, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Thailand, the United Kingdom, and the United States

GCC	Gulf Cooperation Council
GDP	Gross domestic product
GTAP	Global Trade Analysis Project
HIPC	Heavily indebted poor countries
ILO	International Labour Organisation
IMF	International Monetary Fund
LIBOR	London interbank offered rate
M2	A measure of broad money supply in the United States
Mercosur	Latin America Southern Cone trade bloc (Argentina, Brazil, Paraguay, and Uruguay)
MUV	Manufactures unit value index
NIE	Newly industrializing economy
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of Petroleum Exporting Countries
UNCTAD	United Nations Conference on Trade and Development

Data notes

The “classification of economies” tables at the end of this volume classify economies by income, region, export category, and indebtedness. Unless otherwise indicated, the term “developing countries” as used in this volume covers all low- and middle-income countries, including the transition economies.

The following norms are used throughout.

- Billion is 1,000 million.
- All dollar figures are U.S. dollars.
- In general, data for periods through 1997 are actual, data for 1998 are estimated, and data for 1999 onward are projected.