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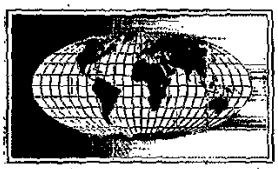

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How a Coping Scenario for the Global Financial Crisis Could Unravel

Many financial analysts say the global economy will shake off Southeast Asia's economic troubles with only a modest reduction in growth growth rates in the US and Europe will decline by about one-third percentage point next year and that an upward growth path will resume within 18 months.

— This scenario includes a $50-60 billion improvement next year in ASEAN current account balances offset by deteriorating trade balances in Japan, the US, and Europe.

What Could Go Wrong?

The global economic outlook would worsen considerably if deflation in Japan and a weak yen made ASEAN exports less competitive or if Korea's financial crisis deepened further. Alternatively, higher interest rates in the US and Europe would undermine the exchange rate and macro policy adjustments already made in Asia and Latin America to cope with their financial problems.

— East Asian and Latin American economies remain vulnerable to further shocks because every month they must renew large amounts of short-term foreign credits; South Korea must roll over about $6 billion monthly, and the total for Brazil may be as much as twice this high.

— Seoul and Tokyo last week hinted at rescue packages for their financial sectors, but the measures may be insufficient.

If the crisis extended to Japan or worsened in Korea, Asia's economic problems would mount rapidly. Slow growth and weak currencies in Japan and Korea would erode many of the gains of the last round of currency depreciations in Southeast Asia; ASEAN growth and exports would be depressed, and another round of sharp depreciations would be unavoidable.

— US growth would be cut about 1 percentage point and the US current account deficit would increase by $45 billion next year and $75 billion in 1999,

— World trade would be reduced by nearly $400 billion a year, reflecting a broader global economic slowdown.

Barriers to Absorbing Asia's Exports

If tighter economic measures in the US—reflecting recent data that suggest rising US wages and a taut labor market—coincided with the spreading and deepening Asian economic crisis, the US economy would have difficulty absorbing increased exports from Asia. At the same time, EU economic policy makers would be constrained from responding to the Asian crisis if they are focused on satisfying Maastricht deficit criteria and setting internal exchange rates.

— A 0.5-percentage-point increase in US interest rates would add $150 million each month to the rollover obligations in Asia and Latin America and cut US growth and imports.

— Under this scenario, Asia and Latin America would face further economic and political turmoil as capital inflows slowed and trade fell.