However, once the banking sector deals with the bad-loan problem, and deregulation in the finance and retail sectors starts to take effect, the economy will have dropped so far below potential that a number of years of strong growth are anticipated.

2.1.3 Outlook in Emerging Markets

The risk environment in developing countries deteriorated significantly in 1998. Southeast Asia underwent a financial meltdown of enormous proportions, and Russia recently experienced the effects of a significant loss of investor confidence. These events illustrate the ease with which, in today's intertwined global economy, financial crises can be transported from one economy to another via the global capital market.

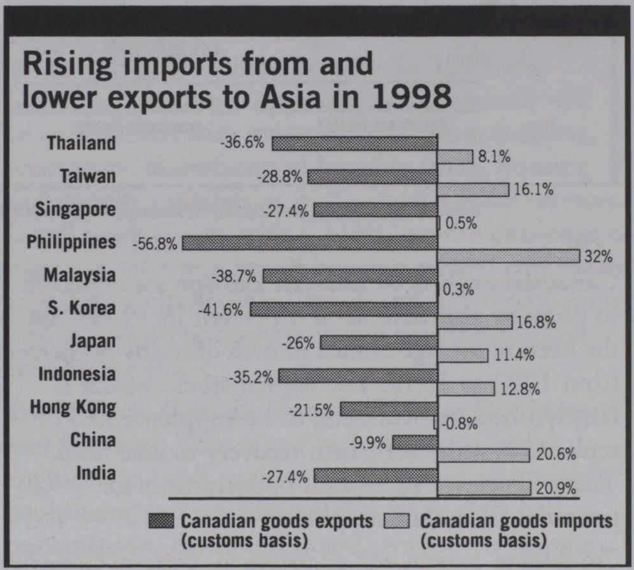
It is the volatility of this unbridled capital market that poses the greatest threat in the risk environment of the developing world. In the wake of the Asian flu, global investors are reassessing the risks and rewards of investing in emerging markets. However, over the longer term, they will likely return to these markets given the attraction of higher returns and the benefits of having a diversified portfolio.

A large portion of this investment will continue to be in the form of purchases of tradable bonds, equities and money market instruments – securities that can be readily sold at the first sign of trouble. The highly liquid nature of these instruments makes them susceptible to capital flight. To add to the volatility, much of this investment is concentrated in mutual funds dominated by American mutual- and hedge-fund investors, which operate with less-than-adequate information in an inadequately regulated world capital market. This "nervous money" could easily capsize many emerging economies, at the very time that many third-world governments are looking to their private sectors to assume greater responsibility for development.

At its core, the crisis in global emerging markets is a crisis of over-investment. From steels slabs to cars, from wood chips to computer chips, we have the capacity to produce far more than we currently consume. With so much excess capacity in virtually all sectors of traded goods, prices are under constant pressure. So the real issue for the Asian crisis economies, as for the world economy, is: Will there be enough growth in the rest of the world to absorb this surge of cheap exports?

The steady decline of commodity prices in recent years was partly due to over-capacity in the global commodity market. This deflationary pressure eroded the profit base of a good number of Canadian commodity producers.

In this sensitive environment, and because of **Asia's** ongoing economic and financial turmoil, Canadian exports to that region are expected to remain virtually flat in 1999 and for the rest of the planning period. A stronger performance is expected from the big economies of China and India: Canadian exports to these countries are expected to rise by 3 percent in 1999.



Source: DFAIT/Trade and Economic Analysis Division (EET)

The sharp depreciation in early 1999 of the Brazilian currency, the real, introduced some added volatility to world financial markets, though the effects have been so far limited largely to Brazil's regional trading partners. However, in the first quarter of 1999, Brazil's current account deficit was slightly smaller than in the same quarter last year. This is a sign that **Central/South America**, led by Brazil, may be bottoming out of the crisis.

The deepening economic crisis in Central/South America has worsened Canada's trade with these economies. For the first two months of 1999, Canadian exports to Mexico declined by 14.6 percent, to Brazil by 22 percent, and to Colombia by 40.8 percent. According to DRI forecasts, in 1999 the real GDP of Brazil is expected to decline by 3.1 percent and that of Argentina by 1.8 percent, before posting growth of 1.8 percent for Brazil and 2.8 percent for Argentina in 2000. Canada's exports to Brazil and Argentina in 1999 will remain lacklustre before recovering in 2000. Prospects for Canada's trade growth with Mexico remain solid in 1999 and 2000.