



## WORLD ECONOMIC OUTLOOK

The Board's biannual reviews of the World Economic Outlook are an integral part of the Fund's ongoing surveillance of economic developments and policies in its member countries and of the global economic system. These surveys of prospects and policies are the outcome of a comprehensive review of world economic developments and comprise detailed analyses of short-term and medium-term prospects for the world economy, as well as for individual countries and country groups. They draw for the most part on the information gathered through the staff's consultations with member countries and provide a framework for assessing the relationships among the economic policies of Fund members.<sup>3</sup>

In the 1995/96 financial year, the Board held two discussions on the World Economic Outlook, in September 1995 and March 1996. Both sessions covered a wide range of topics. In light of the dominant role international financial markets now play in the global economy, in their September 1995 discussion Directors paid special attention to the relationship between domestic policy and global integration, particularly for emerging market economies. In March 1996, they concentrated on the fiscal issues that need to be tackled worldwide to put countries on sustainable economic growth paths (see Box 1).

### Global Situation

In September 1995, when Directors assessed the overall world economic situation, they agreed that it remained broadly positive, with much of the membership enjoying continued economic growth and relatively low inflation.

Directors observed that the world economy had shown resilience to recent episodes of financial market turmoil. They welcomed the realignment of the

world's major currencies, which seemed to have corrected much of the overshooting earlier in the year and reduced the downside risks to prospects for noninflationary growth in some major countries. Continued policy vigilance was needed to reap the full benefits of this favorable outlook. Directors viewed the Madrid Declaration adopted by the Interim Committee in October 1994 (*Annual Report, 1995*, pages 207–208) as still providing a broadly relevant framework on which to base policy orientation.

As regards the main risks facing the world economy, several Directors expressed concern that some of the possible underlying causes behind financial market turbulence earlier in the year might again lead to shifts in market sentiment. They pointed to the risks associated with volatility in globalized financial markets and growing concerns about the stability of banking systems in several countries. Several Board members also cautioned against overreacting to a likely temporary slowdown in economic expansion in some of the large industrial countries by delaying plans for fiscal consolidation or pursuing excessively stimulative monetary policies. Directors stressed that countries needed to address forcefully the problems of high structural unemployment and excessive budget deficits.

In their March 1996 review of the world economy, Directors observed that economic growth on average had held at a satisfactory rate, although it had slowed more markedly than expected in both western Europe and North America. In some countries this had led to further increases in unemployment from already high levels. But with inflation subdued and interest rates quite moderate in most countries, Directors expected only a temporary slowdown and remained optimistic about world growth prospects. Meanwhile, economic activity remained strong in the developing world, particularly in emerging market economies where there had been bold stabilization and reform efforts. On risks to the global outlook, Directors generally agreed with

<sup>3</sup>After the Board's review, the staff reports on the World Economic Outlook are published in May and October; background studies for the review are also published.

the staff that the biggest threats stemmed from inadequate saving levels and serious fiscal imbalances.

### Industrial Country Policies

During the September 1995 discussion, Directors saw the modest downward revisions in growth projections in most industrial countries—except Japan—as reflecting a temporary midcycle pause in the expansion, with underlying growth fundamentals still generally positive. In the United States, the United Kingdom, Australia, and New Zealand, the moderation in growth was expected to help alleviate inflationary pressures, although monetary policies would need to remain prudent. Among the continental European countries, where output gaps were larger, the expansion was seen as likely to continue at a pace somewhat above potential growth, but progress in reducing unemployment was expected to be slow. Thus, a recent easing of official interest rates in Germany, France, and several other countries was welcomed in light of the favorable outlook for inflation, and the need to sustain satisfactory rates of growth.

In Japan, a pickup in growth was seen as likely in 1996, given the orderly reversal of the yen appreciation and the stock market's advance. Directors welcomed the further cut in official interest rates in early September, and they stressed the need to ensure that the supplementary fall 1995 budget avoided a withdrawal of fiscal stimulus until the recovery was well under way. While some Directors called for additional fiscal stimulus, others pointed to the longer-term costs of further fiscal deterioration—they felt that, after the recent easing, monetary and fiscal policies were not likely to provide much more help in stimulating growth. Most speakers agreed that major structural reforms—further deregulation and market opening—were needed to revitalize the Japanese economy. The successfully managed closure of some insolvent financial institutions was an important step toward the resolution of the problem of bad loans. Directors cautioned, however, that other financial institutions might need restructuring, and financial sector problems might continue to slow recovery.

On broader policy issues, Directors expressed continued concern at the economic and social costs of high levels of structural unemployment, particularly in Europe. Governments were urged to reduce labor market distortions that contributed to high unemployment (such as reducing employers' social insurance contributions for the young and low-skilled), lessen the impact of minimum wages for young workers, increase wage flexibility by reducing or eliminating indexation provisions, and improve education and training.

While observing the progress on the fiscal front in some industrial countries, Directors also stressed that much remained to be done to restore an adequate

degree of fiscal balance and to put public debt-to-GDP ratios on a clearly declining trend. They warned against fiscal adjustment fatigue and urged countries to continue to use the expansion wisely by putting fiscal houses in order. Fiscal consolidation remained essential to alleviate pressures on global real interest rates and to offset the growing invisible liabilities of most public pension and health care programs.

Directors generally agreed with the staff's conclusions that, in countries with large risk premiums in bond yields and highly depreciated currencies, fiscal consolidation might substantially improve confidence and reduce risk premiums, as well as strengthen exchange rates in the relatively short run. In other cases, the short-run effects of fiscal consolidation on the exchange rate were complex, since the immediate interest rate effect would tend to weaken the exchange rate, while confidence effects might well pull in the opposite direction. In the longer run, however, an improved budget stance and the resulting rise in national saving would tend to strengthen the equilibrium net foreign investment position, which, in turn, should imply a stronger currency.

At the March 1996 discussion, Directors agreed with the staff's projections that economic growth in western Europe and North America would pick up again in the second half of 1996, but that growth for the year as a whole would be substantially less in France and Germany than had been projected in the fall of 1995. For much of Europe, the moderate pace of expansion projected for 1996 indicated that it would take some time for labor market slack to be absorbed. Directors emphasized the adverse effects of structural rigidities in labor markets and a loss of confidence—perhaps owing to uncertainties about the timetable for EMU—as contributing factors to the European slowdown. More generally, several speakers pointed to the disappointing lack of dynamism and the slow pace of structural adjustment in most European economies.

Most Directors also observed that in Europe there was a divergence in growth performance between two groups of countries. Growth had been relatively well-sustained, although initially unbalanced in some cases, in those countries whose currencies had depreciated in recent years, while economic activity had stagnated and unemployment had turned upward again in the hard-currency countries. It was the view of many Directors that this divergence reflected, in part, differences in the mix and stance of policies: in the weak-currency countries, fiscal policy had been tightened to curtail large fiscal imbalances, and monetary conditions had eased significantly, especially given the depreciation of their currencies in the wake of the 1992–93 crisis in the EMS; in the hard-currency countries, progress toward fiscal consolidation had been more mixed, and mone-

## Box 1

## FISCAL PROBLEMS AND POLICIES

As countries look ahead, it is clear that a number of problems need to be addressed more adequately to reduce risks of adverse financial market reactions, to enhance countries' resilience to adverse economic disturbances, and to strengthen growth in the medium to longer run. Because many of these problems fall in the fiscal area, the Board's discussion of the World Economic Outlook in March 1996 paid special attention to fiscal policy.

**Fiscal Overview**

Directors generally agreed that budget deficits were too large in many countries and that this represented a major economic problem. Such deficits were seen as giving an upward bias to real world interest rates, crowding out investment spending, and adversely affecting long-term growth. The problem of potentially unfavorable spillover effects through highly integrated financial markets was noted, as was the considerable—albeit less visible—debt burden that many countries faced because public pension systems would experience large imbalances between inflows and outflows as populations aged during coming decades.

Overall, the discussion revealed that there was more to the fiscal problems fac-

ing all countries than met the eye. In particular, Directors agreed that there was a need to reform budgeting processes and to provide for greater transparency in government balance sheets so that the assessment and formulation of fiscal policy could be improved and made more forward-looking. Among the proposals suggested to improve fiscal transparency, and thereby discipline, were multiyear budget forecasts, assessments of contingent liabilities and fiscal risks, and statements of unfunded liabilities.

**Industrial Countries**

Directors shared the staff's assessment that, despite progress, budgetary imbalances remained a serious problem in most industrial countries. They generally agreed that the root cause of budget deficits over the past 25 years in these countries had been excessive expenditure growth, which had persistently outstripped revenue growth. This growth had been largely the result of rapidly rising outlays for transfer payments, public pensions, and interest costs. There had been a particular problem with entitlement spending, especially with health care in the United States and public pensions in Europe. Steady increases in Europe's structural unemployment had

also contributed to budgetary imbalances in that part of the world. Although ratios of debt to GDP had flattened out in some of these countries in the mid-1990s, they remained on unsustainable trajectories for many countries, and in almost all cases debt levels were much higher than 15 years ago.

Noting that the present value of unfunded future claims associated with public pension plans in many countries now exceeded total GDP, and that pension plans in some of the major industrial countries were likely to face contribution gaps, Directors concurred that a solution would need to include higher contribution rates, lower benefits, and increased retirement ages.

Directors observed that fiscal consolidation could give a powerful boost to industrial countries' medium- and long-term performance, and they emphasized that bolder policy actions were more likely to succeed than more limited efforts. In particular, budget cuts focused on reducing transfer payments and other government outlays would tend to be more effective than those that relied more heavily on tax increases.

tary policies and exchange rates now appeared to have restricted activity more than was previously thought.

While most Directors agreed that exchange rate depreciation had helped to rekindle activity in some countries, several Directors stressed that a depreciation strategy was not a generally sustainable policy option and pointed out the inflation risk and the important contribution of the hard currencies to global price stability.

There was a consensus among Directors that the European slowdown was temporary, but there was some uncertainty about the timing and strength of the expected pickup in activity. Several Directors noted that lower short-term interest rates and stronger fiscal consolidation plans in the hard-currency countries in recent years had enhanced the prospects for stronger growth in the year ahead. Those Directors saw little risk that some further monetary easing would increase inflationary pressure, noting the significant margins of slack in most European countries. They agreed with

the staff view that there was scope for some monetary relaxation in light of the downside risks. Others, however, saw less room to maneuver, given the signs of a pickup in the growth of monetary aggregates in some countries. Directors concurred that most countries needed to continue to pursue consolidation of structural deficits first and foremost, but also to ensure sufficient convergence for the creation of the monetary union.

In the United States, growth was expected to hold close to potential in 1996 and 1997, with expansion supported by the decline in interest rates in late 1995 and the continuing competitiveness of the dollar. There was general agreement that the level of U.S. short-term interest rates was broadly appropriate and that there did not seem to be a strong case for further significant monetary easing unless the economy performed more weakly than expected. In Japan, economic activity appeared to be picking up after a protracted slowdown, supported by appropriate mone-

### Developing Countries

The Board welcomed the marked improvement in the fiscal stances of many developing countries since the 1980s, noting that better fiscal policies had played a key role in promoting a more stable macroeconomic environment, stronger domestic saving and investment, and market-oriented structural reform. Directors generally agreed that the growth and composition of public expenditure in many developing countries often reflected excessive state involvement in activities that could be carried out more efficiently by the private sector. Many Directors emphasized that weakness in government revenues was also often a critical problem, and that priority should be given to broadening the tax base and improving collection.

Directors observed that a large number of public sector activities conducted through quasi-fiscal institutions did not result in immediate budgetary outlays but frequently entailed the creation of contingent or unfunded liabilities. They warned that, in some developing countries, improvements in the central government's fiscal balance might misrepresent the true evolution of the public sector's overall financial position. In such cases the appearance of fiscal discipline in the central government's accounts might not be

sufficient to ensure macroeconomic stability.

Regarding the link between fiscal policies and economic growth, several Directors noted that whether fiscal policies promoted growth depended on the extent to which the level and composition of government expenditure boosted the stock of physical and human capital, and on whether government services complemented private sector activity. Although some governments might be able to resort to foreign saving, the buildup of external imbalances raised a country's vulnerability to sudden reversals of capital flows, with disruptive consequences for domestic policies and economic activity. Indeed, the need to limit reliance on foreign saving and short-term capital inflows might justify a strengthening of fiscal policies in countries that had already achieved a high degree of fiscal balance.

### Economies in Transition

Directors acknowledged the substantial progress toward fiscal consolidation made by most transition countries. Those more advanced in transition to a market economy had generally held fiscal deficits to modest levels as a percent of GDP or had recorded small surpluses. Directors also welcomed the fiscal consolidation efforts in those countries less advanced in transition,

noting that sound public finances were a fundamental prerequisite for the prudent monetary and credit policies essential for stabilization. Several Directors expressed concern about the apparent weakness of tax revenue systems in countries less advanced in transition; they concurred with the staff's assessment that, if not corrected, weak tax revenues, compounded by poor tax administration, posed a serious threat to stabilization.

Directors welcomed the progress made by transition countries in redefining the role of the state. They expressed concern, however, that government intervention in the economy through various off-budget and quasi-fiscal measures remained a problem, since these activities constituted contingent liabilities with potentially large fiscal costs. (See the section on Fiscal Considerations in Policymaking.) By shielding inefficient state enterprises from market forces, off-budget and quasi-fiscal measures also distorted resource allocation and undermined fiscal stabilization. Directors also underscored the need for strengthening social safety nets, in order to alleviate the adverse effects of enterprise restructuring and other reforms, and for reforming pension plans, in order to secure the progress being made toward fiscal consolidation.

tary and fiscal policies and the correction of the yen's excessive appreciation in the first half of 1995. Once growth was firmly established, Directors felt fiscal consolidation must be a priority for policymakers.

In the September 1995 discussion, Directors observed that price performance had improved in many countries, and inflation was expected to remain low in the world economy even though there was no room for complacency with respect to the need to safeguard and continue progress toward reasonable price stability. A series of pre-emptive monetary tightening moves in countries where slack was rapidly absorbed during 1994 demonstrated the commitment by central banks to price stability and thus served to reduce inflationary expectations. Although producer prices had picked up in some areas, wage increases remained moderate in most countries, and earlier pressures in commodity markets had abated somewhat. Directors stressed that the inflation outlook depended on the continued pursuit of prudent macroeconomic policies.

In the same discussion, noting the complexity of assessing the consistency of exchange rates with economic fundamentals, several Board members pointed to the difficulty of identifying equilibrium exchange rates. Directors agreed, however, that movements in key currency values and interest rates in the first half of 1995 had not reflected only economic fundamentals. They welcomed the coordinated intervention by central banks, which had helped to correct misalignments and had demonstrated, under appropriate market conditions, the benefits of cooperative action among the major industrial countries. At the same time, they cautioned against drawing too broad a conclusion that exchange market intervention was a generally powerful and reliable tool that could be used to influence exchange rates in all circumstances. They stressed that, if recent successes in correcting exchange rate misalignments were to endure, they should be solidly supported by adequate macroeconomic and structural policies.

### Developing Country Policies

In the September 1995 discussion, Directors noted the continuing strong growth prospects in much of the developing world, and they welcomed the extent to which the contagion effects of the financial crisis in Mexico appeared to have been successfully contained. Directors observed that after the Mexican crisis had been contained, financial markets had become more discerning as regards the economic fundamentals among developing countries, and capital inflows had remained high or had resumed in many cases, including in several Western Hemisphere countries. In Asia, although the prospect of a fourth consecutive year of very high growth was welcomed, Directors cautioned about the risks of overheating in some countries. In Africa, Directors noted that growth prospects had improved with more favorable external conditions and the adoption of market-oriented policies by a growing number of countries; but many deep-seated structural weaknesses remained to be tackled, and potential policy slippages constituted a risk to the forecast. In the Middle East, growth prospects were seen generally to have improved, but earlier declines in oil prices were likely to hurt the oil exporting countries.

The robust growth in many developing countries was seen as having been associated with increased openness and greater integration into the global economy, both through traditional trade links and through new financial links. Strong and consistent reform and stabilization efforts had promoted increased openness, contributed to the impressive growth performance of many developing countries, and made them more resilient to cyclical downturns in the industrial countries. Industrial countries were also felt to have benefited from this process, through its positive impact in sustaining the growth of world trade and output. Significant trade barriers were still prevalent in a number of developing countries, however, and appropriate policies were needed to make these economies more responsive to the new trading opportunities arising from increased global integration and the conclusion of the Uruguay Round.

Directors recognized that closer integration also posed new risks for many developing countries. The Mexican financial crisis highlighted the risk of economic disruptions from sudden reversals of capital flows, especially in countries where macroeconomic fundamentals were not sufficiently strong. Directors emphasized that it would be essential to strengthen domestic financial markets and address macroeconomic policy imbalances in some countries for them to benefit fully from a closely integrated world economy.

For countries experiencing large capital inflows, Directors urged policymakers to ensure that fiscal policy remained prudent and did not add to pressure on monetary policy to restrain domestic demand. In some

countries, greater flexibility of exchange rates might be warranted on the basis of improvements in economic fundamentals and would also help to contain inflation. Directors underscored the need to strengthen prudential regulations, address weaknesses in financial systems, and guard against excessive increases in domestic credit, especially where foreign capital inflows were intermediated largely through the domestic banking system.

The Board agreed that freedom of capital movement would promote growth and improve resource allocation over the longer run. Some Directors considered that liberalization of the capital account should be undertaken gradually in economies where financial markets were not well developed, banking sectors were fragile, or macroeconomic imbalances had not been corrected. Directors stressed, however, that a phased approach should not lead to undue delays in capital account liberalization, especially since the latter could serve as an impetus for financial reforms and strengthen the domestic financial system. Some Directors observed that measures to limit short-term foreign-currency-denominated borrowing by banks might be justified on prudential grounds, and that broader measures to discourage excessive short-term debt-creating or portfolio inflows might prove useful in some circumstances. Capital flow restrictions should, however, be viewed as temporary measures and not as a substitute for stronger adjustment efforts.

At the time of the March 1996 review of the World Economic Outlook, Directors welcomed the continued growth momentum in the developing world as a whole and its remarkable resilience to external disturbances. Directors looked for growth to remain buoyant, but to slow slightly, during 1996 in Asia— allaying to some extent earlier concerns about overheating and current account deficits. Nevertheless, macroeconomic and exchange rate policies would need to reflect the challenge that managing large capital inflows posed for many emerging market countries. In the developing countries of the Western Hemisphere, growth was expected to recover following successful adjustment efforts by countries affected by the Mexican crisis, while in the Middle East improved regional stability was seen as enhancing economic growth prospects. For many of the oil-producing countries, however, large—albeit declining—fiscal deficits continued to cloud the outlook. For Africa, Directors welcomed signs of stronger growth, resulting from the stronger macroeconomic and structural policies implemented by a number of countries in recent years. At the same time, they cautioned that the economic outlook remained fragile, vulnerable to slippages in adjustment and reform efforts and to weaker commodity prices.

### Policies in Economies in Transition

During the September 1995 discussion, Directors welcomed the improved outlook in some of the transition economies, noting the extent to which economic performance had varied depending on progress in macroeconomic stabilization and structural reform. In a number of the countries more advanced in the transition process, output was expanding vigorously, and Directors agreed that policies should aim at sustaining growth and disinflation, continuing structural reforms, and, in particular, deepening the role of market-oriented principles. In countries where progress with stabilization and reform remained inadequate or fragile, however, Directors saw economic activity as likely to continue to decline. These countries, it was believed, needed to concentrate on achieving or consolidating macroeconomic stabilization and on establishing market-oriented institutions.

Directors expressed concern about the fragility of the banking system in almost all of the transition economies, including in some of those most advanced in the transition process. They agreed that a comprehensive banking and enterprise reform strategy was necessary to resolve problem loans early on. Weaknesses in the banking system should be addressed through strengthened banking supervision, improved

assessment of credit risk, more stringent capital requirements, and greater participation by foreign banks to spur the modernization of domestic banking practices. Banking sector reform would improve corporate efficiency in the enterprise sector, which, in turn, would further strengthen banks by increasing the number of economically viable borrowers. In the meantime, where banking crises emerged, they needed to be dealt with promptly and in a manner that discouraged their recurrence.

During their March 1996 discussion, Directors welcomed the improved growth prospects and the progress that had been made toward financial stabilization in many transition countries. They noted that robust growth in many of the countries more advanced in transition, where inflation had been reduced significantly, underscored the importance of financial stabilization. In most countries less advanced in transition, output had either stabilized in 1995 or was expected to stabilize in 1996. Directors urged the authorities in these countries to persevere with disciplined financial policies and structural reforms so as to provide the basis for sustained growth. In that context, Directors pointed to the importance of the resolute implementation by Russia of its program supported under the extended Fund facility.

