

# WORLD ECONOMIC OUTLOOK

October 1999

**A Survey by the Staff of the  
International Monetary Fund**



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## Assumptions and Conventions

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates will remain constant at their average levels during July 26–August 16, 1999 except for the bilateral rates among the European exchange rate mechanism (ERM) currencies, which are assumed to remain constant in nominal terms; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary policies in industrial countries, see Box 1.2); that the average price of oil will be \$16.70 a barrel in 1999 and \$18.00 a barrel in 2000, and remain unchanged in real terms over the medium term; and that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 5.4 percent in 1999 and 6.1 percent in 2000. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The estimates and projections are based on statistical information available in early September 1999.

The following conventions have been used throughout the *World Economic Outlook*:

- . . . to indicate that data are not available or not applicable;
- to indicate that the figure is zero or negligible;
- between years or months (for example, 1997–98 or January–June) to indicate the years or months covered, including the beginning and ending years or months;
- / between years or months (for example, 1997/98) to indicate a fiscal or financial year.

“Billion” means a thousand million; “trillion” means a thousand billion.

“Basis points” refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to  $\frac{1}{4}$  of 1 percentage point).

In figures and tables, shaded areas indicate IMF staff projections.

Minor discrepancies between sums of constituent figures and totals shown are due to rounding.

As used in this report, the term “country” does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.



## Further Information and Data

This report on the *World Economic Outlook* is available in full on the IMF's Internet site, [www.imf.org](http://www.imf.org). Accompanying it on the website is a larger compilation of data from the WEO database than in the report itself, consisting of files containing the series most frequently requested by readers. These files may be downloaded for use in a variety of software packages.

Inquiries about the content of the *World Economic Outlook* and the WEO database should be sent by mail, electronic mail, or telefax (telephone inquiries cannot be accepted) to:

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## Preface

The projections and analysis contained in the *World Economic Outlook* are an integral element of the IMF's ongoing surveillance of economic developments and policies in its member countries and of the global economic system. The IMF has published the *World Economic Outlook* annually from 1980 through 1983 and biannually since 1984.

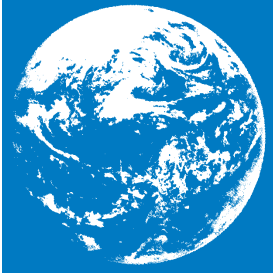
The survey of prospects and policies is the product of a comprehensive interdepartmental review of world economic developments, which draws primarily on information the IMF staff gathers through its consultations with member countries. These consultations are carried out in particular by the IMF's area departments together with the Policy Development and Review Department and the Fiscal Affairs Department.

The country projections are prepared by the IMF's area departments on the basis of internationally consistent assumptions about world activity, exchange rates, and conditions in international financial and commodity markets. For approximately 50 of the largest economies—accounting for 90 percent of world output—the projections are updated for each *World Economic Outlook* exercise. For smaller countries, the projections are based on those prepared at the time of the IMF's regular Article IV consultations with those countries or in connection with the use of IMF resources; for these countries, the projections used in the *World Economic Outlook* are incrementally adjusted to reflect changes in assumptions and global economic conditions.

The analysis in the *World Economic Outlook* draws extensively on the ongoing work of the IMF's area and specialized departments, and is coordinated in the Research Department under the general direction of Michael Mussa, Economic Counsellor and Director of Research. The *World Economic Outlook* project is directed by Flemming Larsen, Deputy Director of the Research Department, together with Graham Hache, Assistant Director for the World Economic Studies Division.

Primary contributors to the current issue include Francesco Caramazza, John H. Green, Maitland MacFarlan, Peter Sturm, Luis Catão, Mark De Broeck, Luca Ricci, Ranil Salgado, Cathy Wright, and Harm Zebregs; and Robert Sharer, Marc Auboin, and Bradley McDonald of the Trade Policy Division of the Policy Development and Review Department who prepared Chapter V. Other contributors include Sanjeev Gupta, Richard Hemming, Kalpana Kochhar, Arvind Subramanian, Steven Symansky, Subhash Thakur, and Andrew Tweedie. The Fiscal Analysis Division of the Fiscal Affairs Department computed the structural budget and fiscal impulse measures. Gretchen Byrne, Mandy Hemmati, Yutong Li, and Anthony G. Turner provided research assistance. Allen Cobler, Nicholas Dopuch, Isabella Dymarskia, Yasoma Liyanarchchi, Olga Plagie, and Irim Siddiqui processed the data and managed the computer systems. Susan Duff, Caroline Bagworth, and Lisa Nugent were responsible for word processing. James McEuen of the External Relations Department edited the manuscript and coordinated production of the publication.

The analysis has benefited from comments and suggestions by staff from other IMF departments, as well as by Executive Directors following their discussion of the *World Economic Outlook* on September 1 and 3, 1999 (see Annex). However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities.



# I

## World Economic Outlook and the Challenges of Global Adjustment

Global economic and financial conditions have improved markedly after the turbulence in emerging markets in 1997–98, which gave rise to fears of a widespread credit crunch and global recession, and most of the economies recently in crisis have begun to recover. But many challenges remain to be addressed to ensure that these recoveries are sustainable, and to foster stronger and more stable growth in the world economy in the next decade. There is particular reason for concern about the unbalanced pattern of growth observed recently among the major industrial countries and about the economic and financial consequences worldwide if the eventual demand slowdown in the United States turns out to be sharper than is generally expected at present. While the return to broad price stability remains an important policy achievement, macroeconomic instability has persisted in much of the world economy, continuing to pose challenges for, and in many ways making new demands on, economic policies.

The world economy appears to be on the mend following the global slowdown in 1998 in the wake of the Asian crisis and the further bouts of financial turbulence and contagion associated with the Russian and Brazilian crises. Financial market confidence has been returning in most of the emerging market economies affected by the crises, allowing monetary conditions to ease and setting the stage for economic recovery. For all the Asian crisis economies, growth projections for 1999 have been revised up significantly, and the economic downturns in Brazil and Russia have been shallower than expected earlier. Oil prices have recovered, and declines in many other commodity prices have been arrested, providing relief for some commodity-exporting countries affected by the ripple effects of the slowdown. There has also been an upward revision of growth in Japan, where there was a significant rise in activity in the first half of 1999 following the steep contraction during 1997–98. And the projected strengthening of growth in Europe seems to be materializing, while the impressive U.S. expansion has continued, amid few signs of emerging price or wage pressures.

The many upward revisions to the earlier projections now point to global growth of about 3 percent in 1999,  $\frac{3}{4}$  of 1 percentage point higher than in the May 1999 *World Economic Outlook* (Table 1.1). Global growth thus appears to have bottomed out at  $2\frac{1}{2}$  percent in 1998, in what the projections suggest will have

been the mildest of the four slowdowns in the world economy in the past three decades, even though some countries have suffered particularly severe recessions (Figure 1.1).

However, a great deal of uncertainty still attaches to the world economic outlook for the next couple of years. It is clear that the U.S. expansion has played a critically important role in moderating the global slowdown;<sup>1</sup> but it is also clear that to forestall a build-up of domestic inflationary pressures and to contain the external current account deficit, the rate of growth in the United States will need to slow. The staff's baseline projections assume a “soft landing”—a slowing of growth to sustainable rates with little friction or disruption—but this cannot be taken for granted. The generously valued stock market, the sharp decline in household saving in recent years into negative territory, high business capital outlays, the heavy reliance on foreign saving, and the high exchange value of the dollar relative to medium-term fundamentals all point to strains and imbalances that may lead to a more abrupt slowing of domestic demand. This in turn raises the question of whether demand in Japan and the euro area will strengthen sufficiently to compensate for a slowdown in the United States and to support activity at home and globally. A strengthening of economic conditions outside the United States would help to improve the U.S. current account balance, but it would also tend to reduce international investors' appetite for dollar-denominated assets; it might thus increase the risk of a sharp correction in the dollar relative to the other major currencies, a risk arising from the imbalances in current accounts among the United States, Japan, and the euro area (Table 1.2). These imbalances might also further increase trade tensions.

If growth were to weaken significantly in the United States without offsets in Japan and Europe, there would also be reason for concern about the sustainability of the recoveries underway in the Asian economies recently in crisis, and much of Latin America would be particularly vulnerable under such a scenario. While conditions in emerging financial markets have im-

<sup>1</sup>If real domestic demand in the United States had expanded in line with potential growth in 1998–99 (rather than at the 5.3 percent rate registered in 1998 and the 4.9 percent increase projected for 1999) world growth would have been about  $\frac{1}{2}$  of 1 percentage point weaker in both years.

**Table 1.1. Overview of the World Economic Outlook Projections***(Annual percent change unless otherwise noted)*

	1997	1998	Current Projections		Differences from May 1999 Projections	
			1999	2000	1999	2000
<b>World output</b>	<b>4.2</b>	<b>2.5</b>	<b>3.0</b>	<b>3.5</b>	<b>0.7</b>	<b>0.1</b>
Advanced economies	3.2	2.2	2.8	2.7	0.8	0.4
Major industrial countries	2.9	2.2	2.6	2.4	0.7	0.4
United States	3.9	3.9	3.7	2.6	0.4	0.4
Japan	1.4	-2.8	1.0	1.5	2.4	1.2
Germany	1.8	2.3	1.4	2.5	-0.1	-0.3
France	2.3	3.2	2.5	3.0	0.3	0.1
Italy	1.5	1.3	1.2	2.4	-0.3	0.0
United Kingdom	3.5	2.2	1.1	2.4	0.4	0.3
Canada	4.0	3.1	3.6	2.6	1.0	0.1
Other advanced economies	4.2	2.1	3.5	3.6	1.0	0.2
<i>Memorandum</i>						
Industrial countries	3.0	2.4	2.6	2.5	0.6	0.3
Euro area	2.4	2.8	2.1	2.8	0.1	-0.1
Newly industrialized Asian economies	5.8	-1.8	5.2	5.1	3.1	0.6
Developing countries	5.8	3.2	3.5	4.8	0.4	-0.1
Africa	3.1	3.4	3.1	5.0	-0.1	-0.1
Asia	6.6	3.7	5.3	5.4	0.6	-0.3
China	8.8	7.8	6.6	6.0	0.0	-1.0
India	5.5	5.8	5.7	5.5	0.5	0.4
ASEAN-4 <sup>1</sup>	3.6	-9.8	1.4	3.6	2.5	0.6
Middle East and Europe	4.5	3.2	1.8	3.1	-0.2	-0.2
Western Hemisphere	5.3	2.2	0.1	3.9	0.6	0.4
Brazil	3.7	0.1	-1.0	4.0	2.8	0.3
Countries in transition	2.2	-0.2	0.8	2.8	1.7	0.3
Central and eastern Europe	3.0	2.2	1.0	3.3	-1.0	-0.4
Excluding Belarus and Ukraine	3.4	2.3	1.7	4.0	-1.3	-0.6
Russia	0.9	-4.6	0.0	2.0	7.0	2.0
Transcaucasus and central Asia	2.5	2.2	2.0	2.9	0.2	-0.2
<b>World trade volume (goods and services)</b>	<b>9.9</b>	<b>3.6</b>	<b>3.7</b>	<b>6.2</b>	<b>-0.1</b>	<b>0.4</b>
Imports						
Advanced economies	9.2	4.8	5.9	5.9	0.9	0.2
Developing countries	11.4	-1.3	1.1	7.2	-1.5	0.4
Countries in transition	7.0	2.9	-2.7	8.2	-2.5	2.0
Exports						
Advanced economies	10.3	3.2	3.0	6.2	0.2	0.6
Developing countries	11.4	4.9	2.4	5.6	-2.2	0.1
Countries in transition	5.0	5.9	2.7	7.2	-3.7	0.6
<b>Commodity prices</b>						
Oil <sup>2</sup>						
In SDRs	-0.2	-31.2	27.2	7.4	36.4	-6.0
In U.S. dollars	-5.4	-32.1	27.7	7.8	36.0	-5.6
Nonfuel <sup>3</sup>						
In SDRs	2.0	-13.5	-7.6	3.0	-2.7	1.1
In U.S. dollars	-3.3	-14.8	-7.2	3.4	-3.2	1.6
<b>Consumer prices</b>						
Advanced economies	2.1	1.5	1.4	1.8	0.0	0.1
Developing countries	9.2	10.3	6.7	5.8	-1.9	-1.7
Countries in transition	28.2	20.9	39.3	18.1	-1.6	5.7
<b>Six-month LIBOR (in percent)<sup>4</sup></b>						
On U.S. dollar deposits	5.8	5.5	5.4	6.1	0.2	0.9
On Japanese yen deposits	0.7	0.6	0.2	0.2	0.0	-0.1
On euro deposits	3.5	3.7	3.0	3.5	0.0	0.4

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during July 26–August 16, 1999.

<sup>1</sup>Indonesia, Malaysia, the Philippines, and Thailand.

<sup>2</sup>Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil. The average price of oil in U.S. dollars a barrel was \$13.07 in 1998; the assumed price is \$16.70 in 1999 and \$18.00 in 2000.

<sup>3</sup>Average, based on world commodity export weights.

<sup>4</sup>London interbank offered rate.

proved since the Brazilian crisis, some emerging market economies remain fragile and vulnerable to shifts in market sentiment. In fact, sentiment toward emerging markets has remained more adverse than in most of 1996–97 and much of 1998, with yield spreads remaining wide and volatile for many countries, reflecting the greater recognition of the risks attached to emerging market investments (Figure 1.2).

An additional risk factor relates to potential financial market reactions to actual or perceived Y2K compliance problems in emerging markets (see the Appendix to this Chapter). To contain the risk of capital flow reversals triggered by uncertainty about potential Y2K-related difficulties, it is essential that countries be fully transparent both about their preparedness and about contingency plans to cope with any system failure in sensitive areas.

Many problems and risks therefore remain. Global adjustment of uneven growth and payments imbalances is now perhaps the key challenge, and it is the theme running through much of this report. The achievement of a soft landing in the United States, sustained recoveries in the emerging market economies recently in crisis and in Japan, and a sustained strengthening of growth in Europe, as in the staff's baseline projections, are clearly feasible, but there is also a serious risk of worse scenarios. Economic policies will have an important bearing on the outcome and on the degree of macroeconomic and financial stability that will be associated with the adjustment process.

## Macroeconomic Stability and the Forces of Globalization: Lessons from the 1990s

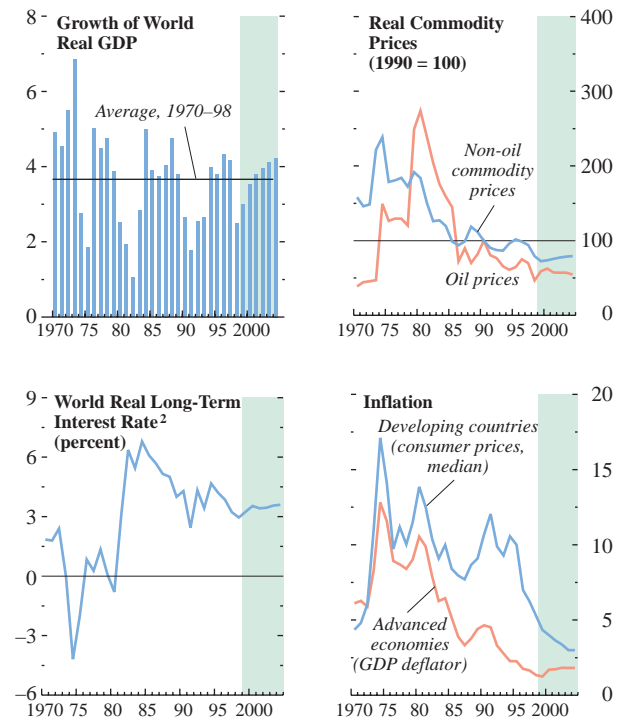
The current global adjustment challenge has its roots in the uneven and, in many countries, highly unstable macroeconomic conditions that have characterized much of the 1990s. Globally, macroeconomic instability has been reflected in two significant slowdowns in less than a decade—in 1991–93 and again in 1998–99—and in an average growth rate of world output in the 1990s of only 3 percent, below the average growth rates of the 1980s (3½ percent) and the 1970s (4½ percent).

The instability has included a large number of currency crises (from the ERM crises to the Mexican, Asian, Russian, and Brazilian crises); substantial swings in exchange rates among the major currencies, especially the yen/dollar rate; run-ups in asset prices followed by pronounced asset price deflations (notably in Japan, the Nordic countries, and the Asian emerging markets); and banking crises in almost all regions of the world—often, though not always, linked to asset price collapses. The U.S. economy is perhaps the most striking, though not the only, exception to the instability of the past decade: the U.S. recession in 1990–91 was unusually mild and the subse-

**Figure 1.1. Global Indicators<sup>1</sup>**

(Annual percent change unless otherwise noted)

For the world economy as a whole, the recent slowdown in growth appears to have been the mildest of the four that have occurred in the past three decades.



<sup>1</sup>Shaded areas indicate IMF staff projections. Aggregates are computed on the basis of purchasing-power-parity (PPP) weights unless otherwise indicated.

<sup>2</sup>GDP-weighted average of ten-year (or nearest maturity) government bond yields less inflation rates for the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada. Excluding Italy prior to 1972.

**Table 1.2. Selected Economies:  
Current Account Positions***(Percent of GDP)*

	1997	1998	1999	2000
<b>Advanced economies</b>				
United States	-1.8	-2.6	-3.5	-3.5
Japan	2.2	3.2	3.4	3.1
Germany	-0.1	-0.2	-0.0	0.2
France	2.8	2.8	2.6	2.8
Italy	2.8	1.7	1.6	1.7
United Kingdom	0.8	0.2	-1.3	-1.6
Canada	-1.6	-1.8	-1.0	-0.9
Australia	-3.1	-4.8	-6.0	-5.2
Austria	-2.4	-2.1	-1.8	-1.5
Finland	5.6	5.8	5.3	5.4
Greece	-2.6	-2.7	-2.3	-2.4
Hong Kong SAR <sup>1</sup>	-3.2	0.7	1.5	2.4
Ireland	2.5	0.9	0.6	0.4
Israel	-3.4	-0.7	-2.6	-2.8
Korea	-1.7	12.5	5.9	3.4
New Zealand	-7.1	-6.1	-6.7	-5.8
Norway	5.2	-0.8	0.6	3.2
Singapore	15.7	20.9	21.1	20.4
Spain	0.4	-0.2	-0.6	-0.7
Sweden	2.8	1.9	1.1	1.4
Switzerland	8.9	8.4	8.0	8.3
Taiwan Province of China	2.7	1.3	2.6	3.0
<i>Memorandum</i>				
Euro area	1.7	1.3	1.2	1.4
<b>Developing countries</b>				
Algeria	7.2	-1.9	-0.1	0.8
Argentina	-4.1	-4.9	-4.0	-3.6
Brazil	-4.1	-4.3	-3.8	-3.1
Cameroon	-2.8	-2.7	-4.3	-3.3
Chile	-5.4	-6.2	-2.6	-3.7
China	3.8	3.4	1.3	1.1
Côte d'Ivoire	-4.8	-4.5	-3.6	-3.5
Egypt	0.2	-3.0	-3.5	-3.7
India	-1.3	-1.0	-1.3	-1.5
Indonesia	-1.8	4.0	2.4	0.7
Malaysia	-5.1	12.9	11.7	5.1
Mexico	-1.9	-3.8	-2.3	-3.0
Nigeria	4.9	-8.4	-14.3	-5.5
Pakistan	-5.6	-2.7	-2.7	-1.7
Philippines	-5.3	2.0	2.2	0.8
Saudi Arabia	0.2	-11.1	-4.6	-4.6
South Africa	-1.5	-1.6	-0.6	-0.8
Thailand	-2.0	12.8	8.8	5.9
Turkey	-1.4	0.9	-0.6	-1.8
Uganda	-0.9	-2.0	-3.7	-2.7
<b>Countries in transition</b>				
Czech Republic	-6.0	-1.9	-1.5	-1.9
Estonia	-13.3	-8.7	-8.2	-9.2
Hungary	-2.1	-4.8	-5.5	-5.1
Latvia	-5.1	-9.5	-8.4	-7.7
Lithuania	-10.2	-12.1	-11.1	-9.9
Poland <sup>2</sup>	-3.0	-4.2	-6.5	-6.5
Russia	-0.7	0.8	7.8	4.8
Slovak Republic	-10.1	-10.1	-4.9	-2.3
Ukraine	-2.7	-3.0	-2.3	-1.8

<sup>1</sup>Data include only goods and nonfactor services.<sup>2</sup>Based on data for the current balance, including a surplus on unrecorded trade transactions, as estimated by IMF staff.

quent expansion will become the country's longest period of sustained growth on record if it continues through early next year. Other economies have also enjoyed comparatively strong and stable growth in the 1990s, including Australia (see Box 1.1), China, India, Ireland, the Netherlands, Norway, and Taiwan Province of China. Nevertheless, in surprisingly many industrial and emerging market countries, economic performance in the 1990s has tended to be weak or unstable or both.

It is unclear whether macroeconomic instability generally has been increasing. However, the mere fact that it has remained pervasive may be considered surprising given the general improvement in macroeconomic policies in most countries compared with the two preceding decades—suggested, in particular, by declines in inflation and better containment of fiscal imbalances—and the substantial progress worldwide with structural reforms that have increased the scope for market forces to guide the allocation of resources within and across countries. Why, then, has the frequency of crises and episodes of macroeconomic instability not clearly diminished?

Analysis of the role of any particular factors in contributing to changes in economic performance is generally difficult because typically many changes occur simultaneously, and this has been the case in the 1990s. The global economic and financial system today is dramatically different in many respects from that of the 1980s or any earlier period. Four of the most significant changes are the following:

First, as a major policy achievement, world inflation has been brought down to its lowest level in 40 years. Associated with this, the dispersion of inflation rates across countries has also diminished. These developments reflect the strengthened international consensus among monetary authorities on the need to focus on the goal of low inflation—a consensus fostered by experience of the alternative and also by peer pressure and demonstration effects among countries. The strengthening of fiscal discipline in many countries has also contributed to monetary discipline and the decline in actual and expected inflation. Although hard to substantiate or measure, it seems likely that factors such as trade liberalization, extensive deregulation in many industries, the privatization of many state-owned enterprises, the reduced willingness of governments to bail out uncompetitive enterprises and sectors, and enhanced information about price developments across countries have also been contributing to the general convergence toward price stability worldwide.

The effect on inflation of this last set of factors—which operate essentially on the price level rather than its rate of change—may be expected to wane over time, and it remains to be seen if price stability will be maintained on a lasting basis. But at least for the moment, low inflation has reduced the risk of one potential source of cyclical instability—the emergence of

price pressures in the late stages of an economic upswing that ultimately necessitate a significant tightening of monetary conditions. In fact, the concerns of monetary authorities in some countries recently—for example, China and Japan—have focused on the risk of *falling* prices, or deflation (see Box 4.3). This may also add to macroeconomic instability, partly owing to the reduced ability of monetary policy to stabilize output at negative inflation rates because of the difficulties of pushing nominal interest rates below zero.

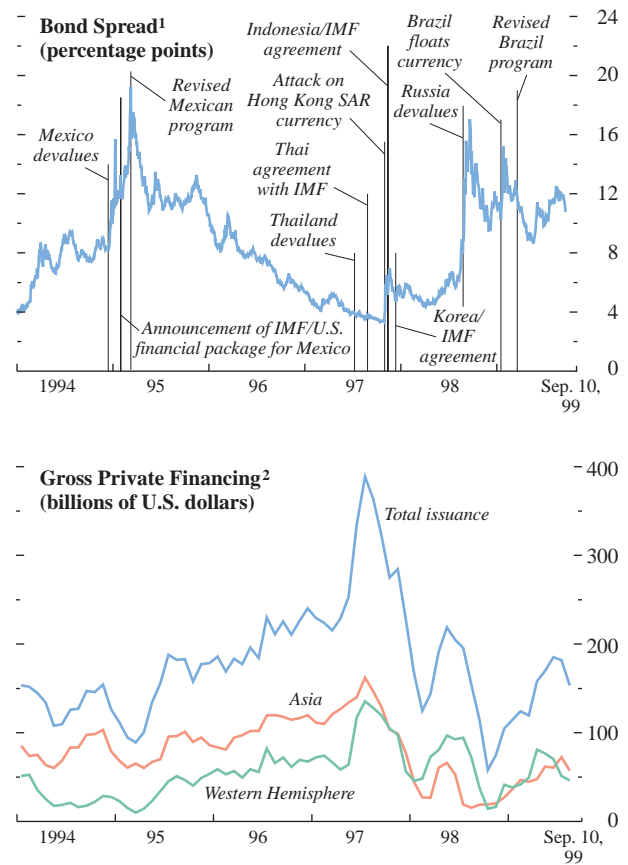
But even while inflation in product markets (for example, CPI inflation) has been very subdued, asset prices have continued to display considerable volatility, with a number of significant spikes since the mid-1980s. This volatility in asset prices (especially stock market and real estate prices) has contributed significantly to macroeconomic instability in several countries, raising anew questions about the weight monetary authorities should attach in their policy decisions to asset market developments.

The second striking development of the 1990s is the rapid international integration of financial markets that has followed the general trend toward financial market liberalization in the industrial countries in the 1970s and 1980s and the reduction in capital and exchange controls in emerging market countries more recently. As a result, the 1990s have witnessed private capital flows to emerging market countries unprecedented in scale (relative to economic activity) at least since the first world war. The secular rise in *gross* capital flows can be explained to a large extent by market integration and the appetite of international investors for high yields and portfolio diversification. However, the large flows into emerging market countries during the buildup to the recent emerging market crises, in *gross* and, more particularly, *net* terms, also reflected, in part, unsustainable developments in the recipient countries (including explicit and implicit exchange rate guarantees), together with a low demand for capital in Japan and western Europe associated with the weakness of activity in those economies in much of the 1990s. Following the Asian crisis, a growing share of Japan's and Europe's saving surpluses has flowed into the United States. This suggests, somewhat paradoxically, that strong cyclical recoveries in Europe, Japan, and the Asian emerging market economies might make it more difficult for the U.S. expansion to sustain its momentum.

Third, as illustrated by the last point, economic and financial linkages and policy transmission mechanisms across countries have become more complex in the 1990s, warranting a further reassessment of key relationships. Historically, the developing countries' economic cycle was mostly positively correlated with that of the industrial countries due to the impulses transmitted through trade and commodity prices. In the early 1990s, however, when the industrial countries went through successive episodes of cyclical weakness, growth actually accelerated in many emerg-

## Figure 1.2. Financing Conditions for Emerging Markets

Financing conditions for emerging markets have improved since the Brazilian crisis, but they remain less favorable than prior to the Russian crisis.



Sources: Bloomberg Financial Markets, LP; and IMF staff estimates.

<sup>1</sup>J.P. Morgan's Emerging Market Bond Index (EMBI) spread relative to the theoretical U.S. zero-coupon yield curve, and secondary market yield spreads on U.S. dollar-denominated Eurobonds.

<sup>2</sup>Excludes interbank flows. Three-month moving averages; annualized.

### Box 1.1. Australia and New Zealand: Divergences, Prospects, and Vulnerabilities

Economic performance differed sharply between Australia and New Zealand in 1998, the former growing at a strong 5 percent rate while the latter slipped briefly into recession, with output falling by  $\frac{1}{4}$  of 1 percent in the year as a whole. This divergence may at first seem surprising, given the strong trade and financial links between these countries and the fact that their economic fundamentals are similar in many respects: their common strengths include low and declining levels of public debt, low inflation, sound financial systems, and good records of structural reforms; while on the negative side, both countries have very low household saving rates, relatively wide current account deficits, and substantial trade exposures to the crisis-affected economies of Asia.

The explanation for the divergence between the two economies in 1998 lies partly in some notable differences in economic performance in the lead-up to the Asian crises. Exports grew much more strongly in Australia than in New Zealand during 1995–97, by 9 percent a year (in volume terms) in the former compared with  $3\frac{1}{2}$  percent in the latter. Australia's relatively strong export performance, combined with the renegotiation of export contracts by some commodity suppliers at relatively favorable prices before the crisis broke, provided Australia with a cushion against the subsequent slowdown in trade that New Zealand lacked. Also contributing to the economic slowdown in New Zealand was a severe drought, which led to a substantial fall in agricultural output in 1998. Another important factor was the conduct of monetary policy. Following an extended period of substantial inflationary pressure stemming from strong output growth, immigration inflows, and buoyant residential real estate markets, the Reserve Bank of New Zealand eased monetary conditions only gradually in 1996–97. In Australia, by contrast, with asset prices rising at a more moderate pace and inflation subdued, the central bank eased monetary policy more substantially in 1996. Partly reflecting these developments, private consumption and investment picked up strongly in Australia after 1996, but weakened in New Zealand. For example, residential construction in Australia increased in 1997 and 1998 after declining in the two previous years, whereas construction declined sharply in New Zealand in 1998. Also notable is the substantial appreciation in the real exchange rate in

New Zealand, of almost 30 percent between 1993 and mid-1997, which worsened net exports. Furthermore, share prices in Australia largely maintained their earlier gains during and after 1997, supporting private sector confidence and demand, while in New Zealand, the stock market fell sharply after mid-1997—losing around one-third of its value in the following year before a more recent correction.

Looking ahead, output in Australia is projected to grow by 4 percent in 1999 and 3 percent in 2000. The slowdown in 1999 is attributable mainly to weaker private investment, especially in the mining sector as a result of low commodity prices, and also to a much-reduced contribution from stockbuilding (which provided 1.7 percentage points of growth in 1998). The further slowing in 2000 reflects a broader-based decrease in consumption growth, partly offset by a pickup in exports (especially tourism receipts, including for the 2000 Olympic Games). An increase is expected in inflation in 2000 associated with the introduction of a new value added-type goods and services tax (GST), but inflation excluding the GST effect is expected to be around the middle of the Reserve Bank of Australia's medium-term target of 2–3 percent.

In New Zealand, growth has resumed after the recession in the first half of 1998—supported by a substantial easing in monetary conditions—and is projected to reach around  $2\frac{1}{2}$  percent in 1999 and  $3\frac{1}{4}$  percent in 2000. Improvements in household and business confidence have contributed to a pickup in consumption and investment, while export growth has been underpinned by improvements in export markets and the 20 percent decline in the real effective exchange rate since mid-1997. Inflation is expected to remain below 2 percent.

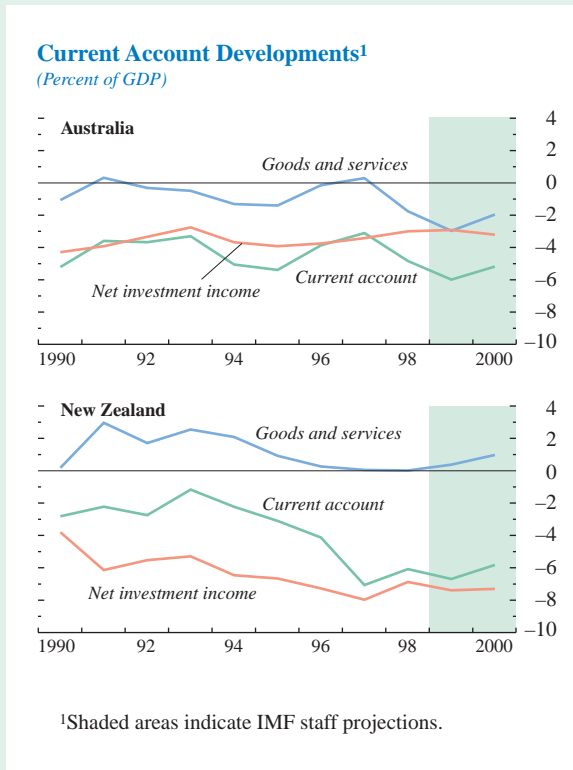
The main area of vulnerability in both economies is in their external imbalances. Current account deficits are projected to increase to about 6 percent of GDP in Australia in 1999, and closer to 7 percent in New Zealand, before declining in 2000 (see figure). Persistent deficits have generated a high level of net external liabilities—amounting to around 60 percent of GDP in Australia and nearly 100 percent of GDP in New Zealand. Reflecting this, net investment income outflows have been equivalent to around 3–4 percent of GDP in Australia in recent years, and 7–8 percent of GDP in New

ing market economies, fueled by the rapid growth of trade among them (especially in Asia) as well as by substantial capital inflows.

More recently, in the wake of the Asian crisis, all industrial countries with significant trade links with Asia would have been expected to experience adverse effects on growth. In fact, however, while Japan and, to a lesser extent, Europe were negatively affected, the United States' economic expansion appears to have gained further momentum. A flight to dollar-denominated assets helped to sustain the U.S. expansion by boosting domestic demand through lower interest rates

and the dampening effect on prices of an appreciating dollar, notwithstanding the negative impact on U.S. exports.

In both examples, the integration of financial markets appears to have contributed to a tendency for global financial resources to move to whichever countries and regions are relatively dynamic at the time. In principle, such reallocations of financial resources are beneficial for the recipient countries and also for global growth and efficiency. However, as experience shows, large net capital flows into strongly expanding economies may exacerbate risks of overheating and



Zealand; in the latter case, these outflows have tended to move procyclically, and account for much of the deficit's recent change.

Assessing the sustainability of these deficits is not straightforward.<sup>1</sup> For example, potential mitigating factors include the high level of foreign direct investment in each country—amounting to 27 percent of foreign liabil-

<sup>1</sup>See, for example, the discussions of current account sustainability in the *World Economic Outlook* of May 1998 (Box 8, pp. 86–87) and May 1999 (pp. 38–44).

ities in Australia and nearly 50 percent in New Zealand. FDI is a relatively stable form of foreign financing (as shown by recent experiences in emerging markets), and also tends to produce a flow of reinvested earnings. There are other important considerations: much of the debt (around 40 percent in Australia and 50 percent in New Zealand) is denominated in the local currency; and a large share of short-term debt is owed by banks, which have high credit ratings and, in the case of New Zealand, significant foreign ownership. Both countries' strong records with macroeconomic and structural policies have provided them with another important buffer against the recent turmoil in international financial markets. Reflecting this, market sentiment has remained favorable, there has been a significant narrowing since the mid-1990s in spreads on long-term bond yields over comparable U.S. yields, and Standard and Poor's has recently upgraded Australia's credit rating to AA+ (the same as for New Zealand).

Nevertheless, high and rising foreign indebtedness significantly increases the exposure of Australia and New Zealand to external shocks. While there appears to be little risk at present of a significant downturn in investor sentiment, the possibility of future reversals should not be entirely discounted. Were they to occur, such reversals could well be sharp rather than smooth, and cause substantial exchange rate depreciations. But the structure of foreign liabilities in both countries would probably make such an adjustment much less disruptive than that seen, for example, in some of the Asian crisis nations. Current account deficits are projected to decline in Australia and New Zealand over the medium term, supported by recent depreciations in real effective exchange rates, rising budget surpluses, and the expected recovery in commodity prices and in trading partners' imports. This adjustment may well take place over an extended time period, however. Hence, further efforts to increase national saving are needed over the medium term in order to reduce risks of a change in market sentiment. Reforms in the social welfare system (such as those currently underway in New Zealand) could help in this regard, as could changes in the tax system to raise the share of indirect taxation (as in the recent tax package in Australia).

asset market bubbles, while rapid reversals of such flows can severely strain weak financial systems and lead to destabilizing currency movements.

And fourth, flexible exchange rates have become increasingly prevalent. During the 1990s, a number of key emerging market currencies have been floated, often to resolve crises associated in part with unsustainable exchange rate pegs. While the adoption of a single currency in the euro area together with a handful of quite successful currency board arrangements (those in Argentina and Hong Kong SAR being the most prominent) stand out as exceptions, the trend world-

wide since the breakdown of the Bretton Woods system has been toward exchange rate flexibility. As a result, exchange rates have been allowed to reflect more clearly differences in policies and investment opportunities. In the 1990s, short-term exchange rate volatility has remained high with no clear trend, which is somewhat surprising in view of the decline in worldwide inflation. But while the need for *nominal* exchange rate fluctuations to compensate for international differences in inflation has diminished as inflation rates have converged toward low levels, forces making for movements in *real* exchange rates—such as cyclical diver-

gences—may well have increased in many cases, as suggested by the cyclical instability mentioned earlier, the increased integration of financial markets, and the greater prevalence of floating exchange rates.

A related development in the 1990s has been the increased understanding among policymakers and observers that cyclically driven movements in exchange rates can be beneficial, by helping to damp economic cycles, provided that the resulting deviations from long-run fundamental equilibrium exchange rates (FEERs) do not become lasting misalignments or exacerbate inflationary (or deflationary) pressures. This more positive attitude toward exchange rate movements is observed mainly in larger countries, however; the preference—more prevalent, for various reasons, in smaller economies—for an exchange rate anchor may in some cases lead to future reforms of regimes that are now floating, such as the adoption of regional currency unions (as in the euro area), currency boards, or one of the major international currencies as the domestic currency (as with dollarization).

Is there any link between these developments and the pervasive macroeconomic instability experienced in the 1990s? It is clear that the achievement of broad price stability in most of the world economy has not been sufficient to eliminate macroeconomic instability. But the factors that have contributed to continued instability are complex. Some observers have argued that market forces (“capitalism”) are prone to generate excesses and instability. And others have suggested that although low inflation may be necessary for maximum sustainable growth, it may also provide fertile soil for asset market instability since it may induce investors to take excessive risks in their search for high yields:

As recent experience attests, a prolonged period of price stability does help to foster economic stability. But, as we have also observed over several years, as have others in times past, such a benign economic environment can induce investors to take on more risk and drive asset prices to unsustainable levels. (Alan Greenspan, testimony before Joint Economic Committee of Congress, June 17, 1999).

This may help to explain the surge in capital flows to emerging market countries that occurred when inflation was abating in the mature markets. Partly on the basis of the conclusions of some contemporary economists studying the events that preceded the interwar depression, it has also been suggested that efforts by monetary authorities to keep inflation (moderately) positive in the face of strong productivity gains that otherwise would lead to price declines and increase the purchasing power of nominal incomes may generate false profit signals, fuel asset price inflation, and exacerbate risks of instability.<sup>2</sup>

<sup>2</sup>“Beyond Price Stability: A Reconsideration of Monetary Policy in a Period of Low Inflation,” Federal Reserve Bank of Cleveland, *Annual Report*, 1998.

Although further research into these issues is needed, there does seem to be a basis for several hypotheses about the working of today’s global economic and financial system and the likely implications for economic policies:

- (i) If indeed there are features of the global economy that help to dampen inflation in product markets, there may be an increased need for vigilance toward other evidence of macroeconomic imbalance and potential inflationary pressure—including in asset markets and sectoral financial balances. In particular, financial (saving-investment) balances for the household sector, the financial sector, and the non-financial corporate sector, as well as the balance of payments, may display signs of strain and vulnerability to shocks in the late stages of an economic upswing even when inflation is low. Such financial imbalances may be closely related to runups in asset prices, which helps to explain why asset price inflation followed by asset price corrections can be particularly destabilizing.
- (ii) The international integration of financial markets carries significant implications for policy spillovers. Cyclical slack and easy monetary conditions tend to foster capital outflows toward economies with stronger growth performance and prospects. If these capital flows are large relative to the size of the recipient economies, they may well be destabilizing for them, unless policies are appropriately adjusted to take account of, and to some extent offset, the extra stimulus being imported from the rest of the world, and unless the domestic financial system is sound.
- (iii) Conversely, in countries with weak economic growth and an absence of inflationary pressures (or perhaps experiencing deflation), capital market integration and the associated potential for capital outflows make it even more important that an expansionary monetary stance be accompanied by sufficient progress in tackling structural obstacles to growth (such as labor market rigidities and other structural deficiencies) for the expansionary policy to be effective in boosting domestic demand and activity.
- (iv) Overheating in asset markets may call for monetary tightening, not only when it threatens an undesirable increase in product-price inflation through its effects on aggregate demand, but also when there is strong evidence that asset prices are rising to more and more unsustainable levels—generating correspondingly higher risks of a correction that would be significantly destabilizing for the economy and the financial system. In the latter case, monetary authorities are confronted with one of

their most difficult challenges: there is inevitably uncertainty about whether a rise in asset prices is in fact sustainable, since it may have arisen from a lasting change in wealth-holders' portfolio preferences or a lasting rise in the rate of return on capital; and furthermore, the effect of monetary tightening on asset prices is uncertain. Moreover, acting to slow or arrest a run-up in asset prices that may be generally popular is likely to be politically difficult, particularly for central banks whose independence is based on a mandate to control CPI inflation. But such action may be necessary to minimize the risks of macroeconomic and financial instability that may carry greater costs. And it should be viewed as symmetrical to the responsibility of monetary authorities to provide liquidity and ease monetary conditions in the face of sharp declines in asset prices that threaten disruption of the financial and payment system. Fiscal policy may also have a role, of course, when asset markets are overheating; and, especially when capital inflows are already exerting upward pressure on the exchange rate, it may be preferable to tighten fiscal policy to dampen demand pressures.

Taken together, developments in the global economy in the 1990s and the hypotheses to which they give rise are not particularly reassuring. They point to a global economic and financial system with great potential for allocating resources more efficiently within and among countries, but also with a potential for excesses to develop in asset markets and the private sector, and therefore for recurrent macroeconomic instability even when macroeconomic policies are reasonably well disciplined, as in the 1990s. Despite the success in taming inflation, and also the success of many countries in putting their public finances on a sounder footing, the task of macroeconomic stabilization has not gone away and in some respects may even have become more demanding, as illustrated by the dilemmas and challenges now facing policymakers around the globe.

## The Inevitable U.S. Slowdown and Adjustment

The strength of demand and activity in the United States continued to exceed expectations in the first half of 1999, and it now seems likely that for the third successive year output growth in 1999 as a whole will be almost 4 percent (Table 1.3). If, as projected, the expansion continues into 2000, it will next February become the longest since at least the middle of the 19th century, when comparable data began. The expansion is notable not only for its duration. There has also been an increase in the growth of labor productivity in the past two years, which is unusual for the mature phase

of a cyclical expansion. This seems to be related partly to the rapid expansion of fixed investment and the capital stock in recent years, and partly to faster technical progress. The more rapid productivity growth and more importantly a reappraisal of past data have led IMF staff this year to revise upwards the assumed growth rate for U.S. productive potential to about 2¾ percent, from 2¼ percent previously.

The expansion has been remarkable also for the behavior of inflation, which has shown no significant sustained increase as resource utilization has risen in the economy as a whole. During 1999, consumer price inflation has risen somewhat from the rate of about 1½ percent experienced in 1998, mainly owing to increases in oil and other commodity prices. There is still little evidence of any sustained rise in wage inflation even though unemployment has fallen to about 4¼ percent, its lowest level in almost three decades. The IMF staff's current estimate of the NAIRU (non-accelerating-inflation rate of unemployment) is about 5 percent compared with nearly 6 percent at the beginning of the expansion.

The recent impressive performance of the U.S. economy is, in large part, testimony to laudable policies. These include the turnaround in the fiscal balance from deficit to surplus (a structural improvement equivalent to roughly 3½ percent of GDP since 1993); the agile management of monetary conditions by the Federal Reserve in achieving and maintaining low inflation, in helping to maintain stable growth and also in helping to calm global financial turbulence; and structural policies that have continued to foster the flexible working of markets. But in spite of the economy's evident strengths, there is no doubt that in the period ahead a significant slowdown to sustainable levels will be necessary. Only the timing is in question.

Estimates for the second quarter indicate that *GDP growth* slowed to 1.8 percent at an annual rate, but with domestic demand, especially by the private sector, still growing significantly faster than most estimates of potential. Declines in commodity prices and the rise of the dollar have helped to maintain low inflation in recent years, with nominal wage increases being restrained partly by the associated real wage gains (see Chapter III). As these forces wane and go into reverse, resource pressures are likely to reassert themselves and cause inflation to rise unless slower growth is maintained. And the slowdown will need to help contain the external current account deficit, which has recently risen above 3 percent of GDP and is approaching the historic peaks of the mid-1980s. Thus the growth of domestic demand will need to slow more significantly, from its recent rate of about 5 percent (4 percent in the second quarter excluding inventory accumulation). This adjustment is assumed in the projections to occur smoothly.

The main *risks* to the smooth slowdown or "soft-landing" scenario represented in the baseline are four-

**Table 1.3. Advanced Economies: Real GDP, Consumer Prices, and Unemployment***(Annual percent change and percent of labor force)*

	Real GDP				Consumer Prices				Unemployment			
	1997	1998	1999	2000	1997	1998	1999	2000	1997	1998	1999	2000
<b>Advanced economies</b>	<b>3.2</b>	<b>2.2</b>	<b>2.8</b>	<b>2.7</b>	<b>2.1</b>	<b>1.5</b>	<b>1.4</b>	<b>1.8</b>	<b>6.8</b>	<b>6.7</b>	<b>6.5</b>	<b>6.5</b>
Major industrial countries	2.9	2.2	2.6	2.4	2.0	1.3	1.4	1.7	6.5	6.2	6.2	6.4
United States	3.9	3.9	3.7	2.6	2.3	1.6	2.2	2.5	4.9	4.5	4.3	4.5
Japan	1.4	-2.8	1.0	1.5	1.7	0.6	-0.4	0.0	3.4	4.1	5.0	5.8
Germany	1.8	2.3	1.4	2.5	1.5	0.6	0.4	0.8	9.9	9.4	9.1	8.6
France	2.3	3.2	2.5	3.0	1.3	0.7	0.5	1.1	12.5	11.6	11.3	10.7
Italy	1.5	1.3	1.2	2.4	1.7	1.7	1.5	1.6	11.7	11.8	11.7	11.4
United Kingdom <sup>1</sup>	3.5	2.2	1.1	2.4	2.8	2.7	2.3	2.2	5.7	4.7	4.8	5.3
Canada	4.0	3.1	3.6	2.6	1.4	1.0	1.5	1.7	9.2	8.3	8.0	8.1
Other advanced economies	4.2	2.1	3.5	3.6	2.4	2.5	1.4	2.1	7.8	8.1	7.5	6.9
Spain	3.7	4.0	3.4	3.5	1.9	1.8	2.1	2.1	20.8	18.8	15.7	14.0
Netherlands	3.6	3.8	2.6	2.5	2.2	2.0	2.3	2.1	5.5	4.1	3.6	3.7
Belgium	3.0	2.9	1.4	2.5	1.5	0.9	1.1	1.2	9.4	9.5	9.2	9.2
Sweden	1.8	2.6	3.2	3.0	0.5	-0.1	0.2	1.0	8.0	6.5	5.4	5.1
Austria	2.5	3.3	2.0	2.5	1.2	0.8	0.7	0.9	4.4	4.7	4.3	4.2
Denmark	3.1	2.9	1.3	1.5	2.2	1.7	2.5	2.5	7.7	6.3	6.0	6.2
Finland	5.6	5.6	3.6	3.8	1.2	1.3	1.3	2.3	12.6	11.4	10.3	9.2
Greece	3.2	3.7	3.3	3.6	5.4	4.5	2.3	2.2	10.3	10.1	10.3	10.2
Portugal	3.8	3.9	3.0	3.2	2.2	2.8	2.3	2.2	6.7	5.0	4.6	4.6
Ireland	10.7	8.9	7.5	7.0	1.5	2.4	2.0	2.0	9.8	7.7	6.5	6.2
Luxembourg	4.8	5.7	3.5	4.4	1.4	1.0	0.7	1.4	3.4	3.1	2.9	2.8
Switzerland	1.7	2.1	1.2	1.9	0.5	0.1	0.8	1.0	5.2	3.9	3.0	2.9
Norway	4.3	2.1	1.0	2.8	2.6	2.3	2.3	2.3	4.1	3.2	3.6	4.0
Israel	2.7	2.0	1.7	3.0	9.1	5.4	5.5	4.6	7.7	8.6	9.3	8.8
Iceland	5.4	5.1	5.6	4.7	1.8	1.7	3.5	3.2	3.7	3.0	1.7	1.7
Korea	5.0	-5.8	6.5	5.5	4.4	7.5	0.7	2.8	2.6	6.8	7.0	6.0
Australia <sup>2</sup>	3.9	5.1	4.0	3.0	1.7	1.6	1.8	3.8	8.5	8.0	7.2	7.0
Taiwan Province of China	6.8	4.9	5.0	5.1	0.9	1.7	1.0	1.2	2.7	2.8	3.0	2.7
Hong Kong SAR	5.3	-5.1	1.2	3.6	5.7	2.6	-3.1	1.0	2.2	4.7	6.1	5.4
Singapore	9.0	0.3	4.5	5.0	2.0	-0.3	0.2	0.6	1.8	3.2	4.3	4.2
New Zealand <sup>2</sup>	2.1	-0.3	2.6	3.3	1.7	1.5	1.3	1.9	6.6	7.5	7.2	7.0
<i>Memorandum</i>												
European Union	2.6	2.7	2.0	2.7	1.8	1.4	1.3	1.5	10.4	9.6	9.1	8.8
Euro area	2.4	2.8	2.1	2.8	1.6	1.2	1.0	1.3	11.7	10.9	10.3	9.7

<sup>1</sup>Consumer prices are based on the retail price index excluding mortgage interest.<sup>2</sup>Consumer prices excluding interest rate components; for Australia, also excluding other volatile items.

fold and interrelated. One is that significant inflationary pressures could emerge and prompt a substantial monetary tightening. The second is that the dollar, whose exchange value is well above the levels estimated to be consistent with medium-term fundamentals, could come under downward pressure, perhaps because investors become more wary of the United States' increasing external debt or find more attractive havens for their investments in other economies that may be enjoying renewed growth. Marked depreciation of the dollar would increase price pressures, potentially leading again to a substantial rise in interest rates. The third risk, of a significant decline in stock market prices, could be associated with either of the first two, or it could materialize independently as a result of a reassessment by investors of profit prospects or equity valuations. As with the increases in interest rates in the other risk scenarios, it would tend to lead to a more abrupt slowdown of private spending and

growth than in the baseline projections, with an associated correction of the private sector's unprecedented shortfall recently of saving relative to investment. The fourth risk is that a large tax cut could further boost private consumption, while crowding out private investment and net exports through higher interest rates and a stronger dollar. While these developments might add further momentum to the expansion in the short run, they would exacerbate existing imbalances and increase the risk of a harder landing later on.

How can policies help to minimize these risks? It is mainly the task of *monetary policy* to prevent a rise in inflation, through forward-looking policy actions. The Federal Reserve's actions to raise short-term interest rates in June and August, which partly reversed the cuts that played an important role in helping to stabilize international financial markets late last year, were appropriate steps. Together with the increases in longer-term interest rates in recent months, this will

help to slow the growth of domestic demand. But further steps may well be needed to prevent the emergence of inflationary pressures. It will therefore be important for the Federal Reserve to continue to be forward-looking in its conduct of policy, to respond again promptly if domestic demand growth fails to abate or if prospective inflationary pressures persist, to be particularly alert to repercussions in the economy of the rise in the stock market as well as to any sign that it is broadening to a wider range of asset prices, and to provide consistent signals to financial markets of its intention to rein in demand growth. It is through such forward-looking actions that the risks of further overheating and a hard landing are most likely to be minimized.

*Fiscal policy* has also helped to restrain demand growth in the current expansion, as can be inferred from the budget's swing into surplus—which is likely to reach about 1½ percent of GDP in 1999 in terms of the general government balance, compared with a deficit of 3½ percent of GDP in 1993.<sup>3</sup> Continuing budget surpluses are projected on the basis of current policies, and their realization will be important not only to contribute to demand restraint given the economy's cyclical position and the external deficit, but also to prepare for the increase in unfunded liabilities associated with population aging in the decades ahead (Box 1.2). By contrast, eating into the surpluses through tax cuts or spending increases would exacerbate the risk of overheating. The maintenance of surpluses would also provide more room for a moderate easing of fiscal policy to help stabilize the economy in the event of a sharp slowdown in domestic demand.

The strong U.S. expansion has contributed importantly to *Canada's* recent robust growth performance. Growth in Canada has exceeded potential for most of the period since mid-1996, and following the slowdown of late 1997 and early 1998 associated with the Asian crisis and weakness of commodity prices, it has strengthened again. Unemployment has recently fallen to below 8 percent, its lowest level for a decade, while core consumer price inflation has remained close to the lower end of the 1–3 percent target range. There has been further progress in reducing the public sector debt burden, and the strengthening of the public finances will allow the automatic stabilizers to be used in the event of a significant slowdown. Signs that the economic expansion is gaining strength and that inflation has bottomed out may point to a need for a gradual move back to a somewhat less accommodative monetary stance, though the anticipated slowdown in U.S. growth would lessen potential inflation risks.

<sup>3</sup>Of the 5.2 percentage points of GDP decline in the fiscal deficit since 1993, approximately two-thirds is due to policy actions (Table 1.4).

## Japan: Recovery in Sight?

Real GDP in Japan surprisingly rose by an extraordinarily strong 2.0 percent in the first quarter of 1999, after five consecutive quarters of decline, raising hopes that the economy had finally emerged from recession. One half of this GDP increase came from public investment, reflecting the fiscal stimulus packages put in place in 1998, but more noteworthy was the growth in private demand. Although growth subsequently moderated in the second quarter, in part because of a decline in public investment, there are increasing signs indicating a turnaround. Moreover, concerns about deflation and the health of the financial system appear to have abated. At the same time, there are still many weaknesses and uncertainties in the current economic situation. Household confidence is still fragile in a context of falling incomes and fears of job losses, and many businesses, particularly those less exposed to international competition and pressures for restructuring, are still suffering from large debt burdens and excess capacity built up during the asset price bubble of the late 1980s and early 1990s. There is also a danger that public investment will fall further in the second half of this fiscal year as the effects of earlier stimulus packages wear off. Net exports will benefit from the economic recovery in the Asia region, but the strengthening of the yen in late 1998 and so far in 1999 is likely to limit the impetus to growth from the external sector.

Despite these concerns, growth projections have been revised up significantly from those in the May 1999 *World Economic Outlook*. Positive growth of 1 percent is now projected for 1999, rising to 1½ percent in 2000, and there is clearly the potential for a stronger pickup next year if private sector confidence strengthens further. At the same time, there are continuing downside risks, related in part to the needed restructuring of the corporate sector that is in progress. Unemployment is projected to increase further in 2000, with inflation remaining close to zero.

Macroeconomic policies in Japan continue to face formidable challenges. These involve not just questions about the degree and form of further support to nurture the emerging recovery, but also the balance to be struck between these short-term requirements and longer-term policy objectives. These judgments are particularly difficult in the case of fiscal policy. On current policies the general government deficit (excluding social security) is projected to rise to almost 10 percent of GDP in 1999 (from 7.5 percent in 1998), and to remain around this level in 2000. Given the need to support domestic demand and economic adjustment, it is important to ensure that the level of stimulus is maintained as long as the recovery in private demand has not firmly taken hold. But Japan also faces a critical task of fiscal consolidation over the medium term. Public debt has increased rapidly as a result of the large deficits incurred during the current

**Table 1.4. Major Industrial Countries: General Government Fiscal Balances and Debt<sup>1</sup>**  
(Percent of GDP)

	1982–92	1993	1994	1995	1996	1997	1998	1999	2000	2004
<b>Major industrial countries</b>										
Actual balance	-3.0	-4.3	-3.5	-3.4	-2.7	-1.2	-0.8	-1.0	-0.6	0.8
Output gap	-0.9	-2.7	-2.2	-2.3	-1.7	-1.2	-1.3	-1.0	-0.8	0.4
Structural balance	-2.6	-3.0	-2.4	-2.4	-1.9	-0.6	-0.2	-0.5	-0.1	0.7
<b>United States</b>										
Actual balance	-2.9	-3.6	-2.3	-1.9	-0.9	0.4	1.3	1.6	2.0	2.3
Output gap	-1.7	-3.6	-2.8	-3.2	-2.5	-1.3	-0.1	0.9	0.8	0.4
Structural balance	-2.4	-2.2	-1.2	-0.8	-0.0	0.8	1.3	1.3	1.7	2.2
Net debt	39.3	54.2	54.9	54.5	54.1	51.4	48.4	45.0	41.5	27.6
Gross debt	53.5	68.5	67.8	67.9	67.9	65.9	62.1	57.7	53.2	35.4
<b>Japan</b>										
Actual balance	-0.3	-1.6	-2.3	-3.6	-4.2	-3.4	-5.3	-7.3	-7.1	-1.4
Output gap	0.2	-0.4	-1.7	-1.9	1.1	0.4	-4.1	-4.2	-3.7	1.1
Structural balance	-0.0	-1.5	-1.8	-3.0	-4.6	-3.5	-3.8	-5.7	-5.6	-1.8
Net debt	18.4	5.2	7.7	13.0	16.4	19.5	30.5	37.6	44.3	52.2
Gross debt	68.0	75.1	82.2	89.7	94.4	101.1	117.9	127.8	137.2	149.9
<i>Memorandum</i>										
Actual balance excluding social security	-3.3	-4.8	-5.1	-6.5	-6.8	-5.9	-7.5	-9.5	-9.3	-4.1
Structural balance excluding social security	-3.4	-4.7	-4.7	-6.0	-7.1	-6.0	-6.5	-8.5	-8.4	-4.4
<b>Germany<sup>2</sup></b>										
Actual balance	-2.1	-3.1	-2.4	-3.2	-3.4	-2.6	-2.0	-1.9	-1.1	-0.3
Output gap	-1.3	-0.2	0.0	-0.3	-1.6	-1.9	-1.8	-2.4	-2.0	-0.0
Structural balance	-1.6	-3.0	-2.3	-3.0	-2.3	-1.3	-0.7	-0.4	0.0	-0.3
Net debt	22.0	35.5	40.6	49.4	52.1	52.8	52.4	51.9	50.9	44.6
Gross debt	41.3	48.0	50.2	58.3	60.8	61.5	61.1	60.6	59.6	53.3
<b>France</b>										
Actual balance	-2.4	-5.9	-5.8	-5.5	-4.1	-3.0	-2.7	-2.4	-1.8	0.1
Output gap	0.3	-3.8	-3.0	-2.7	-3.3	-3.2	-2.2	-2.1	-1.4	0.0
Structural balance	-2.6	-3.4	-3.7	-3.6	-1.9	-0.9	-1.3	-1.1	-0.9	0.1
Net debt <sup>3</sup>	19.4	34.4	40.2	43.6	46.3	48.1	48.4	48.9	48.7	45.7
Gross debt	31.5	45.2	48.3	52.5	55.4	57.8	58.2	58.7	58.5	55.4
<b>Italy</b>										
Actual balance	-10.9	-9.4	-9.1	-7.7	-7.0	-2.8	-2.7	-2.4	-1.6	-0.1
Output gap	0.3	-2.6	-2.5	-1.1	-2.0	-2.3	-2.8	-3.4	-2.8	0.1
Structural balance	-10.9	-8.2	-7.9	-7.0	-6.0	-1.7	-1.5	-1.0	-0.4	-0.1
Net debt	77.4	111.8	117.2	116.6	116.0	113.8	112.4	109.6	104.3	89.2
Gross debt	84.7	118.1	123.8	123.2	122.5	120.1	118.7	115.7	110.2	94.2
<b>United Kingdom</b>										
Actual balance	-2.4	-8.0	-6.8	-5.8	-4.4	-2.1	0.3	-0.4	-0.6	-0.7
Output gap	-1.1	-4.0	-2.2	-1.1	-0.9	0.6	0.6	-1.1	-0.9	-0.0
Structural balance	-1.7	-4.8	-4.4	-4.6	-3.7	-2.1	-0.3	-0.5	0.1	-0.6
Net debt	34.4	32.7	33.0	39.1	41.6	43.9	44.8	42.9	41.9	36.0
Gross debt	55.0	61.8	59.4	64.5	64.8	65.8	65.8	62.6	61.0	51.2
<b>Canada</b>										
Actual balance	-5.3	-7.6	-5.6	-4.3	-1.8	0.8	0.9	1.5	1.2	1.8
Output gap	-0.9	-4.3	-2.1	-1.9	-2.9	-1.9	-1.4	-0.3	-0.2	0.1
Structural balance	-4.8	-4.6	-4.1	-3.1	-0.1	1.8	1.6	1.7	1.3	1.8
Net debt	36.1	66.2	68.7	70.2	69.8	65.5	62.3	57.8	54.3	39.5
Gross debt	68.4	98.8	99.4	102.2	101.8	97.7	95.8	90.0	85.2	65.7

Note: The budget projections are based on information available through mid-September 1999. The specific assumptions for each country are set out in Box 1.2.

<sup>1</sup>The output gap is actual less potential output, as a percent of potential output. Structural balances are expressed as a percent of potential output. The structural budget balance is the budgetary position that would be observed if the level of actual output coincided with potential output. Changes in the structural budget balance consequently include effects of temporary fiscal measures, the impact of fluctuations in interest rates and debt-service costs, and other noncyclical fluctuations in the budget balance. The computations of structural budget balances are based on IMF staff estimates of potential GDP and revenue and expenditure elasticities (see the October 1993 *World Economic Outlook*, Annex I). Net debt is defined as gross debt less financial assets of the general government, which include assets held by the social security insurance system. Debt data refer to end of year; for the United Kingdom they refer to end of March. Estimates of the output gap and of the structural budget balance are subject to significant margins of uncertainty.

<sup>2</sup>Data before 1990 refer to west Germany. For net debt, the first column refers to 1986–92. Beginning in 1995, the debt and debt-service obligations of the Treuhandanstalt (and of various other agencies) were taken over by the general government. This debt is equivalent to 8 percent of GDP, and the associated debt service to ½ of 1 percent of GDP.

<sup>3</sup>Figure for 1982–92 is average of 1984–93.

### Box 1.2. Policy Assumptions Underlying the Projections for Selected Advanced Economies

Fiscal policy assumptions for the short term are based on official budgets adjusted for any deviations in outturns as estimated by IMF staff and also for differences in economic assumptions between IMF staff and national authorities. The assumptions for the medium term take into account future policy measures that are judged likely to be implemented. Both projections and policy assumptions are generally based on information available through September 1999. In cases where future budget intentions have not been announced with sufficient specificity to permit a judgment about the feasibility of their implementation, an unchanged structural primary balance is assumed, unless otherwise indicated. For the larger advanced economies, the specific assumptions adopted are as follows (see Tables 14–16 in the Statistical Appendix for the projected implications of these assumptions).

**United States.** The fiscal projections are based on the Administration's June 1999 Mid-Session Review of the FY 2000 Budget (including the Social Security reform proposal). The projections are adjusted for differences between the IMF staff's and the Administration's macroeconomic assumptions. State and local government fiscal balances are assumed to remain constant as a percent of GDP.

**Japan.** The projections take account of the FY 1999 initial budget, and the ¥24 trillion stimulus package announced in November 1998. This November package is assumed to raise public investment by ¥4 trillion through 1999, mostly in the first half of the year. Local governments are projected to largely offset their share in jointly financed projects in the stimulus package with cuts in own-account expenditures elsewhere. Of the ¥9.3 trillion in tax cuts included in the November package, ¥¾ trillion is assumed to have occurred in the first quarter of 1999, with the bulk of the remainder taking place over the rest of 1999 and the first quarter of 2000. The projection also assumes a ¥520 billion supplementary budget for FY 1999.

**Germany.** For 1999, the IMF staff projection of the general government deficit (1.9 percent of GDP) is based on the Financial Planning Council projection of June 1999 adjusted for different macroeconomic assumptions.

For 2000 and the medium term, the IMF staff's projections incorporate the effects of the income tax reform package approved by Parliament in March 1999, and assume implementation of the government's fiscal consolidation and tax reform package announced in June 1999.

**France.** The projections are in line with announced fiscal targets, adjusted for differences between the IMF staff's macroeconomic assumptions and those of the French administration. For 1999, the projection assumes a revenue performance that still benefits from the robust growth in 1998; for 2000 and beyond, the path of the public finances is broadly consistent with the government Stability Program.

**Italy.** The fiscal projections are based on the authorities' projections for 1999, adjusted for the most recent developments and interest rate forecasts; and on the medium-term fiscal plan covering the period 2000–03, adjusted for differences in macroeconomic assumptions. For 2000–03, announced measures are assumed to be implemented fully and to have the impact as indicated in the medium-term government plan. Details on the measures for 2000 will be unveiled in the Budget Law to be submitted to parliament in September.

**United Kingdom.** The budgeted revenue targets and spending ceilings for FY 1999/00 (April–March) are assumed to be observed. Thereafter, current expenditure is assumed to grow in line with potential output, and capital expenditure in line with the new expenditure plans announced in the 1999/2000 Budget. For revenues, the projections assume an income elasticity of one over the medium term, but also incorporate previous budgets' tax commitments that are expected to continue during the projection period.

**Canada.** Federal government outlays for departmental spending and business subsidies are assumed to conform to the commitments announced in the February 1999 budget. Following a reduction of 15 cents in the employment insurance premium effective in January 1999, (continued on next page)

downturn, and financial market concerns about the sustainability of this trend have already been reflected in upward pressure on long-term interest rates. By most measures, Japan's public debt is significantly larger than in most other major industrial countries (Box 1.3). With Japan facing age-related pressures relatively early in the next century, fiscal reforms and other measures to improve the viability of the public pension system are all the more important. Legislation to address this issue was submitted to the *Diet* in July.

Monetary policy is also very supportive, with overnight interest rates effectively zero since March. The Bank of Japan's stated commitment to maintain this policy until the threat of deflation disappears, com-

bined with the resumed purchase of long-term government bonds by the Trust Fund Bureau, have helped to lower long-term interest rates since February, although they have risen again since May as hopes of recovery have encouraged expectations that monetary policy will start to be tightened sooner than earlier thought. The main monetary policy levers still available involve liquidity injections to the banking system through, for example, open-market operations, and exchange market intervention. The Bank of Japan has expanded the range and maturities of assets it purchases to inject liquidity, and there is scope for further moves in this direction, provided that funds are supplied only to credit-worthy entities and that they do not ease pressures for

**Box 1.2 (concluded)**

the staff assumes further gradual cuts in the rate from 2000 on, which would reduce it to \$2.20 per \$100 of taxable employee earnings by 2004. Other revenue and outlays are assumed to evolve in line with the IMF's staff macroeconomic projections. After FY 1998/99, it is assumed that the federal government will be able to maintain budget surpluses which would reach 1 percent of GDP. The consolidated fiscal position of the provinces is assumed to be consistent with their stated medium-term targets.

**Australia.** The fiscal outlook is based on the authorities' May 1999 Budget projections of ratios of expenditure and revenue to GDP until FY 2002/03 (July–June), with these ratios assumed to remain constant thereafter. The budget projections reflect the impact of the tax reform package to be introduced in 2000.

**Belgium.** For 1999, the fiscal deficit is based on the budget, adjusted for the difference between the staff's and the authorities' growth projections. For the medium term, fiscal projections incorporate a slight decline in the structural primary balance, in line with the 1999–2002 Stability Program.

**Korea.** The projections for 1999 are based on the supplementary budget announced in June 1999. Tax revenues are projected to grow 1 percent faster than nominal GDP, while other revenues are projected to increase in line with GDP. Noninterest current spending is assumed to rise by 5 percent in real terms. Capital spending as a ratio of GDP is projected to be gradually reduced to 1996–97 levels by 2002.

**Netherlands.** The projections for 1999 are based on the budget and the supplementary budget, adjusted for the staff's macroeconomic projections. Projections for 2000–2004 primarily reflect the government's rules-based approach to fiscal policy, by taking into account the authorities' expenditure norms and baseline path for revenue (which incorporates planned tax reform in 2001). The government's projections have been adjusted to reflect the slightly higher growth projected by IMF staff and to include revenue and expenditure items that

are not covered by the government's fiscal policy framework.

**Spain.** The projections for 1999 assume that the budget (including a reform of personal income taxes) is implemented as approved, allowing for differences in macroeconomic assumptions. Projections for 2000 and beyond are based on unchanged policies.

**Switzerland.** The 1999 projections are based on the official budget, adjusted for slower growth and extraordinary expenditures. The projections for 2000–01 are in line with present official estimates and incorporate announced fiscal measures to balance the Confederation's budget by 2001. Beyond 2001, the general government's structural budget balance is assumed to remain unchanged.

Monetary policy assumptions are based on the established framework for monetary policy in each country. In most cases this implies a nonaccommodative stance over the business cycle, so that official interest rates will firm when economic indicators suggest that inflation will rise above its acceptable rate or range, and ease when indicators suggest that prospective inflation will not exceed the acceptable rate or range, that prospective output growth is below its potential rate, and that the margin of slack in the economy is significant. On this basis, the London interbank offered rate (LIBOR) on six-month U.S. dollar deposits is assumed to average 5.4 percent in 1999 (20 basis points more than projected in the May 1999 *World Economic Outlook*) and 6.1 percent in 2000. The projected path for U.S. dollar short-term interest rates reflects the assumption that the Federal Reserve will raise the target federal funds rate by in total 75 basis points before the end of the first quarter of 2000, which is consistent with market expectations in early August. The rate on six-month Japanese yen deposits is assumed to average 0.2 percent in 1999 (the same as in the May 1999 *World Economic Outlook*) and also in 2000. The rate on six-month euro deposits is assumed to average 3.0 percent in 1999 and 3.5 percent in 2000. Changes in interest rate assumptions compared with the May 1999 *World Economic Outlook* are summarized in Table 1.1.

bank and enterprise restructuring. Since early July, the yen has appreciated significantly, notwithstanding reported intervention in the foreign exchange market to limit an overly rapid appreciation.

While macroeconomic policies can provide important short-term support to the economy, structural reforms will determine how durable and resilient the recovery will be. The framework for dealing with the banking sector's problems is largely in place, and the emphasis now must be on implementation. The need for rapid restructuring and the rebuilding of confidence is made all the more urgent by the prospective replacement in March 2001 of blanket deposit insurance with limited coverage. Preconditions for restructuring

are certainly evident: recapitalization of viable institutions and nationalization of failed banks are proceeding; prudential supervision and bank accounting standards appear to have improved, driven in part by the new Financial Supervisory Agency; and new tax incentives and the establishment of the Resolution and Collection Corporation should help with the disposal of bad loans. Nevertheless, several concerns and potential weaknesses remain. The full extent of banks' balance sheet problems may still not have been recognized, including additional bad loans incurred during the recent recession. The banking sector is still large relative to the size of the economy, and there is a risk that the recapitalization program may be reducing

pressures for restructuring. In this regard, the authorities need to use the leverage provided by public capital participation in banks to promote consolidation, ensure a focus on core profitability, and push through changes in ownership and management when needed. Progress also has to be made in reprivatizing nationalized banks, or at least their marketable assets.

Other reforms in the financial services sector are generally well-advanced, although direct public sector involvement in the provision of financial services (for example through the post office savings system) needs to be reduced, and tighter supervision along with pressures for reform need to be applied to the troubled life insurance industry. Corporate sector restructuring should be helped by measures introduced in June 1999 to provide greater scope for debt-equity swaps by banks and ease the way for large-scale mergers. Improvements in the bankruptcy code will be considered by the *Diet* later in 1999, and further reforms are also being considered for the legal framework and tax system to encourage firms to implement restructuring measures, and to facilitate ownership changes. Progress in other areas has been uneven. Firms in manufacturing appear to be generally well-advanced in improving their balance sheets, whereas among firms oriented to the domestic market the lack of competition is slowing restructuring and discouraging business start-ups. Thus, only limited progress has been made with deregulation and liberalization in the transportation, telecommunications, retail, and agriculture sectors, which continue to be largely shielded from foreign competition.

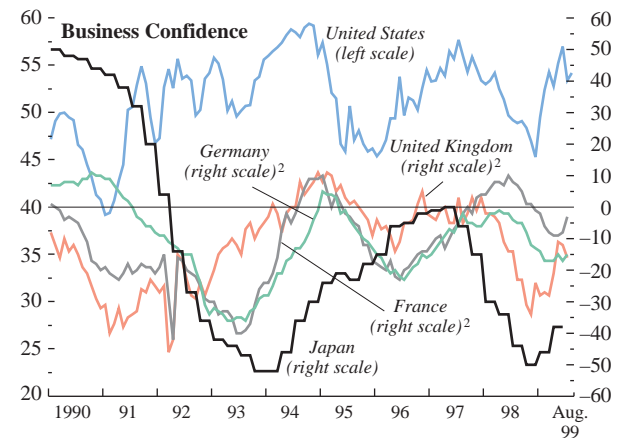
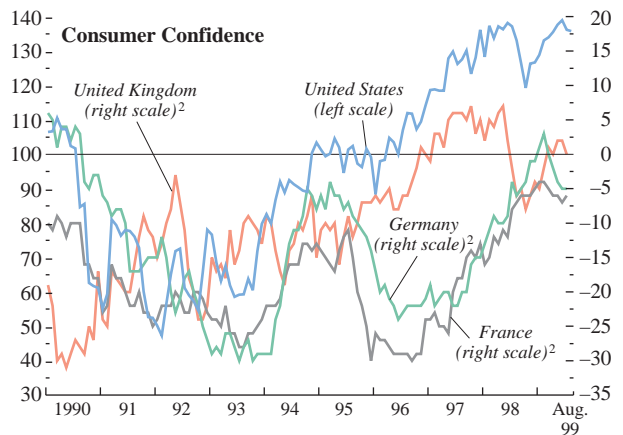
### Securing a Lasting Revival of Growth in Europe

Following the marked slowing of growth in much of western Europe in the latter part of 1998, there have been indications in recent months that expansions have begun to pick up again. As in the May 1999 *World Economic Outlook*, growth is projected to recover to above-potential rates in the second half of 1999, and in 2000 as a whole should average 2¾ percent in the euro area after this year's slowdown to 2 percent.<sup>4</sup> But since the earlier assessment, downside risks have been reduced by the improvements in the external economic environment; the easing of the European Central Bank's official interest rates by 50 basis points in April; reductions in official interest rates in several European countries outside the euro area; a modest upturn in business sentiment; and signs that the pickup is broadening. Consumer confidence has remained at high levels, partly reflecting further, albeit modest, declines in unemployment (Figure 1.3).

<sup>4</sup>During the phased transition to the new European System of Accounts (ESA 95) beginning in 1999, more than the usual degree of uncertainty surrounds the interpretation of national accounts data.

**Figure 1.3. Selected European Countries, Japan, and the United States: Indicators of Consumer and Business Confidence<sup>1</sup>**

Business confidence has recently picked up in several major industrial countries. Consumer confidence generally remains strong, although it has weakened somewhat in Germany and France.



Sources: Consumer confidence—for the United States, the Conference Board; for European countries, the European Commission. Business confidence—for the United States, the U.S. Department of Commerce, Purchasing Managers Composite Diffusion Index; for European countries, the European Commission; for Japan, Bank of Japan.

<sup>1</sup>Indicators are not comparable across countries.

<sup>2</sup>Percent of respondents expecting an improvement in their situation minus percent expecting a deterioration.

### Box 1.3. Comparing G-7 Fiscal Positions—Who Has a Debt Problem?

The fiscal policy advice that the IMF gives member countries depends on both longer-term debt sustainability considerations and short-term aggregate demand conditions. In many cases, there is no ambiguity about the appropriate advice, at least in qualitative terms. There are instances, however, where longer-term and short-term considerations point to conflicting advice. Japan has recently been a case in point, with the IMF recommending significant *short-term* fiscal stimulus to counter weakness in aggregate demand, even though Japan is among the most indebted of the major industrial countries. A high level of gross debt and a rapidly aging population suggest that long-term sustainability is a key issue in Japan, and that there is a need to return to fiscal consolidation as soon as conditions permit. However, other debt indicators, and in particular net debt rather than gross debt, point to Japan's debt position being less worrisome. This box discusses the debt indicators that are used to assess debt sustainability in formulating fiscal policy advice. Estimates for 1998 are reported in the table for the G-7 countries.

- **Gross debt** refers to the government's stock of outstanding financial liabilities. According to this indicator, Italy and Japan are the most indebted G-7

countries, with gross debt of 119 percent and 118 percent of GDP respectively at the end of 1998.

- **Net debt including social security assets** subtracts all government financial assets from gross debt, including assets of the social security system, often in the form of government debt. Japan is the only G-7 country where the latter is sizable. When social security assets are included in government debt, Japan, with net debt of about 30 percent of GDP in 1998, is found to be the least indebted G-7 country. The corresponding figure for Italy is about 112 percent of GDP, which is again the highest; it is only slightly less than the gross debt because the social security system holds no assets. However, including the social security assets in net debt without also taking into account the future claims of the social security system against government assets may be considered also to give a misleading measure of the government's true financial situation.
- **Net debt excluding social security** partly addresses the social security issue by assuming that the social security system is independent, so that the government debt that it holds should not be treated as a government asset. According to this indicator, Japan's net debt in 1998 was 79 percent of GDP, making it,

#### General Government Fiscal Indicators, 1998<sup>1</sup>

(In percent of GDP)

	Canada	France	Germany	Italy	Japan	United Kingdom	United States
Gross debt	95.8	58.2	61.1	118.7	117.9	62.2	62.1
Net debt including social security assets	62.3	48.4	52.4	112.4	30.5	42.4	48.4
Net debt excluding social security assets <sup>2</sup>	62.3	48.4	52.4	112.4	79.1	42.4	56.1
Overall balance including social security	0.9	-2.7	-2.0	-2.7	-5.3	0.3	1.3
Overall balance excluding social security	2.9	-2.6	-2.3	1.3	-7.5	...	-1.7
Structural balance including social security	1.6	-1.3	-0.7	-1.5	-3.8	-0.3	1.3

<sup>1</sup>All data are from the World Economic Outlook database unless it is indicated otherwise.

<sup>2</sup>Social security assets are assumed to be zero in countries with pay-as-you-go social security systems. For Japan and the United States, data on social security assets are taken from official sources.

The depreciation of the euro since its introduction at the beginning of the year—by 10 percent in terms of the dollar and 6 percent in nominal effective terms, after taking into account some recovery in late July—has added significantly to the support for demand and activity in the euro area. In the context of the area's recent cyclical weakness, the depreciation has been helpful, and it has not threatened the objective of keeping inflation below 2 percent: inflation in the area has recently been running at about 1 percent and is still projected to remain within the ECB's definition of price stability in 1999–2000. However, the euro's decline has taken it to values significantly below those

estimated to be consistent with medium-term fundamentals—although probably not inconsistent with current cyclical conditions—and the euro may be expected to strengthen further in the period ahead as growth in the area picks up and the U.S. economy slows. This prospective appreciation is reflected in interest differentials favoring assets denominated in most non-euro currencies except the yen and the Swiss franc.

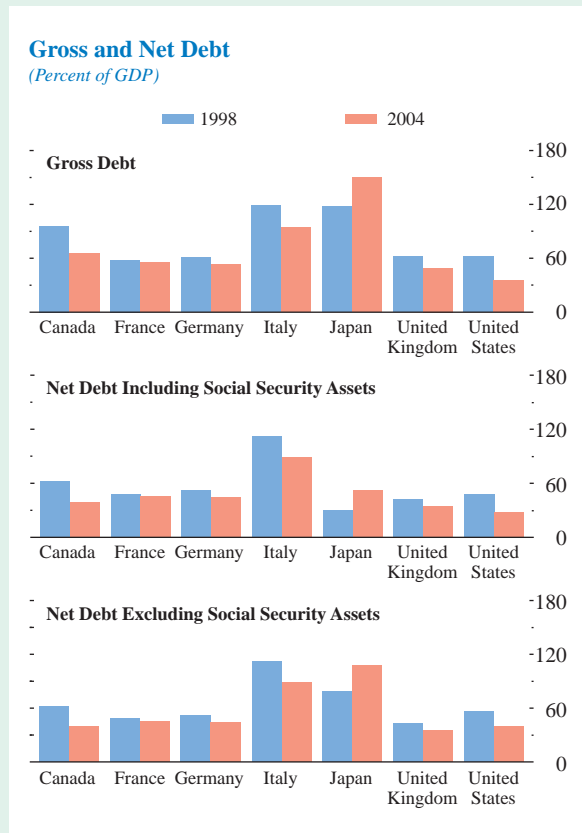
Monetary conditions in the euro area are clearly supportive of recovery at present. Moreover, given the still significant margin of slack in the area as a whole and its dampening effect on inflation, official interest

on this measure, the second most indebted G-7 country behind Italy (where net debt was 112 percent of GDP both including and excluding social security). For other G-7 countries, this debt indicator is in the range of 40–65 percent of GDP.

- An alternative approach would be to add net future public pension liabilities—equal to the present value of future pension liabilities less the assets of the public pension system—to net debt excluding social security to produce a comprehensive measure of **net debt including future public pension liabilities**. The most up-to-date, comparable estimates of future public pension liabilities for G-7 countries are those of Chand and Jaeger (1996).<sup>1</sup> However, these refer to the period 1995–2020, and therefore do not reflect significant public pension reforms undertaken since 1995 or the impact of different demographic developments across G-7 countries after 2020. For these reasons, it would be inappropriate to report a comprehensive measure of net debt based on these estimates. But broadly speaking, future public pension liabilities are at present significantly higher in France, Germany, and Japan than in other G-7 countries, in each case exceeding 100 percent of GDP according to Chand and Jaeger. Italy and Japan would remain the most indebted G-7 countries using the comprehensive measure of net debt, although it is unclear which of these countries would have the larger debt.

A significant shortcoming of all the debt indicators discussed above is that they ignore the implications of the projected profile of fiscal deficits for future levels of debt. As the table also indicates, the G-7 countries start with very different fiscal balances and cyclical positions and, according to WEO projections, these will not evolve in the same way across countries. The figure shows how gross debt, net debt including social security, and net debt

<sup>1</sup>See Sheetal K. Chand and Albert Jaeger, *Aging Populations and Public Pension Schemes*, IMF Occasional Paper No. 146 (December 1996).



excluding social security in 2004 compare with 1998. In each case, the debt increases significantly in Japan, despite the projection that the large structural deficit in 1998 will narrow significantly. Gross debt reaches more than 150 percent of GDP, making Japan by a considerable margin the most indebted G-7 country in 2004. Net debt also increases, and net debt excluding social security in Japan is the highest by 2004. For other G-7 countries, each debt indicator declines between 1998 and 2004.

rates can probably be maintained at present levels at least through the remainder of this year. Of course, the appropriate stance of monetary policy may need to be adjusted during the course of next year depending on the strength of economic growth, conditions in labor markets, developments in foreign exchange markets, and other factors likely to have bearing on inflation and the sustainability of the expansion.

With the ECB’s monetary policy being determined by developments in the euro area as a whole, cyclical divergences in growth performance and inflationary pressures within the area—notable among which are the relatively strong growth and overheating risks evi-

dent in Ireland, the Netherlands, Portugal, and Spain, the relatively solid expansion under way in France, and the contrasting recent sluggishness of activity in Germany and Italy—have to be dealt with by national fiscal and structural policies. But here there is also an unfinished agenda of longstanding problems to be tackled.

In most of the euro area, there has been little further progress with fiscal consolidation since the Maastricht treaty test year of 1997, and tax burdens are at or close to historic peaks. To put government finances on a sound footing and to improve prospects for a lasting revival of growth, most countries need progressively to

eliminate their structural deficits, and some countries with particularly heavy debt burdens or particularly adverse demographic prospects need to aim for structural surpluses. In relation to these needs, several countries' medium-term fiscal programs, which envisage deficits remaining through 2002, are insufficiently ambitious. Assuming that a sustainable recovery materializes, all countries in the area should ensure that their programs are strong enough to produce fiscal positions close to balance or in surplus by 2002, and also strong enough to create room for reducing Europe's debilitating tax rates. In this regard, the recent German consolidation package is particularly welcome: it includes appropriately targeted expenditure restraint and income tax reforms that together are expected to achieve both a broadly balanced medium-term fiscal position and a lower tax burden. The additional measures needed to achieve medium-term fiscal balance in Austria, France, Italy, and Portugal amount to 1–1½ percent of GDP. Elsewhere the adjustment needed is smaller, but in Ireland, the Netherlands, and Spain additional fiscal consolidation would have the benefit of helping to moderate inflationary pressures and reduce the risks of a subsequent hard landing—considerations that also add force to the argument for budgetary tightening in Portugal. In the countries experiencing relatively weak growth, there is room to allow the automatic stabilizers to operate as long as the 3 percent deficit limit of the Stability and Growth Pact is not put at risk.

The further reduction of structural budget deficits, together with the reduction of tax burdens needed to improve incentives for employment and job creation, will require wide-ranging reforms to contain the growth of expenditures, especially spending on subsidies, pensions, and welfare payments. But structural fiscal imbalances are also related to the problem of structural unemployment. The labor market reforms needed to achieve a substantial reduction of unemployment in Europe were discussed in the May 1999 *World Economic Outlook*. They include reforms of unemployment benefit and labor taxation systems, the liberalization of job protection legislation, and reform of the wage determination process. In addition, questionable policies such as statutory reductions in working time need to be implemented flexibly if they cannot be avoided. The employment pact agreed at the Cologne European Council in early June 1999, which added a dialogue on macroeconomic developments (involving governments, the ECB, trade unions, the Commission, and employers' organizations) to existing processes focusing on national reform programs, seems unlikely to add sufficiently to pressures for meaningful and long overdue reforms.

Outside the euro area also, there have been increasing indications in some cases that growth has begun to strengthen in recent months. In the *United Kingdom*, growth slowed virtually to a halt in late 1998 and early

1999 largely owing to a marked decline in net exports, which reflected the strength of sterling as well as the weakening of external demand. More recent data—including a moderate pickup in growth in the second quarter—suggest that the economy has bottomed out without a recession, and the projections show growth picking up through 1999 and reaching its potential rate early next year. This apparent “soft landing” has been made possible partly by subdued inflation at the peak of the cycle—since April it has been below its 2½ percent target rate—which has in turn partly reflected markedly improved labor market performance as well as skillful management of monetary policy. The growth of labor earnings moderated further during the recent slowdown of growth, facilitating further declines in unemployment to 19-year lows. The Bank of England lowered official interest rates in two steps in April and June to 5 percent and, then, in view of strengthening consumer demand, raised rates by ¼ of 1 percent in September. Looking ahead, the appropriate direction and timing of subsequent changes will depend on the strength of the recovery, movements in sterling, and other influences on prospective inflation.

In *Sweden*, the benefits of macroeconomic and structural reforms introduced in response to the severe economic difficulties of the early 1990s have been apparent in the form of robust growth, projected to remain around 3 percent in 1999 and 2000, combined not only with declining unemployment, but also fiscal surpluses and negligible inflation. Fiscal policy needs to remain firm to consolidate these gains, achieve further reductions in public debt, still high at around 70 percent of GDP, and further reduce the size of the public sector.<sup>5</sup> Additional labor market reforms are also needed to improve growth in private sector employment. In both *Denmark* and *Norway*, by contrast, growth is projected to slow to less than 1½ percent in 1999 before picking up again in 2000. The slowdowns this year are partly the result of firmer macroeconomic policies introduced to stem signs of overheating that emerged in 1998, although in Norway the main factor has been a large contraction in investment following many years of rapid growth. Continued fiscal restraint would be appropriate in Norway to take pressure off interest rates, which have been relatively high by European standards. Growth in *Switzerland*, which had picked up in 1997–98 after several years of stagnation, slowed again late last year as exports weakened. With the Swiss franc broadly stable against the euro since the beginning of the year, monetary conditions are now supporting a strengthening of growth, but structural reforms, especially in product markets, are needed to improve medium-term growth prospects.

<sup>5</sup>The share of general government expenditure in GDP has fallen from 70 percent in 1993 to a projected 59 percent in 1999, still the highest among the industrial countries.

## Emerging Market Economies in Asia and Latin America: Ensuring Sustainable Recoveries

The macroeconomic performance of the crisis-hit economies in *Asia* has continued to improve in recent months. Positive GDP growth is expected in almost all countries in the region in 1999 as a whole, with projections in some cases revised up substantially (Table 1.5). Exports have generally increased, supported by competitive exchange rates and improved growth in regional trading partners. The bottoming out of some commodity prices and an upturn in the electronics industry have also helped to underpin the recovery. The partial recovery of capital inflows has eased financing constraints in most cases, and the rise in confidence, along with declining inflation, has permitted further monetary easing. Fiscal policy also continues to play an important supportive role. A resumption of inventory accumulation is being felt as well, while weather-related turnarounds in agriculture are also contributing to growth in Indonesia and the Philippines—an influence also apparent in India. Stronger growth is projected for 2000 in most countries as the recent improvements in economic confidence and activity are followed by a broader-based pickup in domestic demand. For the recovery to be sustainable, however, there is an agenda of structural reforms still to be completed. Plans for financial sector restructuring are generally well advanced, with more stringent prudential standards in place, bank recapitalization proceeding, and plans adopted for the privatization of state-owned institutions. But reforms in the corporate sector are lagging behind in all the crisis countries, and past experience from many other countries points to the risk that losses in this sector, rather than being borne by corporate shareholders, may be largely shifted to the financial system and ultimately to taxpayers through repeated recapitalizations of banks.

*Korea* has been recovering at a surprisingly fast pace from the sharp contraction of 1998, backed by supportive macroeconomic policies—including interest rates below precrisis levels and an expansionary fiscal stance; low inflation; and a competitive exchange rate. The large current account surplus and strong capital inflows have led to some strengthening of the won, although the Bank of Korea has intervened to slow the pace of appreciation and to rebuild reserves. The sustainability of Korea's growth, however, depends on decisive and comprehensive actions to tackle the unfinished agenda of reforms in the financial and corporate sectors. In the financial sector, the focus of attention needs to turn from the banking sector—where restructuring is well advanced—to non-bank financial intermediaries. In the corporate sector, rapid and equitable resolution of the Daewoo situation and, more generally, strengthening the corporate

workout procedure for the other large and midsize *chaebol* are critical.

In *Malaysia*, a strong economic recovery is also now underway in response to fiscal and monetary stimulus and the pegging of the exchange rate at a competitive level. Output growth for the year, currently projected at about 2½ percent, may well need to be revised upward. Continuing excess capacity in the economy has been reflected in declining inflation as well as a large trade surplus. Capital controls, introduced in September 1998, remain in effect, but have been modified. Financial and corporate sector restructuring is continuing; with bank recapitalization and purchases of nonperforming loans (NPLs) essentially completed, the current focus is on disposal of NPLs and consolidation of the banking system. As the recovery progresses, the authorities will need to review the exchange rate peg and remaining capital controls.

In *Thailand* also the recovery has strengthened. A range of indicators point to an increase in consumer spending, and net exports have also picked up; but with capacity utilization still low, investment has remained weak. Fiscal and monetary policies continue to support the recovery. The overall public sector deficit, including the costs of financial sector restructuring, is projected to exceed 7 percent of GDP in the 1998/99 fiscal year before declining steadily with the recovery in economic activity. Overnight interest rates have recently been as low as 1 percent, compared with over 10 percent in the run-up to the crisis. Financial sector restructuring is broadly on track, with banks now focused on raising additional capital to meet higher prudential standards, and the bank privatization program is moving ahead after some initial delays. The framework for corporate restructuring is largely in place, strengthened by recent passage of bankruptcy and foreclosure laws; this framework now needs to be implemented.

The hardest-hit crisis economy in Asia, *Indonesia*, now also seems to have turned around, and although real GDP is still projected to decline a little further in 1999 as a whole, positive growth resumed in the first half. Inflation is expected to reach single digits on a 12-month basis by the end of the year. However, the scandal surrounding Bank Bali and the crisis in East Timor risk setting back prospects of an early return to financial stability and sustained growth. While the recovery so far has been driven by improvements in agricultural output and exports, Indonesia still faces deep-seated structural problems that must be addressed for a robust recovery to take hold. High levels of nonperforming loans (which amounted to around 55 percent of total loans at end-April, but declined to 40 percent after some were transferred to the bank restructuring agency) have increased the extent of bank insolvency and the costs of rehabilitation. While a coherent recovery strategy is in place, it has yet to be firmly implemented. To contain bank restructuring costs, in-

**Table 1.5. Selected Developing Countries: Real GDP and Consumer Prices***(Annual percent change)*

	Real GDP				Consumer Prices <sup>1</sup>			
	1997	1998	1999	2000	1997	1998	1999	2000
<b>Developing countries</b>	<b>5.8</b>	<b>3.2</b>	<b>3.5</b>	<b>4.8</b>	<b>9.2</b>	<b>10.3</b>	<b>6.7</b>	<b>5.8</b>
<b>Median</b>	<b>4.1</b>	<b>3.5</b>	<b>3.7</b>	<b>4.4</b>	<b>6.2</b>	<b>5.3</b>	<b>4.3</b>	<b>4.0</b>
<b>Africa</b>	<b>3.1</b>	<b>3.4</b>	<b>3.1</b>	<b>5.0</b>	<b>11.1</b>	<b>8.7</b>	<b>9.0</b>	<b>6.9</b>
Algeria	1.1	4.7	4.6	5.4	6.8	6.2	5.3	5.0
Cameroon	5.1	5.0	4.4	4.8	5.2	2.8	2.0	2.0
Côte d'Ivoire	6.0	5.4	5.5	5.8	5.6	4.5	2.5	2.5
Ghana	4.2	4.6	5.5	6.0	28.8	19.3	10.0	6.4
Kenya	2.1	1.5	2.1	3.5	11.2	6.6	5.0	5.0
Morocco	-2.0	6.3	0.6	5.1	1.0	2.7	2.0	2.5
Nigeria	3.1	1.9	0.5	3.3	8.5	10.0	12.5	12.5
South Africa	2.5	0.5	0.7	3.5	8.6	6.9	6.5	5.5
Sudan	6.7	5.0	5.5	5.2	46.7	17.0	16.9	9.0
Tanzania	3.5	3.3	3.9	5.1	16.1	12.6	7.8	5.1
Tunisia	5.4	5.1	5.5	6.5	3.7	3.6	3.6	3.5
Uganda	5.2	5.5	7.0	7.0	7.8	5.8	5.0	5.0
SAF/ESAF countries <sup>2</sup>	5.2	4.6	5.6	5.8	8.0	7.7	5.9	4.3
CFA countries	5.1	4.9	4.5	5.3	4.4	3.6	2.7	2.5
<b>Asia</b>	<b>6.6</b>	<b>3.7</b>	<b>5.3</b>	<b>5.4</b>	<b>4.8</b>	<b>8.0</b>	<b>3.1</b>	<b>3.5</b>
Bangladesh	5.2	4.8	4.5	4.5	4.8	7.9	7.9	7.0
China	8.8	7.8	6.6	6.0	2.8	-0.8	-1.5	1.5
India	5.5	5.8	5.7	5.5	7.2	13.0	6.5	7.2
Indonesia	4.7	-13.7	-0.8	2.6	6.6	59.6	22.7	5.7
Malaysia	7.7	-6.7	2.4	6.5	2.7	5.3	3.0	2.4
Pakistan	1.2	3.3	3.1	4.0	12.5	7.8	6.1	6.5
Philippines	5.2	-0.5	2.2	3.5	6.0	9.7	8.5	6.0
Thailand	-1.3	-9.4	4.0	4.0	5.6	8.1	0.5	2.0
Vietnam	8.2	3.5	3.5	4.5	3.2	7.7	7.6	6.0
<b>Middle East and Europe</b>	<b>4.5</b>	<b>3.2</b>	<b>1.8</b>	<b>3.1</b>	<b>23.1</b>	<b>23.6</b>	<b>18.3</b>	<b>13.1</b>
Egypt	5.0	5.4	6.0	5.4	6.2	3.8	3.7	4.0
Iran, Islamic Republic of	3.0	1.7	1.0	2.5	17.3	22.0	15.0	10.0
Jordan	1.3	2.2	2.0	2.5	3.0	4.5	1.9	2.8
Kuwait	2.5	2.2	-1.1	0.7	0.7	0.5	0.9	1.7
Saudi Arabia	2.7	1.6	-2.0	1.1	-0.4	-0.2	1.5	1.1
Turkey	7.6	2.8	1.2	2.6	85.7	84.6	60.4	38.2
<b>Western Hemisphere</b>	<b>5.3</b>	<b>2.2</b>	<b>0.1</b>	<b>3.9</b>	<b>13.2</b>	<b>10.6</b>	<b>9.8</b>	<b>7.6</b>
Argentina	8.1	3.9	-3.0	1.5	0.8	0.9	-0.8	0.6
Brazil	3.7	0.1	-1.0	4.0	6.0	3.8	4.6	4.8
Chile	7.6	3.4	-0.4	5.5	6.1	5.1	4.0	3.3
Colombia	2.8	0.6	0.0	2.6	18.5	18.7	11.7	10.8
Dominican Republic	8.2	7.3	7.0	7.0	8.3	4.8	7.8	4.2
Ecuador	3.5	0.4	-7.0	1.5	30.6	36.1	55.1	36.2
Guatemala	4.1	4.9	3.9	4.5	7.1	7.5	6.5	6.0
Mexico	7.0	4.6	3.0	5.0	20.6	16.7	17.1	11.2
Peru	7.2	0.7	3.0	5.5	8.5	7.3	4.4	5.3
Uruguay	5.1	4.5	-2.0	2.5	19.8	10.8	6.0	3.0
Venezuela	5.9	-0.7	-7.6	1.6	50.0	35.8	24.4	17.3

<sup>1</sup>In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages, rather than as December/December changes during the year as is the practice in some countries.

<sup>2</sup>African countries that had arrangements, as of the end of 1997, under the IMF's Structural Adjustment Facility (SAF) or Enhanced Structural Adjustment Facility (ESAF).

creased loan recovery from major corporate debtors is essential. There is also a need for improved implementation of the newly amended bankruptcy law, the fully effective introduction of anticorruption legislation, and a wide range of reforms to strengthen corporate governance.

In the *Philippines*, a turnaround in agriculture and rising exports are supporting a broader pickup in domestic output and spending. Improvements in confidence, together with declines in inflation, have helped interest rates to fall below precrisis levels. Financial sector reforms are generally on track; however, more

rapid progress is needed in several areas of public sector reform.

Following the weakening of activity in 1998, a strong economic recovery is under way in *Singapore*, with growth of 4–5 percent expected in 1999–2000. Helping to support activity has been a substantial easing of fiscal policy—an appropriate response given the country’s particularly strong record of fiscal discipline and its large external assets—and a recovery of exports of electronic products. Notwithstanding the easing of monetary policy following the outbreak of the regional economic crisis, inflation has remained near zero.

There are also recent signs of an economic turnaround in *Hong Kong SAR*. Led by a rebound in private consumption, output rose sharply in the second quarter this year after five consecutive quarters of decline. While the decline in exports appears to have bottomed out, private investment remains sluggish. Financial market developments have been encouraging, with stock market and real estate prices recovering, downward pressures on the currency receding, and interest rates declining close to rates on U.S. dollar-denominated assets. However, with the price level continuing to decline, real interest rates are still relatively high. The banking sector remains strong, notwithstanding recent increases in nonperforming loans and exposures of some banks (and their clients) to potential difficulties in China.

*China* has weathered the effects of the Asian crisis relatively well, aided by fiscal stimulus in mid-1998, and also by its relatively strong external position. GDP growth, while slowing, has remained rapid by most standards. The appreciation of regional currencies and deflation in China have also reversed the real effective appreciation of the renminbi in the initial stage of the crisis. Nevertheless, strains on the economy are showing, reflected in weak private demand, deflationary pressures, capital outflows, and higher unemployment. Against this background, the authorities’ intention to ease fiscal policies further in 1999 is appropriate especially to the extent that this can be used to strengthen social safety nets and foster restructuring. Following recent reductions in interest rates, however, the scope for further monetary easing may be constrained given the emergence of significant differentials in favor of foreign rates. On the structural side, the key challenge remains to accelerate reforms in the state enterprise and financial sectors and to strengthen the revenue effort over the medium term. The welcome establishment of Asset Management Companies will need to be accompanied by the development of a strong credit culture and further enterprise restructuring to prevent new losses in the future. Given the likely costs of bank and enterprise restructuring, it will also be important to strengthen the fiscal position over the medium term, including through further revenue mobilization.

Economic activity in *India* held up relatively well throughout the financial crisis in Asia, supported in

part by earlier structural reforms that contributed to growth rates of over 7 percent in the mid-1990s, and current indicators suggest that GDP growth should remain strong at around 5½ to 6 percent in 1999 and 2000. The increase in agricultural incomes is providing a boost to domestic demand, and with exports also recovering, industrial production has begun to revive. Inflationary pressures, meanwhile, have declined, with wholesale prices increasing at their slowest rate in over a decade; this decline largely reflects the easing of supply problems in a number of key agricultural commodities. However, to establish the conditions for strong sustainable growth over the medium term, policy action is needed on a number of fronts. A key concern is the large public sector deficit, which is expected to rise to almost 10 percent of GDP in 1999/2000, resulting in a high level of public sector debt, and is adversely affecting investment. The priority for the new government to be formed in October will be to establish an ambitious and well-specified medium-term fiscal adjustment program, coupled with commitments to build on the progress already evident in a number of areas of structural reform. In addition to the public sector reforms needed for fiscal consolidation, prospects for meaningful growth in per capita income would be greatly improved through faster progress with the privatization of state-owned banks, combined with measures to increase labor market flexibility, deregulate product markets, and liberalize the trade regime.

In *Pakistan*, the external position strengthened in the first half of 1999, with international reserves recovering from a precariously low level at the turn of the year. This reflected the resumption of financial support from the IMF, an associated rescheduling of debt to official bilateral creditors, and a strengthening of economic policies, especially steps to reinforce the budget and the unification of the exchange rate. Sustained improvement in the external position and a recovery of growth will require more determined implementation than in the past of wide-ranging structural reforms, especially fiscal reforms aimed at broadening the tax base and improving tax collection.

Recent developments in *Latin America* have been very mixed, contributing to divergent revisions in economic projections. For the region as a whole, real GDP is now expected to be flat in 1999, and the growth projection for 2000 has been revised up to 4 percent. Upward revisions to growth projections for Brazil and Mexico, however, have been partly offset by downward revisions for Argentina, Chile, Colombia, Ecuador, and Venezuela. The downside risks remain substantial, given the policy challenges that many countries continue to face, the heavy political calendar in the region, and the fragility of financial sentiment, which was demonstrated again by turbulence in early July. The possibility of a cyclical slowdown in the United States is also a risk factor.

Underpinning the faster-than-expected recovery in *Brazil* has been the firm implementation of stabilization policies, which has led to a rapid rebuilding of economic confidence since March. With the exchange rate having stabilized after its initial overshooting, and the pass-through effects on inflation having been well contained, the monetary authorities have been able to reduce interest rates steadily. Higher tax revenues and firm expenditure controls have kept the primary budget surplus above its 1999 target and this, combined with lower interest rates and the stronger exchange rate, has begun to reverse the rapid buildup of net public debt of recent years. External trade has been weak, with exports declining by 14 percent and imports by 17 percent in the first half of 1999. However, substantial gains in export market share are expected in the period ahead, following the 35 percent decline in the real effective exchange rate in the first half of 1999. Further progress in strengthening the macroeconomic framework—including improved control of public spending and effective implementation of the new inflation-targeting framework for monetary policy—along with structural reforms, is needed to support the recovery and reduce the country's high risk premium still apparent in real interest rates.

The economic outlook in *Mexico* has also improved, led by stronger exports and industrial production and a more recent pickup in private consumption, and reflecting the buoyancy of growth in the country's main trading partners in North America. Financial market indicators also signal a rise in confidence since the end of 1998; the exchange rate and the stock market have both strengthened, and interest rates have fallen—albeit with partial mid-year reversals linked to U.S. interest rate developments. Fiscal policy remains firm, although further measures to reduce the budget's dependence on oil-related revenues would be desirable. The monetary authorities are gradually shifting toward an inflation-targeting framework that should help in reducing inflation further. The banking sector remains weak following the 1994–95 financial crisis, with low profitability, undercapitalization, a substantial burden of nonperforming loans, and continued credit disintermediation. Much more rapid progress with bank restructuring is required. The authorities have recently announced new measures to strengthen the regulatory framework including tougher rules on capital and loan-loss provision requirements to establish conditions necessary for the dismantling of the universal deposit insurance guarantee, implemented earlier this year, by the end of 2002. Draft legislation to reform the bankruptcy law is also expected to be presented to congress later this year to improve creditor-borrower relations and support a resumption of credit extension to the private sector.

Since late 1998, economic activity in *Argentina* has declined more sharply than previously expected, and GDP is now projected to fall by 3 percent in 1999, with

continued downside risks to the projected recovery. Tight financial conditions and a worsening of the terms of trade (stemming from lower agricultural commodity prices) have contributed to weak domestic demand; this has led to a large fall in imports, recently down by as much as one-fourth on a 12-month basis. The recession has also contributed to a weakening of the fiscal position. Firm macroeconomic management and a clear commitment to further structural reforms will be called for from the government that emerges from the October elections. In *Chile*, the slowdown that began in 1998 also continued in the first half of 1999. While exports have declined owing to poor external market conditions, weak domestic demand has led to a sharper fall in imports and a reduction in the current account deficit. These developments, together with continuing low inflation and rising unemployment, have permitted a lowering of the central bank's real interest rate target by over 3 percentage points since the beginning of the year; they also prompted the authorities to introduce an expansionary fiscal package.

Colombia, Ecuador, and Venezuela have all been experiencing severe economic difficulties in recent months, with sizeable contractions in output projected for Ecuador and Venezuela in 1999 and only modest recoveries expected in 2000. While inflation in *Venezuela* has declined since 1998, it remains high and has resulted in a significant appreciation of the real exchange rate. The increase in oil prices in recent months has contributed to substantial improvements in Venezuela's external balance and fiscal position, but the public sector deficit is expected to remain at about 5 percent of GDP in 1999. While the authorities have taken steps to stem the fiscal slippage, including limiting public sector wage increases, additional reforms are needed to improve the quality of fiscal adjustment. Over the longer term, there is a need for reforms directed at strengthening the non-oil sector of the economy. The economy of *Ecuador* is particularly fragile, with inflation rising, a large part of the banking sector in crisis, and the fiscal position deteriorating. Inflation is expected to increase further, driven by monetary expansion following the central bank's provision of liquidity support to troubled banks, combined with the large exchange rate depreciation earlier in the year. Monetary control needs to be rapidly reestablished, implementation of a credible strategy for resolving the banking crisis is also urgently required, and structural improvements in the public finances are needed as well.

After many years of relative macroeconomic stability and steady growth, *Colombia* has recently been suffering its most severe recession since the 1930s, with unemployment reaching a record high of 20 percent and the banking sector in acute crisis. The peso was devalued by about 12 percent in late June to halt the depletion of international reserves. Policies adopted subsequently to strengthen the public finances

and restructure the banking sector are essential to return Colombia to a path of sustainable growth.

### Middle East and Africa: Varying Responses to Adjustment Pressures

The economies of the Middle East and Africa have recently been influenced by three developments. First were movements in *commodity prices*. The increase in oil prices since March is helping to improve the external balances, fiscal positions, and short-term growth prospects of oil-exporting countries, while the persistent weakness of non-oil commodity prices continues to constrain growth in many other countries, especially in Africa (Box 1.4). Second, pressures for *structural reforms* have increased, in some cases because of the economic difficulties brought on by depressed commodity prices in recent years. Thus, increased official attention has been given to preparations for, and in some cases the implementation of, the privatization of public utility and transportation companies (in many of the 20 sub-Saharan African ESAF countries, including Cameroon, Côte d'Ivoire, Ghana, Mozambique, Senegal, and Tanzania, and also in Algeria, Jordan, Kuwait, Saudi Arabia, and South Africa); and to public sector reforms and other structural measures intended to improve fiscal control (in all ESAF countries in sub-Saharan Africa) or to improve the business and investment environment (for example, in Morocco). The full implementation of such reforms would have substantial benefits for the two regions' longer-term economic prospects. Third, the economic outlook is also being shaped by various improvements in *trade and political cooperation*. Several positive developments can be cited, including the common external tariff being implemented by the West African Economic and Monetary Union; tariff reductions introduced under the Pan-Arab Free Trade Agreement; trade agreements with the EU concluded by Morocco, Tunisia, and South Africa, together with a range of other bilateral trade liberalization measures; plans for establishing free-trade areas in 2000 in the Common Market for Eastern and Southern Africa and also in the Southern African Development Community; and renewed momentum in the Middle East peace process. Another important development is that some countries, particularly in Africa, are beginning to benefit from the reductions in their external debt overhang stemming mainly from the HIPC Initiative. Countries obtaining debt relief under this initiative have used the resources freed up to increase public spending on anti-poverty programs. On the other hand, the military conflicts that involve, directly or indirectly, around one-third of the countries of sub-Saharan Africa represent a major impediment to building political and economic stability (see Chapter VI).

For *Africa* as a whole, projected growth has been revised down slightly, with GDP now expected to grow by around 3 percent in 1999 and 5 percent in 2000. However, this aggregate picture masks the fact that Algeria and many of the smaller countries—including Cameroon, Côte d'Ivoire, Ghana, Mozambique, Sudan, Tanzania, Tunisia, and Uganda—have been performing rather well in macroeconomic terms: growth of 4–5½ percent is projected for most of these countries in 1999, with some further strengthening expected in 2000, and inflation has generally been held at low-to-moderate single-digit levels. This relatively strong performance may be attributed in part to continued appropriate macroeconomic policies and, in some cases, markedly more favorable weather conditions. For Ghana, Mozambique, and Uganda, their recent strong performance is a continuation of sustained growth since the early 1990s. In *Algeria*, fiscal and monetary policies were tightened in 1999 to counter the deterioration in the external environment caused by the decline in oil prices, and an extensive program of structural reforms has been implemented since 1995. In *Tunisia*, consistently strong growth is projected to continue in 1999 and 2000, driven by strong export performance and supported by fiscal consolidation and a flexibly managed exchange rate regime.

On the other hand, economic activity has been much weaker in three of the other largest African economies. In *South Africa*, growth is expected to strengthen somewhat in 1999 following the slowdown in 1998, supported by renewed financial market confidence, much lower interest rates, and improved prospects for exports (especially to Asia). While further modest reductions in interest rates may be appropriate as inflation continues to decline and a firm fiscal position is maintained, the scope for interest rate declines is limited by the need to safeguard the external position and thus help reduce the net open forward position of the Reserve Bank. This would reduce the South African risk premium and boost the trend rate of growth. Rapid implementation of structural reforms would also underpin prospects for stronger growth in 2000 and over the medium term. GDP in *Nigeria* is projected to grow by only ½ of 1 percent in 1999, combined with budget and current account deficits of around 8 percent and 14 percent of GDP, respectively. While these adverse developments are partly attributable to lower oil prices in 1998 and early 1999 and the subsequent sharp reduction in oil production associated with lower OPEC quotas—non-oil GDP is expected to increase by 3 percent in 1999 compared with a 4 percent decline in oil GDP—slippages in fiscal and monetary policies in the first quarter of 1999 have exacerbated the situation. These problems have since been partially corrected, with higher oil prices also improving export and public sector revenues. However, to revive economic growth over the medium term, there is a need for further fis-

### Box 1.4. Oil Price Assumptions and the *World Economic Outlook*

The price of oil has continued to fluctuate widely in recent years (see first figure). After reaching a peak of nearly \$25 a barrel in early 1997, oil prices fell sharply, to below \$11 a barrel in early 1999, as the global economic slowdown weakened oil demand at the same time global production continued to increase. Since March 1998, there have been efforts by oil-producing countries to raise prices by constraining supply. These efforts proved unsuccessful until they were intensified in March 1999, around the time that global demand for oil began to pick up. Oil prices subsequently rose sharply, and pushed above \$21 a barrel in August. With this recent rise, petroleum prices are now above their 10-year average.

As with other commodity prices, the future path of oil prices is an essential assumption underlying projections in the *World Economic Outlook*. The methodology used to set the oil price assumption is technical rather than

judgmental or model-based. Near-term projections—up to eight quarters ahead—are determined by futures quotations, averaged over five trading sessions to reduce any undue impact of day-to-day volatility.<sup>1</sup> Beyond eight quarters, prices in the baseline are assumed constant in real terms, using as a deflator the projection for export unit values for manufactured goods from the most recent *World Economic Outlook*.

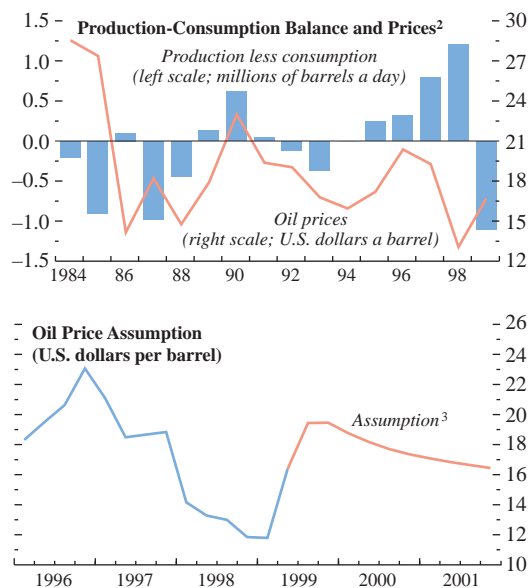
The oil price assumption used in this *World Economic Outlook* was set on August 18, 1999 along with other global economic assumptions such as prices for other commodities, exchange rates, and interest rates for the major currencies. The baseline oil price for 1999, \$16.70, reflects actual prices during the first seven months of the year, including a low of less than \$11 a barrel in February, and the prices in futures markets (in the five trading days prior to August 18) for oil to be delivered through the remaining months of the year (see first figure). The assumption for 2000, \$18.00, is based entirely on futures prices and reflects the downward slope in the term structure of futures prices for delivery through the year.

After the global economic assumptions for the *World Economic Outlook* were set in mid-August, spot and near-term future oil prices rose to \$23 a barrel in mid-September. This change in market conditions, if sustained, would suggest an upward revision to the oil price baseline of about 7 to 8 percent for 1999–2000 if a revision were to be made at the time of writing. The revision in 2001 is in the 3 to 4 percent range; it is smaller because of the tendency for futures prices at longer delivery dates to be less influenced by day-to-day shifts in the spot market and anchored more, albeit loosely, to past average oil prices.

A change in the price of oil affects the world economy through several channels and review of these can provide an indication of how the macroeconomic projections may be affected by a revised assumption. The following analysis and accompanying tables and figures assume a 10 percent increase in the price of oil, about the same increase that has occurred in markets since the baseline assumption was set.

- A rise in oil prices would cause a transfer of income from oil consumers to oil producers. For instance, if oil prices increase by 10 percent, or about \$2 a barrel at current prices, oil-producing countries would gain about \$16 billion in export revenue, if the price

#### World Oil Markets: Production, Consumption, and Prices<sup>1</sup>



Sources: Bloomberg Financial Markets, LP; International Energy Agency; and IMF staff estimates.

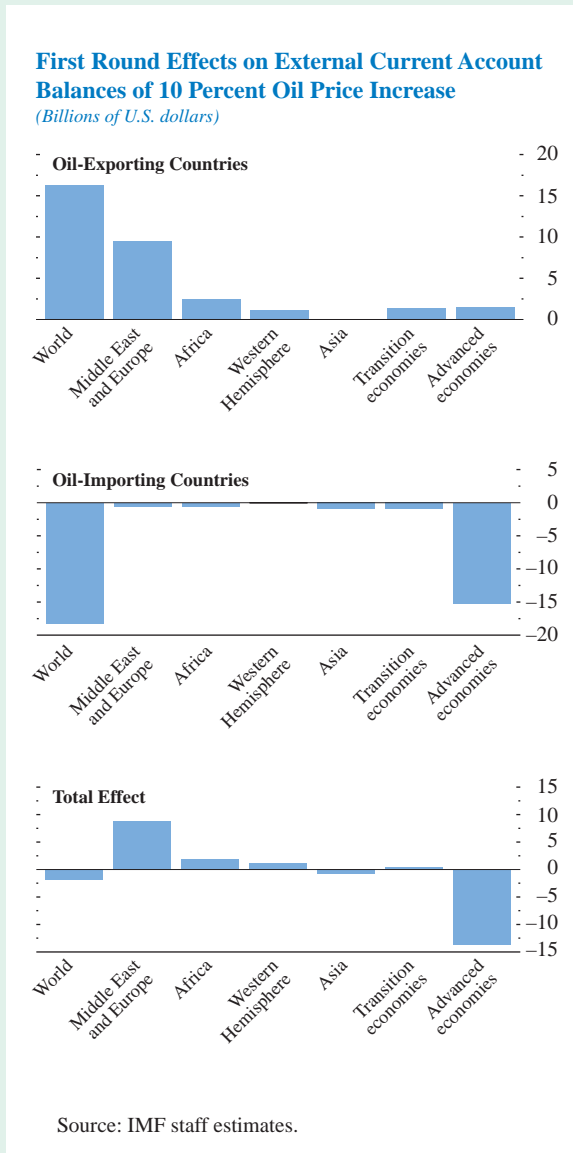
<sup>1</sup>Simple average of U.K. Brent, Dubai, and West Texas Intermediate spot prices.

<sup>2</sup>For 1999, the production-consumption balance is an estimate. The oil price is the *WEO* assumption.

<sup>3</sup>Based on oil price futures as of August 18, 1999.

cal consolidation, reductions in the high rate of inflation compared with other countries in the region, and determined implementation of the new government's

plans for privatization, deregulation, and other structural reforms. Weak growth in *Morocco* in 1999 is partly the result of a drought-related decline in agri-



rise were to be sustained for a full year and the volume of oil trade were unchanged (see second figure). Oil-importing countries would see their import bills rise by the same amount. On a regional basis, countries in the Middle East would gain about \$10 billion, or about 2 percent of their aggregate GDP. Other regions would see smaller gains. Oil-importing advanced economies would pay the bulk of the higher

**Impact of a 10 Percent Increase in Oil Prices<sup>1</sup>**

	Real GDP	CPI Inflation
<b>Major Industrial Countries</b>		
United States	-0.1	0.2
Japan	-0.1	0.1
Euro area	-0.1	0.2
United Kingdom	-	0.1
Canada	-0.1	0.2
<b>Oil-Importing Developing Countries<sup>2</sup></b>		
Africa	-	0.3
Asia	-0.2	0.4
Western Hemisphere	-	0.3

Source: Major industrial countries: MULTIMOD simulation. Developing country regions: IMF staff estimates.

<sup>1</sup>Deviation from baseline.

<sup>2</sup>Weighted average of the larger economies in each region that are not major oil exporters. The Middle East and Europe region is not shown because of the importance of oil in this region.

import costs, as trade in oil is mostly balanced across emerging economies on a regional basis, except for the Middle East.

- For the industrial countries, a 10 percent rise in oil prices would tend to raise inflation rates and reduce real output slightly (see first table). The estimated reduction in output and rise in inflation are smaller than the experiences of the 1970s and early 1980s would suggest because the ratio of oil consumed to GDP in these countries has declined considerably since then owing to greater efficiency in the use of oil. The estimated impact on inflation is also muted because the monetary authorities in the major industrial countries are assumed to target inflation and therefore tighten policies with the rise in oil prices.
- For oil-exporting developing countries, a 10 percent rise in oil prices would lead to an increase in export and tax revenue that could improve government balances (see second table). How governments react, and the extent to which higher real incomes are passed on to the private sector, may depend partly on the country's past access to external financing. Countries such as Saudi Arabia and Kuwait that have traditionally been net creditor countries may choose to replenish reserves. In these cases, a rise in oil prices may have little immediate impact on the domestic economy. Alternatively, they may use the additional revenue to ease spending restraints adopted as oil prices declined, and contribute to a pickup in domestic demand. For other oil exporters that in the past have been net debtors, such as Mexico, Nigeria,

(continued on next page)

cultural output, and a rebound is expected in 2000. Again, however, there is a need for additional fiscal consolidation and structural reforms; progress in

these areas would enhance the potential benefits to be derived from the important trade liberalization measures that were recently introduced.

**Box 1.4 (concluded)****Selected Oil-Exporting Developing and Transition Countries: First-Year Impact of a 10 Percent Increase in Oil Prices on Public Sector Revenues<sup>1</sup>**

	1997–98 Averages		Estimated Impact on Government Revenue (percent of GDP)
	Oil revenue as a percent of total public sector revenue	Fiscal position Overall balance (percent of GDP)	
<b>Africa</b>			
Algeria	18.4	-0.8	1.4
Angola	75.0	-17.4	6.0
Cameroon	25.3	-1.4	0.4
Congo, Rep. of	68.5	-10.3	1.2
Gabon	58.9	-5.0	1.4
Nigeria	77.8	-5.7	1.9
<b>Asia</b>			
Brunei Darussalam	80.0	-16.2	6.4
<b>Middle East and Europe</b>			
Bahrain	55.4	-5.1	1.1
Egypt	8.1	-1.2	0.1
Iran	54.0	-2.7	1.1
Kuwait	59.8	13.4	1.4
Oman	74.1	-1.4	1.3
Qatar	57.6	-9.2	0.6
Saudi Arabia	67.2	-6.5	1.0
Syrian Arab Rep.	39.3	-3.2	0.8
<b>Western Hemisphere</b>			
Mexico	34.7	-1.1	0.4
Trinidad and Tobago	11.2	-0.7	0.4
Venezuela	69.3	-2.4	1.2
<b>Countries in Transition</b>			
Kazakhstan	10.0	-7.5	0.2
Russia	4.0	-7.9	0.1

Source: IMF staff estimates.

<sup>1</sup>Countries classified as fuel exporters. See Statistical Appendix Table C for the full classification of countries by major export.

and Venezuela, a rise in oil prices could not only increase export earnings and real incomes, but also lower external borrowing costs on the assumption that higher oil prices would reduce the risk premia charged these countries as their expected future export earnings rose. The impact on GDP in oil-exporting countries would depend on how the increase in oil prices came about: if it is due to a rise in world demand, then oil production and therefore total GDP could increase compared to the base case; if it is due to a reduction in supply, oil production and GDP could fall below baseline levels. In the current conjuncture, the oil production restrictions put in place have lowered overall output.

- In oil-importing developing countries, higher world oil prices would raise domestic prices, and in the

near term lead to lower non-oil imports, to the extent that oil demand is more price-inelastic than other imported goods and that additional external financing of higher oil imports is not available (see first table). Real income would be reduced through the adverse shift in the terms of trade, and output would likely fall. The estimated impact on output in developing countries is small because some of the larger countries in each region produce oil (and therefore are less dependent on oil imports), although they are not classified as fuel exporters. In addition, several developing countries, for example Egypt and the South Asian countries, are dependent on trade with oil producers and could benefit from higher oil prices as oil producers increase their imports from these countries.

In the Middle East, moderate economic growth is projected to continue, although Saudi Arabia and Kuwait may experience negative growth this year on

account of lower oil output. In *Egypt*, growth is expected to remain relatively strong in 1999, with inflation stable around 4 percent. Some recent develop-

ments, however, have underscored that further progress with economic reforms and liberalization will be needed to sustain this strong performance. The external current account position has moved from a slight surplus in 1996/97 to a moderate deficit in 1998/99, driven in part by strong expansion of domestic credit; and external reserves have been declining while interest rates have remained relatively low, leading to the use of central bank financing to fund the government deficit. In the *I.R. of Iran*, following the sharp deterioration in most economic indicators in 1998, the authorities have begun to implement an important program of macroeconomic consolidation and structural reforms aimed at reducing some of the large distortions in the economy and fostering stronger growth in the medium term. The goals include sharply reducing the budget deficit; lowering inflation by halving the rate of money growth and restoring positive real interest rates; and liberalizing the foreign exchange market and domestic prices. Following last year's oil price decline, the authorities in *Saudi Arabia* and *Kuwait* also moved to tighten fiscal policy, including through measures designed to strengthen expenditure control and broaden the tax base, and accelerated plans for the privatization of some large state enterprises. With the recent recovery in oil prices, domestic demand is expected to pick up in the period ahead.

Following the contraction that began in the second quarter of 1998, before the devastating recent earthquake, economic activity in *Turkey* appeared to have bottomed out.<sup>6</sup> The newly elected government has signaled its commitment to economic adjustment and reform, which are needed to address the substantial uncertainties surrounding the short- to medium-term outlook, associated in turn with the precarious macroeconomic environment and the effects of persistently high inflation. Fiscal policy was relaxed in the run-up to the elections in April 1999, adding pressures to debt-servicing costs which had increased sharply following the rise in interest rates in the second half of 1998. Without adjustment, the operational public sector deficit could reach 10 percent of GDP in 1999. After declining to its lowest level this decade, inflation has been threatening to pick up again. The rate of currency depreciation, after being increased in the after-

math of the Russian crisis from around 2½ percent to 4–5 percent a month, has more recently been reduced to 3–3½ percent. A much firmer macroeconomic policy framework, involving a commitment to fiscal discipline and a renewed focus on disinflation, is needed to safeguard economic and financial stability. This needs to be supported by wide-ranging reforms in such areas as the pension system, agricultural policies, and the financial sector.

### After a Decade of Transition: Widening Gaps Between Strong and Weak Performers

The recent crises in emerging markets have widened the differences between the stronger and weaker transition economies. Exports have slowed throughout the region, most strongly in countries with substantial trade links with Russia, but there have been marked differences in countries' resilience and policy responses in the face of this and other related shocks. Currency depreciations in Russia and its neighbors may help their adjustment, but concerns about economic policies and prospects in a number of these countries may have prolonged exchange rate volatility and have probably delayed the reduction in interest rate risk premia. In other cases, macroeconomic credibility has been enhanced by policies conducive to a much greater degree of exchange rate stability. Structural conditions have also been critical in determining how countries performed under recent pressures. Countries that entered the recent crises with weak banking systems and unstructured enterprises found their problems further aggravated by the subsequent economic downturn. And foreign investment flows have also become more discriminating. In southeastern Europe, economic prospects have been adversely affected by the conflict in Kosovo (Box 1.5).

After some modest growth in 1997 and early 1998 for the first time since transition began, economic activity in *Russia* again weakened in the wake of the 1998 financial crisis. Continuing economic and political uncertainties have led to further capital flight and a sharp decline in foreign direct investment compared with precrisis levels. Nevertheless, some recent developments suggest that the economic decline is being reversed. Industrial output has picked up, reaching a level above that of a year earlier. This is apparently the result in part of increased import substitution following the large depreciation of the ruble. Higher oil prices have had a positive effect on the current account balance and on government revenues. Monetary policy has remained reasonably firm, with limited resort to monetary expansion to fund the budget deficit. As a result, inflation has slowed to around 3 percent a month or less, gross foreign reserves have increased, and the ruble has been broadly stable since April.

<sup>6</sup>The projections for Turkey were prepared prior to the August earthquake. Based on preliminary estimates of earthquake damage prepared by the World Bank, the IMF staff estimates that GDP could decline by ½ to ¾ of 1 percent in 1999 relative to the baseline projection, and could be 1 to 1¼ percent higher than the baseline in 2000 as a result of the reconstruction effort. The current account deficit is expected to widen, especially in 2000 as construction-related activity picks up. Furthermore, recent indicators suggest that the downturn in 1998–99 was deeper than earlier assumed, but that the economy was recovering rapidly before the earthquake hit. Taking these developments and the earthquake's impact into account, GDP is now expected to contract by nearly 1 percent in 1999, and to grow by just over 5 percent in 2000.

**Table 1.6. Countries in Transition: Real GDP and Consumer Prices***(Annual percent change)*

	Real GDP				Consumer Prices			
	1997	1998	1999	2000	1997	1998	1999	2000
<b>Countries in transition</b>	<b>2.2</b>	<b>-0.2</b>	<b>0.8</b>	<b>2.8</b>	<b>28</b>	<b>21</b>	<b>39</b>	<b>18</b>
<b>Median</b>	<b>3.5</b>	<b>3.7</b>	<b>1.8</b>	<b>3.7</b>	<b>15</b>	<b>10</b>	<b>8</b>	<b>6</b>
Central and eastern Europe	3.0	2.2	1.0	3.3	37	18	21	16
Excluding Belarus and Ukraine	3.4	2.3	1.7	4.0	39	15	9	6
Albania	-7.0	8.0	8.0	8.0	32	21	7	6
Belarus	11.4	8.3	-2.0	0.0	64	73	320	250
Bosnia and Herzegovina	30.0	18.0	8.0	14.0	14	10	5	3
Bulgaria	-7.0	3.5	1.5	4.0	1,082	22	-1	4
Croatia	6.5	2.3	-2.0	2.5	4	6	4	3
Czech Republic	0.3	-2.3	0.0	1.5	8	11	3	5
Estonia	10.6	4.0	0.5	5.0	11	8	4	3
Hungary	4.6	5.1	3.7	4.5	18	14	9	8
Latvia	6.5	3.8	2.0	4.0	8	5	2	3
Lithuania	7.3	5.1	0.5	4.0	9	5	2	3
Macedonia, former Yugoslav Rep. of	1.5	2.9	-4.0	3.0	2	1	2	2
Moldova	1.3	-8.6	-5.0	1.0	12	8	28	6
Poland	6.8	4.8	3.7	5.0	15	12	7	5
Romania	-6.9	-7.3	-3.5	2.5	155	59	40	17
Slovak Republic	6.5	4.4	0.7	4.9	6	7	9	7
Slovenia	4.6	3.9	3.0	3.8	8	8	5	5
Ukraine	-3.0	-1.7	-2.5	0.0	16	11	26	15
Russia	0.9	-4.6	0.0	2.0	15	28	88	23
Transcaucasus and central Asia	2.5	2.2	2.0	2.9	37	15	16	15
Armenia	3.1	7.2	3.5	5.0	14	9	3	8
Azerbaijan	5.8	10.0	3.8	2.8	4	-1	-5	4
Georgia	11.0	2.9	2.0	5.0	7	4	22	5
Kazakhstan	2.0	-2.5	-1.5	3.0	17	7	7	11
Kyrgyz Republic	9.9	2.0	2.7	3.5	26	12	32	16
Mongolia	4.0	3.5	3.5	4.0	37	9	9	6
Tajikistan	1.7	5.3	5.5	6.0	88	43	15	7
Turkmenistan	-25.9	5.0	18.5	-1.0	84	17	27	54
Uzbekistan	2.4	3.3	2.1	2.0	71	29	28	22

Taking recent developments into account and assuming the implementation of a coherent stabilization and reform program, IMF staff now project zero growth in 1999 as a whole, followed by growth of 2 percent in 2000 (Table 1.6). Major policy challenges still lie ahead. The recently approved IMF program includes a fiscal plan to deliver a 2 percent primary surplus, and to meet this target, along with other macroeconomic objectives, full implementation of a wide range of reform measures is needed. Without such action, the fiscal position would again deteriorate, pressures for increased central bank funding of the deficit could increase, and the fragile economic situation could quickly deteriorate. There has been some, albeit limited, progress with banking sector reforms: a bank restructuring agency has been set up, and the authorities have revoked the licenses of 6 of the 18 large Moscow-based banks. Indeed, many of the large banks are insolvent, a few have been closed, and there appears to have been widespread asset-stripping from problem banks. While the legal frameworks for bankruptcies and for the opera-

tions of the bank restructuring agency have now largely been put in place, corporate restructuring and many other reforms are also needed.

The Russian crisis has led to a general downgrading of growth projections for neighboring countries. In most countries in the region, exchange rates have depreciated, inflation has increased, and fiscal positions have deteriorated. However, there have been notable differences in countries' responses to these developments. In *Ukraine*, for example, additional measures have been taken to improve tax collection, control public spending, and help put fiscal performance back on track; firm monetary policies have been maintained; and some reform momentum has been maintained in a number of key areas including banking sector reforms. In contrast, in *Belarus*, where the economy remains largely centrally planned and unreformed, there has been rapid credit expansion because of support provided to the housing and agricultural sectors. The exchange rate has continued to fall and inflation remains high.

While most of the *Baltic countries'* exports now go to western Europe, difficulties arising from their still substantial exposures to eastern markets have contributed to significant slowdowns in growth and increases in fiscal deficits. External current account deficits, although still high, have shown some signs of improvement under the impact of slower growth. These countries' monetary frameworks, based on formal or de facto currency boards, have remained robust, helping to maintain low inflation and foreign investor confidence; banking sectors, although facing periodic pressures, are well supervised and sufficiently capitalized (although some Latvian banks may need further recapitalization); and other structural reforms are generally well advanced, with privatization programs moving—albeit with delays in some cases—into more complex areas such as energy and transportation. Growth in the Baltic countries is therefore projected to recover relatively soon.

*Bulgaria's* recent experience illustrates how a country can recover from a domestic economic crisis and withstand external difficulties if it pursues disciplined macroeconomic and structural policies. The economy has not been immune to the region's recent problems: exports have declined and the current account deficit has increased including as a result of the Kosovo conflict. Thus, following the rebound in growth in 1998, GDP is expected to show a more modest pickup in 1999. Fiscal performance has been strong, and with the exchange rate stable under the currency board arrangement, inflation and interest rates have fallen to their lowest levels of the decade. There has also been important progress in restructuring the state-owned banks and enterprises. In *Romania*, the economy contracted by around 14 percent in 1997–1998, and a further decline in activity is projected this year. Sustained implementation of the recently adopted Fund-supported program—involving fiscal consolidation and accelerated structural reform—is critical to reduce imbalances in the economy and improve access to international finance. While the pace of privatization has increased, a great deal of banking and corporate sector restructuring is still needed.

Growth in *Hungary* and *Poland* has continued to hold up relatively well, although export growth has slowed and current account deficits have increased as a result of the Russian crisis and weaker EU growth. Despite some weakening earlier in the year, these countries' currencies have generally remained in the top half of their exchange market trading bands, supported partly by strong inflows of foreign direct investment. Underpinning economic confidence are strong and well-regulated banking sectors, and the generally advanced state of corporate restructuring. Fiscal consolidation is important to reduce current account deficits and provide scope for further monetary easing. The slowdown in economic activity has been more severe in the *Czech* and *Slovak Republics*, with

GDP continuing to decline in early 1999 in the former following the sharp contraction in 1998. While weaker export markets have contributed to these economic downturns, the main influences have been domestic. Economic policies began to be tightened in the Czech Republic in 1997 and in Slovakia in early 1999 in response to rising fiscal and external imbalances. The core of the difficulties, however, is the poor financial condition of much of these countries' banking sectors and the slow pace of restructuring in some large industrial enterprises.

\* \* \*

## Appendix: Year 2000 Contingency Planning

As this century draws to a close, computers and other systems with embedded microprocessors may begin to confuse the year 2000 with the year 1900, potentially causing some failures of these systems around the world. The so-called “Year 2000 (Y2K) computer bug” is a legacy of a computer programming shortcut that involves using two digits instead of four to identify the year in computer programs. It originated in the early days of computing when computer memory was much more expensive than today. Programmers at that time may have thought that their work would become obsolete well before the year 2000, but unfortunately, the practice continued until recently, despite dramatic reductions in computer memory costs. Because of the critical role of computer systems in finance, power generation and distribution, other utilities, industry, commerce, communications, transportation, health, education, research, and government—i.e., all sectors of a modern economy—the potential economic impact of the Y2K bug, had it gone unaddressed, could have been substantial.

Fortunately, there has been considerable progress in preparing computer systems for the year 2000, which should mitigate most problems. Many businesses, financial institutions, and government agencies throughout the world have been aware of the problem for some time and have been testing, repairing, and replacing computers and software to bring them up to date. At the international level, trade associations, governments, and international organizations, including the Bank for International Settlements (BIS), the United Nations, the World Bank, and the IMF, have worked to promote Y2K awareness, and the relevant institutions have provided technical assistance including for the preparation of contingency plans. The World Bank has made special loans available to help developing countries prepare for Y2K, while several groups, including the BIS (particularly through its role in coordinating the Joint Year 2000 Council) and the United Nations, have been monitoring Y2K readiness across a large number of countries. The Joint Year

### Box 1.5. The Regional Economic Impact of the Kosovo Crisis

The conflict associated with the crisis in the Kosovo province of the Federal Republic of Yugoslavia (Serbia-Montenegro) (FRY) between late March and early June 1999 has had a major impact on neighboring countries, although exposure to the crisis and the channels of transmission have varied among them. While the FRY is not a member of the IMF, the member countries most affected have been Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Former Yugoslav Republic of Macedonia (FYR of Macedonia), and Romania.<sup>1</sup> In each of these six countries, the conflict has generated balance of payments and budgetary gaps that, to varying degrees, have been—or will be—filled by international donors and through domestic policy adjustments. This box discusses the channels through which the economies of these countries have been affected by the crisis in Kosovo, and the resulting aggregate balance of payments and budgetary implications.<sup>2</sup>

The main channels of transmission of the crisis have been through the influx of refugees, disruption to international trade in goods and services, the closing of transportation routes through FRY, damage to consumer and investor confidence, reduced access to international capital markets, and adverse effects on the process of structural reform and development, including weakened governance. Although the conflict ended in early June, the impact on several of the affected countries is likely to be felt well beyond 1999—though at much reduced levels

of intensity. Partially offsetting these effects in the period ahead, however, will be the positive impact on growth that is expected as reconstruction activity in the region picks up.

The most visible effect of the conflict was the large influx of refugees from Kosovo to neighboring countries. At its peak, the number of refugees reached almost one million.<sup>3</sup> These were absorbed primarily by Albania and FYR of Macedonia in numbers equivalent to 13 percent of the local populations of these countries. Bosnia-Herzegovina also received large numbers of refugees. The direct cost of providing humanitarian relief to the refugees—in the forms of food, shelter, medicines, and clothing—was assumed largely by foreign aid agencies, but a significant part was also borne by the budgets of the host countries, putting pressure on their already weak fiscal positions. The presence of large numbers of refugees also required increased spending on internal security for law and order to be maintained. The influx of refugees and humanitarian relief efforts strained the economic infrastructure in host countries, causing congestion and reduced levels of economic activity and foreign trade in several cases. The repatriation of the majority of the refugees during the summer relieved most of these pressures on the host countries' fiscal and balance of payments positions. However, in the case of Albania, continued budgetary support is required for the refugees that are likely to remain with host families during the coming winter and to cover restorations and repair costs while, in FYR of Macedonia, besides the continuing negative impact of the crisis on budget revenue, spending on security is expected to remain high.

To some degree, all six economies have been affected by disruptions to their foreign trade, whether through the suspension of direct trade links with FRY, or the reduction in transit trade to third countries (primarily in the European Union) previously routed through FRY. The closing of the border with FRY has had its most severe impact on FYR of Macedonia as direct and transit trade through FRY represented over two-thirds of that country's exports. Bosnia-Herzegovina has also been affected substantially as FRY is a major export market. Bulgaria and Romania, countries with little direct trade with FRY, have been affected through the disruption of transit trade caused by damage to transport and storage infrastructure

<sup>1</sup>Ukraine and Moldova have also experienced adverse effects, the former primarily on account of lost shipping revenues and the latter reflecting reduced exports to Romania. Owing to their geographic location and strong trade links with the most affected neighboring countries, the economies of Austria, Greece, Hungary, Italy, Slovenia, and Turkey have also been somewhat affected, as have been the budgets of the countries that financed the military campaign.

<sup>2</sup>Reliable information about the economic situation in the FRY is limited. It is clear, nevertheless, that the conflict has resulted in considerable damage to infrastructure and productive capacity and a severe setback to economic activity, exacerbating the effects of a prolonged period of stagnation and high inflation, which in turn has reflected a number of factors such as a failure of earlier stabilization efforts, a lack of economic reforms, and the impact of UN sanctions. The economic dislocation in the FRY and the disruption to its transportation network have had a significant impact on neighboring countries because the FRY provides important transit routes, besides having been a major trading partner of some of the neighboring countries.

<sup>3</sup>This excludes refugees within Serbia and Montenegro.

2000 Council is also creating and enhancing channels to coordinate international communication about Y2K developments among financial sector authorities, including central banks and banking, securities, and insurance supervisors and regulators.

Despite all of these efforts, however, there remains a degree of uncertainty about the actual state of readiness among countries and sectors and about the poten-

tial economic and financial ramifications. Actual or perceived Y2K-related difficulties could affect an economy both through direct effects on the real economy and through shifts in financial market sentiment. Y2K failures could have direct *real effects* on economic activity through possible disruptions to production in key sectors. Similar problems in trading partner countries could cut export demand, hinder delivery of

in FRY and along the Danube, requiring that such trade be rerouted. This disruption, which has resulted in congestion and delays along alternative trade routes, increases in transportation costs, and some loss in export markets, is expected to persist into 2000.

Security concerns led to the widespread cancellation of tourism bookings in the region at the outset of the conflict, most notably in Croatia where tourism is a major source of foreign exchange earnings. Furthermore, foreign tourism failed to recover fully when the conflict ended since the summer holiday season was already in progress, thereby contributing to large external financing gaps in the affected countries. Reduced investor confidence during the conflict also led to postponements of foreign direct investment—including privatization—and higher foreign borrowing costs, causing several countries to delay approaches to international capital markets.

These factors have all had a negative effect on economic growth in most of the affected countries, with the impact sufficiently large in some cases to cause output to contract. While there has been some offsetting impact on imports from lower domestic income and expenditure, on balance the disruption to trade in goods and services, as well as some weakening in the capital account, resulted in an aggregate balance of payments gap for the countries concerned of about \$1 billion for 1999. Budgetary gaps totaling \$450 million have also arisen from lost revenues—as a result of lower incomes and imports, and disruptions to customs collections—and from refugee-related expenditures that are not covered by humanitarian aid, as well as increased spending for defense and public order.

The IMF, in cooperation with the World Bank and other relevant agencies, has taken the lead in providing regional economic assessments and projections of external financing needs in the wake of the Kosovo crisis and in coordinating the international community's response to the economic and financial challenges posed by the crisis.<sup>4</sup> Along with policy advice and technical assistance,

<sup>4</sup>See "The Economic Consequences of the Kosovo Crisis—Preliminary Assessment of External Financing Needs and the Roles of the IMF and World Bank in the International Response," by the staffs of the IMF and the World Bank, April 16, 1999, and "The Economic Consequences of the Kosovo Crisis—An Updated Assessment," IMF, May 25, 1999 (<http://www.imf.org/external/pubs/ft/kosovo/052599.htm>).

the Fund has also provided additional financial support under its various facilities to the countries most severely affected by the crisis, notably Albania, Bosnia and Herzegovina, and FYR of Macedonia.

Aid commitments for Albania, Bosnia and Herzegovina, Bulgaria, and FYR of Macedonia have helped to narrow their balance of payments gaps. To coordinate financial assistance to the Balkan region, a high-level steering group has been set up comprising the leading industrial countries and international organizations, including the IMF and the World Bank. The group held a first meeting—organized to raise funds for humanitarian aid and civil administration in Kosovo—at the end of July. Additional donor meetings are planned to address broader reconstruction and development needs.

The Balkan region faces major economic challenges. Following the peace agreement, attention has shifted to reconstruction, especially in Kosovo. This process is being coordinated by the United Nations Interim Administration Mission in Kosovo (UNMIK), which was set up in accordance with a UN Security Council resolution authorizing the Secretary-General to establish an international civil presence in Kosovo. As a province of a non-IMF member, Kosovo is not eligible to use the Fund's resources. However, at the request of the UNMIK, the Executive Board of the Fund has recently approved the provision of technical assistance to Kosovo in the areas of budgeting, tax and customs administration, and the payments system.

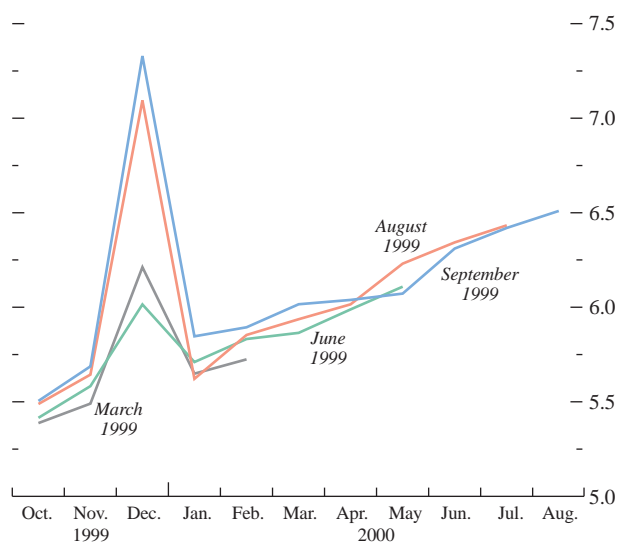
Economic performance in the region had been disappointing even prior to the Kosovo conflict, reflecting slow progress with economic restructuring and institution building. In addition to addressing their immediate reconstruction needs, the Balkan countries need to step up their efforts to achieve a successful transition to market-based economies so as to foster economic stability and growth, which in turn should help to reduce the risk of renewed conflict. Achieving these goals will also require sustained external assistance and further integration with the rest of Europe and the global economy. Intensified intraregional cooperation, including through liberalization and promotion of trade among the Balkan countries, has an important role to play. The process of reform and development in the region and its integration into the global economy is set to receive an impetus under the Stability Pact for Southeastern Europe, adopted at the Cologne summit in June 1999 and inaugurated at the Sarajevo summit in July 1999.

critical imports, or cause price spikes. Possible demand effects include precautionary behavior induced by the anticipation of potential supply disruptions, which may lead consumers and businesses to stockpile goods before the end of this year and subsequently reduce inventories early next year. Additional demand effects could come from the purchases of computers and computer services as enterprises and government

agencies replace or repair their systems to make them Y2K compliant. Spending in these areas has already increased, although it is hard to separate the direct Y2K impact from other factors affecting the demand for computers. *Financial market repercussions* could arise from anticipation of potential Y2K problems, including self-reinforcing expectations of portfolio shifts because of precautionary behavior. As a result,

**Figure 1.4. Y2K Interest Rate Spike<sup>1</sup>***(Percent)*

Concerns about potential Y2K problems are reflected in a significant premium on liquidity by the end of 1999.



<sup>1</sup>Each curve represents the forward interest rates implied by prevailing U.S. LIBOR rates at the beginning of the month indicated for instruments with duration of one to twelve months.

investors might seek to reduce their exposure to risk and shift investments to international financial centers and into assets regarded as being safer or more liquid, such as assets denominated in reserve currencies. This could potentially lead to turbulence in financial markets and pressures on a country's external capital account. This risk is probably greater for emerging market countries. However, even among the mature economies, precautionary portfolio shifts may affect the demand for currency and relative risk premia across classes of financial assets.

According to survey evidence, most industrial and many developing and transition economies have been making significant strides towards Y2K compliance, and most key sectors are expected to be ready for Y2K.<sup>7</sup> Supply disruptions therefore seem likely to be limited, especially in the industrial countries. There is, however, considerable uncertainty about the reliability of the available information concerning the actual level of preparedness because of the breadth and complexity of the repair effort, and because information about readiness often depends on self-reporting assessments, in which respondents may have an incentive to overstate their true level of preparedness. Nevertheless, even if supply disruptions are limited, because of *perceptions* of potential Y2K problems, rather than necessarily the problems themselves, there could still be significant precautionary demand effects as well as a tendency for financial investors to favor liquid assets denominated in reserve currencies as the end of 1999 approaches.

This uncertainty about Y2K can already be observed in financial markets where, for example, euro-dollar forward markets show a sharp rise in short-term interest rates toward the end of 1999 that falls off in early 2000 (Figure 1.4). This "Y2K spike" is being widely interpreted to indicate that investors expect a considerable increase in the demand for liquidity around the end of the year. Liquidity conditions generally tighten at year end as institutions adjust their balance sheets for reporting purposes, but the rise in forward interest rates for end-1999 is far greater than in the past. In recent months, year-end forward rates have also been increasing. Similar evidence can be found in some other—but not all—mature and emerging financial markets.<sup>8</sup> In addition, part of the recent rise in corpo-

<sup>7</sup>According to survey data prepared by the Gartner Group, the major industrial countries are well prepared, with an average score of 3.8 out of a possible 4.0 (a score of 4.0 indicates only isolated and minor disruptions). Preparedness in developing countries is lower, 2½ on average, with scores ranging from 1 (moderate to severe widespread disruptions) to 3 (isolated, moderate disruptions). A survey of self-assessed readiness compiled by the United Nations indicates that most of the approximately 100 developing countries surveyed reported that they will have Y2K repairs completed before January 1, 2000.

<sup>8</sup>See, for example, Elaine Buckberg and John Montgomery, "Global: Y2K and Emerging Markets—Financial Risk Dominates," Morgan Stanley, Dean Witter (New York, 1999).

rate and emerging market bond spreads has been attributed to Y2K concerns by some analysts, although other factors are clearly also important. The effects of uncertainty on financial markets underscore the importance of full disclosure whenever possible and the need to plan for contingencies, even when countries are thought to be well prepared for the technical aspects of Y2K.

Central banks have already developed or are developing contingency plans to correct or minimize potential disruptions in the financial sector. Generally, central banks hold a large reserve of banknotes to meet public demand in peak periods (such as during holiday seasons) and for unusual circumstances (such as bad weather) and also provide liquidity to the banking sector, particularly under extraordinary situations, in their role as lenders of last resort. In preparation for Y2K, many central banks are in the process of building stocks of banknotes should the public respond to potential Y2K problems by hoarding cash, and are planning to provide additional liquidity to the banking sector through existing or special facilities should it be needed to ensure the normal operations of credit markets.

For example, the Hong Kong Monetary Authority will increase banknotes in reserve to HK\$150 billion (compared to a circulation of about HK\$90 billion), the Bank of Japan to 40 trillion yen (compared to a circulation of about 56 trillion yen), the Swedish Riksbank to 90 billion kronor (compared to a circulation of about 80 billion kronor), while the U.S. Federal Reserve is increasing its reserve stock of currency by \$50 billion to a total of \$200 billion (compared to a circulation outside of banks of about \$475 billion).

In addition, the U.S. Federal Reserve has announced a Century Date Change Special Liquidity Facility that will provide exceptional, but temporary financing (with no restrictions on the use and duration of loans from October 1, 1999 to April 7, 2000, but with an interest rate surcharge of 150 basis points) to depository institutions to ensure adequate liquidity to meet any unusual demands in the period around the century date change, while a number of central banks in emerging market countries, such as El Salvador, Hungary, India, and Korea, have announced similar special liquidity facilities. Many other central banks plan to monitor credit market developments particularly carefully around year end and, if needed, are prepared to respond effectively and quickly by providing additional liquidity to financial institutions. Many central banks have also developed backup plans to ensure the proper operation of payment and settlements systems, in case of Y2K failures outside the financial system, including disruptions in power and communications.

As mentioned earlier, multilateral agencies are also developing plans to minimize potential disruptions because of the impact of Y2K. At the IMF, in recent months the staff has been trying to assess the potential economic and financial consequences of the computer

bug in case studies for a significant number of member countries under a hypothetical scenario that a significant number of computer systems might fail and that international investor sentiment would deteriorate. The scenario case studies cover a total of 17 representative developing and transition economies (accounting for almost 60 percent of output in developing and transition countries), including a range of systemically important countries, several economies that export key commodities (for example, oil), and some smaller countries. The countries that were examined are diverse, varying in size, level of development, openness to trade, export diversification, exposure to international capital markets, and level of external debt.

In constructing the scenarios, it was assumed that the number of system failures because of Y2K would be largely (inversely) related to the level of Y2K compliance within the member country. More generalized assumptions were adopted about potential demand effects and changes in investor sentiment, including on a global scale. These global assumptions include an acceleration of world output growth in the second half of 1999 and world trade growth (relative to the WEO baseline) because of an assumed precautionary inventory buildup, followed by a slightly more pronounced slowdown in output and trade growth in the first half of 2000 (because of destocking and some Y2K disruptions). Some commodity prices, particularly oil prices, were assumed to rise as well (compared to the WEO baseline) in the first half of 2000 because of supply disruptions. Moreover, a deterioration in international investor sentiment would lead to increased risk aversion in international capital markets and a flight to quality, which would result in a stronger U.S. dollar. Other countries would tend to suffer some currency depreciation, losses of international reserves, or higher domestic interest rates, depending on the responses of the national authorities. For emerging markets, the flight to quality and liquidity would result in higher risk premia, reduced rates of rollover of short-term credits, and losses of international reserves.

Country-specific assumptions about the vulnerability to Y2K problems were based on a careful assessment of risks through a sector-by-sector analysis using information gathered from international and country-specific sources by comparing Y2K readiness to exposure. Exposure to Y2K largely depends on the level of computerization of the economy and the ability and ease of switching to backup manual systems, if needed. Y2K readiness depends on the extent and progress of the compliance effort, including testing, remediation, and contingency planning. These assessments of exposure and preparedness benefited heavily from interaction with sectoral experts from the World Bank, who have much more detailed knowledge about many sectors than IMF staff. In contrast, assessments were made directly by IMF staff regarding Y2K compliance in central banks and the fiscal sectors. It needs

to be emphasized, of course, that any such assessment is subject to a wide margin of uncertainty because of the lack of reliable information on the scale of Y2K problems, on countries' preparedness, and the potential economic consequences of system failures in critical areas.

With these caveats in mind, the sector-by-sector analysis generally suggested that the most exposed sectors are also likely to be the best prepared for Y2K. This makes it reasonable to assume that supply disruptions will be limited in most cases. The financial sectors, including central banks, payment and settlement systems, commercial banks, and other financial institutions, are considered to be quite well prepared in general with, in many cases, repairs and testing almost complete. In only a few countries do the financial sectors appear to be lagging in the compliance effort, but even in these, the repair efforts are more advanced than in most other domestic sectors. In many of these cases, backup manual systems are expected to be readily available because computerization is fairly recent, or since power failures unrelated to Y2K have been routine in the past.

Other sectors appear on average to be somewhat less well prepared but also less exposed to Y2K. Major risks, however, seem to exist in several countries' power generation and distribution sectors where Y2K exposure is relatively high but preparations appear to be relatively weak. Because of linkages to other sectors, failures in the power sector could lead to economy-wide disruptions. In a few countries, some risks are also present in the communications and transport sectors, which also have substantial linkages to other parts of the economy. There are also concerns about the state of readiness in some nonfinancial private firms, particularly small and medium-sized ones, government services, and public sector enterprises. In general, public and private sector oil producers are considered to be relatively well prepared but concerns remain about oil and natural gas distribution, largely because of potential problems in transportation, including ports and pipelines.

On the basis of the admittedly relatively pessimistic scenario assumptions outlined above, *those developing and transition economies that would be affected by the Y2K problem* could face a temporary slowdown in GDP growth in 2000 of almost 2 percentage points on average (Table 1.7). Precautionary stock building in 1999 and consequent destocking in 2000 would account for some of the negative output effect next year. Inflation rates would rise by about 1 percentage point on average, reflecting higher global commodity prices as well as local supply disruptions. Fiscal balances would deteriorate in many countries because of the negative impact on output, but the fiscal situation could improve in some oil-exporting countries with the temporary rise in world oil prices more than offsetting the revenue effects of production disruptions.

**Table 1.7. Developing and Transition Economies: Y2K Scenario Results<sup>1</sup>**

(Deviation from World Economic Outlook baseline, in percent)

	Average Impact <sup>2</sup>		Standard Deviation <sup>3</sup>	
	1999	2000	1999	2000
GDP growth	0.2	-1.9	0.4	0.8
Inflation	0.3	1.2	0.4	1.1
Fiscal balance (percent of GDP)	0.1	-0.3	0.2	1.2
Current account (percent of GDP)	0.1	0.0	0.5	1.3
Reserves (percent of total reserves)	-6.7	-13.0	7.8	13.5

<sup>1</sup>The 17 scenario countries comprise about 60 percent of GDP in developing and transition economies. However, because the sample was chosen to include a range of countries depending on level of development, source of major export earnings, and systemic importance and was not drawn at random, aggregate results should be seen as indicative only. The high standard deviations—in many cases greater than the average impact—underscore the illustrative nature of this exercise. The small sample size precludes meaningful analysis at the regional level.

<sup>2</sup>Weighted by country size, using *WEO* purchasing-power-parity weights.

<sup>3</sup>Unweighted standard deviation for individual country scenario results.

The impact on the external current account balances across the sample countries would be largely offsetting, again because of the positive impact of higher oil prices in the oil-exporting countries. The scenario exercise implies that capital outflows associated with a possible flight to quality could be relatively large, and the estimated reduction in international reserves would be on average close to 15 percent of total reserves in 2000; but some countries could be significantly more affected. The wide margin of uncertainty attached to this illustrative exercise and the wide differences for individual scenario countries should again be emphasized as underscored by the relatively high standard deviations presented in Table 1.7.

The average impact estimates in the contingency scenarios suggest that the consequences of the Y2K bug could be relatively serious but probably still manageable in most cases. The more advanced developing and transition economies are generally thought to be more reliant on computer technologies, but these countries, in addition to being generally better prepared for Y2K, were also found to have more resources—both domestically and in terms of the financial ability to import—to address Y2K disruptions. Some of these countries, however, may be susceptible to significant capital outflows because of potentially self-reinforcing perceptions of Y2K difficulties, rather than actual problems. In these cases, even though the effects on market sentiment may be less serious than has been assumed in this scenario, there is added risk stemming from potential financial contagion. Indeed,

this applies also to countries that may be relatively well prepared but nevertheless may be perceived otherwise in an environment of pervasive uncertainty. The less advanced developing and transition economies, while less reliant on computer technologies, may paradoxically be subject to more severe and longer lasting supply disruptions because progress in Y2K compliance has been limited so far and because financial and human resource limitations will constrain repair efforts in the period ahead.

Overall, notwithstanding the uncertainties that necessarily characterize this issue, including the reliance on self-reporting assessments of Y2K preparedness in many cases, it seems reasonable to assume that most countries are relatively well prepared by having addressed Y2K problems or by having put in place contingency plans to deal with potential problems. Even under relatively pessimistic alternative assumptions, the contingency scenarios suggest that for most of the countries that might be experiencing problems—either in the form of real sector effects or through financial market repercussions—the potential difficulties should be manageable and in any case are unlikely to be prolonged. Nevertheless, it clearly cannot be excluded that a few countries would be more severely affected, espe-

cially through potential turbulence in financial markets. In such cases, there could be a need for the IMF to provide supplementary financial assistance to help alleviate pressure on a country's foreign reserves, enhance confidence, and limit contagion.

Against this background, the IMF has established a temporary lending facility designed to provide short-term financing to countries facing Y2K-related balance of payments difficulties. The new *Y2K Facility*, which is set to expire on March 31, 2000, will make available funds for six months at a surcharge of 300 basis points above the standard IMF interest rate (and, if necessary, for an additional six months at a 350 basis point surcharge) to countries facing balance of payments pressures that can be distinguished as Y2K-related. Access is limited to 50 percent of a country's quota unless there are exceptional circumstances. To make use of the facility, countries will need to demonstrate that they are pursuing generally sound economic policies, are cooperating with the Fund, and are moving vigorously to deal with their Y2K problems. The facility provides additional assurance to member countries and investors that any pressures in international financial markets in response to perceived Y2K problems—that may or may not materialize—will be contained.