CHAPTER I PROSPECTS AND POLICY CHALLENGES

Since the May 2001 World Economic Outlook, *prospects for 2001–02 have weakened further, and downside risks have been further exacerbated by the recent terrorist attack in the United States (see Box 1.1). Growth projections for almost all regions have been reduced, reflecting a variety of factors, including the greater-than-expected impact of the global slowdown in a number of regions; a delayed recovery in the United States; weakening domestic demand growth and confidence in Europe; the prospect of a period of slower growth in Japan as it presses ahead with structural reforms (although this will have substantial medium-term benefits); the continued decline in information technology spending, which affects Asia in particular; and deteriorating financing conditions for emerging markets, especially in Latin America. GDP growth is now slowing in almost all regions of the globe, accompanied by a sharp decline in trade growth. In response, many countries—especially the United States—have eased macroeconomic policies, most recently in mid-September in the aftermath of the terrorist attack. This easing, along with the gradual abatement of oil prices and of other shocks that have contributed to the slowdown, should help support activity and confidence in the period ahead. But substantial uncertainties and risks persist, as the downturn makes the world more vulnerable to further unexpected developments, and a significant danger of a deeper and more prolonged slowdown remains. The recent terrorist attack has also increased uncertainty. The challenge facing policymakers is how best to limit these downside risks while promoting an orderly resolution of the imbalances in the global economy over the medium term.*

Global growth is now projected at 2.6 percent in 2001,[1] 0.6 percentage points lower than expected in the May 2001 *World Economic Outlook*, and a decline of over 2 percentage points from the unusually rapid pace in 2000 (Table 1.1 and Figure 1.1). Among the advanced economies, growth in the *United States* is projected at 1.3 percent, 0.2 percentage points lower than in the May 2001 *World Economic Outlook*, with activity expected to begin to pick up modestly in the period ahead as the effects of previous policy easing take hold. The outlook for other industrial countries has weakened more significantly. In the *euro area*, growth has been marked down by 0.6 percentage points to 1.8 percent, driven by a sharp weakening in domestic demand growth, particularly in *Germany*, and the greater-than-expected impact of the global slowdown. Of most concern, the prospects for *Japan* have become increasingly somber. With GDP now projected to decline by 0.5 percent in 2001, over 1 percentage point worse than earlier projected, Japan is now likely experiencing its fourth recession of the past decade.[2]

Prospects for most developing and transition countries have also deteriorated. Growth has been marked down sharply in the *Western Hemisphere*, where activity has been adversely affected by the renewed financial difficulties in Argentina,

[1]In the *World Economic Outlook*, global growth is calculated using purchasing power parity weights. Global growth rates using market exchange rate based weights—which yield lower figures, mainly due to the relatively smaller weights given to China and other faster growing developing countries—are presented in Table 1 of the Statistical Appendix.

[2]Defining a recession as two quarters of negative real GDP growth.

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

			Current Projections		Difference from May 2001 Projections[1]	
	1999	2000	2001	2002	2001	2002
World output	**3.6**	**4.7**	**2.6**	**3.5**	**–0.6**	**–0.4**
Advanced economies	3.4	3.8	1.3	2.1	–0.6	–0.6
Major advanced economies	3.0	3.4	1.1	1.8	–0.5	–0.6
United States	4.1	4.1	1.3	2.2	–0.2	–0.3
Japan	0.8	1.5	–0.5	0.2	–1.1	–1.3
Germany	1.8	3.0	0.8	1.8	–1.1	–0.8
France	3.0	3.4	2.0	2.1	–0.6	–0.5
Italy	1.6	2.9	1.8	2.0	–0.2	–0.5
United Kingdom	2.3	3.1	2.0	2.4	–0.6	–0.4
Canada	5.1	4.4	2.0	2.2	–0.3	–0.2
Other advanced economies	4.9	5.3	1.9	3.3	–1.1	–0.5
Memorandum						
European Union	2.7	3.4	1.8	2.2	–0.6	–0.6
Euro area	2.7	3.5	1.8	2.2	–0.6	–0.6
Newly industrialized Asian economies	7.9	8.2	1.0	4.3	–2.8	–1.2
Developing countries	3.9	5.8	4.3	5.3	–0.7	–0.3
Africa	2.5	2.8	3.8	4.4	–0.4	—
Developing Asia	6.1	6.8	5.8	6.2	–0.1	–0.1
China	7.1	8.0	7.5	7.1	0.5	—
India	6.8	6.0	4.5	5.7	–1.1	–0.4
ASEAN–4[2]	2.8	5.0	2.4	4.1	–1.0	–0.6
Middle East, Malta, and Turkey	1.0	6.0	2.3	4.8	–0.6	0.2
Western Hemisphere	0.2	4.2	1.7	3.6	–2.0	–0.8
Brazil	0.8	4.5	2.2	3.5	–2.3	–1.0
Countries in transition	3.6	6.3	4.0	4.1	—	–0.1
Central and eastern Europe	2.0	3.8	3.5	4.2	–0.4	–0.2
Commonwealth of Independent States and Mongolia	4.6	7.8	4.4	4.0	0.3	–0.1
Russia	5.4	8.3	4.0	4.0	—	—
Excluding Russia	2.8	6.8	5.4	4.1	1.2	–0.3
World trade volume (goods and services)	**5.3**	**12.4**	**2.7**	**5.2**	**–4.0**	**–1.3**
Imports						
Advanced economies	7.6	11.5	1.7	4.7	–5.0	–1.8
Developing countries	2.1	16.6	6.4	8.0	–2.4	0.1
Countries in transition	–7.8	12.9	10.1	7.9	1.5	1.0
Exports						
Advanced economies	5.0	11.5	1.7	4.5	–4.5	–1.7
Developing countries	4.6	15.1	5.0	6.6	–2.1	–0.4
Countries in transition	0.2	16.5	7.1	6.5	2.5	1.4
Commodity prices						
Oil[3]						
In SDRs	36.5	62.6	–1.4	–8.8	6.3	3.1
In U.S. dollars	37.5	56.9	–5.0	–8.6	4.6	3.2
Nonfuel (average based on world commodity export weights)						
In SDRs	–7.7	6.4	1.0	4.2	–1.6	–0.2
In U.S. dollars	–7.0	2.6	–2.6	4.5	–3.1	—
Consumer prices						
Advanced economies	1.4	2.3	2.4	1.7	0.3	–0.1
Developing countries	6.8	6.0	5.9	5.1	0.2	0.3
Countries in transition	43.9	20.0	16.4	10.7	1.1	0.7
Six-month London interbank offered rate (LIBOR, percent)						
On U.S. dollar deposits	5.5	6.6	4.1	3.7	–0.4	–0.6
On Japanese yen deposits	0.2	0.3	0.2	0.1	–0.2	–0.4
On euro deposits	3.0	4.6	4.3	3.9	–0.1	–0.2

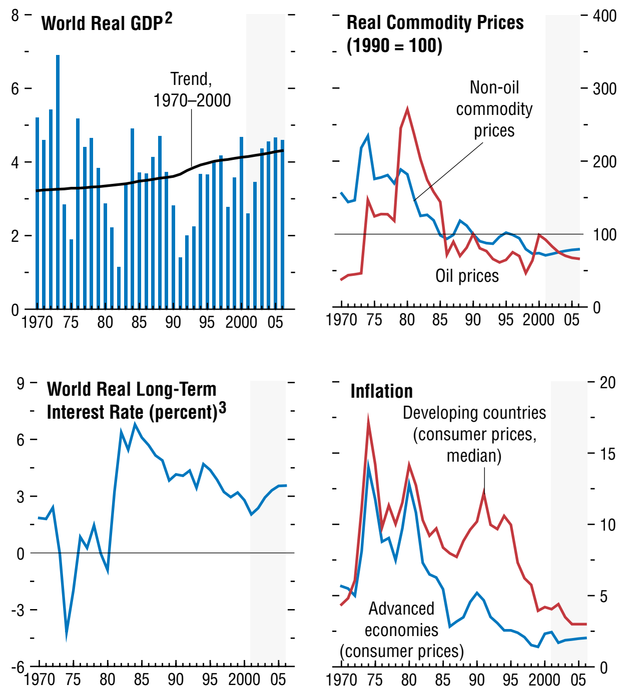
Note: (a) These projections were finalized before the September 11 terrorist attack in the United States and subsequent economic policy actions; (b) real effective exchange rates are assumed to remain constant at the levels prevailing during July 23–August 17, 2001.
[1]Using updated purchasing-power-parity (PPP) weights, summarized in the Statistical Appendix, Table A.
[2]Includes Indonesia, Malaysia, the Philippines, and Thailand.
[3]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 $28.21 in 2000, the assumed price is $26.80 in 2001, and $24.50 in 2002.

as well as political uncertainties and other shocks, including the energy crisis in *Brazil*. Capital inflows to most countries—except *Mexico*—have also slowed, a concern given the region's large external financing requirement. In *emerging Asia*, growth in *China* remains resilient, but many countries have been hard hit by slowing global growth and the downturn in the electronics cycle, with the impact exacerbated by intraregional trade linkages and developments in Japan. Growth prospects have also weakened moderately in the *Middle East* owing to lower oil prices and cuts in production and the ongoing crisis in *Turkey*. Projected growth in *Africa* has also been reduced, although it is still expected to be higher than in 2000, aided by improved weather and an easing of security problems in several countries. In contrast, the outlook for the transition economies has remained broadly unchanged, with the impact of slowing growth in Europe offset by stronger-than-expected rebounds in a number of countries in the Commonwealth of Independent States, notably Ukraine.

This forecast has not been adjusted for the September 11 terrorist attack on the United States. Clearly, recent events will have an impact on activity in the short term, and add to the already significant downside risks both in the United States and elsewhere. The attack has taken a terrible toll in human lives and resulted in substantial property damage, but its direct impact on U.S. activity is likely to be moderate (as was the case, for example, with the Kobe earthquake in Japan on January 11, 1995, where the damage was, if anything, somewhat larger); moreover, indications are that the financial infrastructure around the world has held up well. However, the indirect effects may be more substantial, including the possibility of a sustained deterioration in consumer, corporate, and financial confidence, of a flight to quality in financial markets that could exacerbate existing weaknesses associated with financial stability or funding, and of oil price volatility. While it is as yet too early to make a full assessment of such risks, the recent cuts in interest rates in the United States, Canada, and Europe, accompanied by

Figure 1.1. Global Indicators[1]
(Annual percent change unless otherwise noted)

Global growth is projected to slow markedly in 2001, while inflation remains subdued.



[1]Shaded areas indicate IMF staff projections. Aggregates are computed on the basis of purchasing-power-parity weights unless otherwise indicated.
[2]Average growth rates for individual countries, aggregated using purchasing-power-parity weights; these shift over time in favor of faster growing countries, giving the line an upward trend.
[3]GDP-weighted average of the 10-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.

Box 1.1. The Terrorist Attack: Impact on the Global Outlook

The latest round of quantitative projections presented in this *World Economic Outlook* were completed just before the tragic events of September 11. A central question is how these projections might be interpreted in light of the terrorist attack and its aftermath. At press time, there was no doubt that the attack was having a negative effect on activity in many regions of the globe, and that it had increased what were already significant downside risks to the short-term global outlook, including for emerging market economies. However, it is important to put the current economic situation in perspective. While there are clearly substantial uncertainties about unfolding events, one should not overlook that the economic fundamentals in many countries and in many respects have improved in recent years and, from an economic perspective, this leaves the world somewhat less vulnerable than it might otherwise be. These improvements, together with the aggressive response by central banks across the globe, should help reduce the risk of sustained reductions in consumer and business confidence, a key concern in the months ahead.

The attack has certainly had a substantial initial impact in financial markets, although experience suggests that financial markets can overreact to such shocks initially. In the two weeks following the attack, major stock market indices in the United States, Europe, and Japan have fallen by 5 to 15 percent. Many emerging stock markets have fared even worse, particularly in Latin America and East Asia. There has also been a broad-based flight to quality, reflected in a sharp rise in spreads for both high-yield and emerging-market bonds. Oil prices, after rising immediately after the attack, have since fallen back sharply to levels significantly below those prevailing on September 10. Movements in the major currencies have been relatively moderate, with the U.S. dollar weakening slightly against the euro and the yen.

National regulators, financial authorities, and market participants have shown that the global financial system can continue to function smoothly even under a difficult and totally unanticipated form of extreme duress. Monetary policy in the major economies has responded aggressively to support the global payments system and to strengthen confidence and activity. The monetary authorities in the United States, the euro area, Japan, Switzerland, Canada, and the United Kingdom directly injected large amounts of liquidity. The Federal Reserve also entered into temporary swap arrangements with the European Central Bank (ECB), the Bank of England, and the Bank of Canada to facilitate the functioning of financial markets and to provide liquidity in U.S. dollars. In addition, the Federal Reserve moved to cut interest rates by 50 basis points on September 17, quickly followed by cuts of the same magnitude by the Bank of Canada, and then the ECB and the Swiss National Bank. Subsequently, the Bank of England and the Bank of Japan also cut rates, as did the monetary authorities in a number of other economies, including Denmark, Sweden, New Zealand, Hong Kong SAR, and Korea. In the United States, additional fiscal appropriations for defense, reconstruction, and the airlines will also provide support to activity.

Abstracting from uncertainties surrounding the possibility of further conflict, what is the likely direct economic impact of the events of September 11? The attack has taken a terrible toll in human lives, but the *direct* economic damage—in relation to the overall United States economy—is still relatively moderate, even though certain industries have been hard hit, particularly airlines, insurance, and tourism. While it is difficult to find close parallels in recent history, the direct damage is much smaller than that resulting from the Kobe earthquake of January 1995, which, as it turned out, had only a very limited impact on output growth in Japan (Box 1.3). The potential *indirect* effects of the attacks—on consumer sentiment and spending, on business confidence, and on risk aversion—are likely to be significantly more important. These are much more difficult to assess, and will depend importantly on how non-economic events evolve in the aftermath of the attack.

On the economic front, there are a number of reasons for cautious optimism. First, there is now a sizable amount of policy stimulus in the pipeline in most major economies, even more than had been anticipated before the attack. Second, economic fundamentals across the globe are considerably stronger than they were a few years ago, reflected in lower inflation; stronger fiscal positions; greater monetary policy credibility; and, in many emerging markets, more flexible exchange rate regimes and lower external vulnerabilities. And third, the terrorist attack should not substantially affect underlying productivity growth in the U.S. economy and elsewhere, on which economic prosperity ultimately depends (see Chapter III).

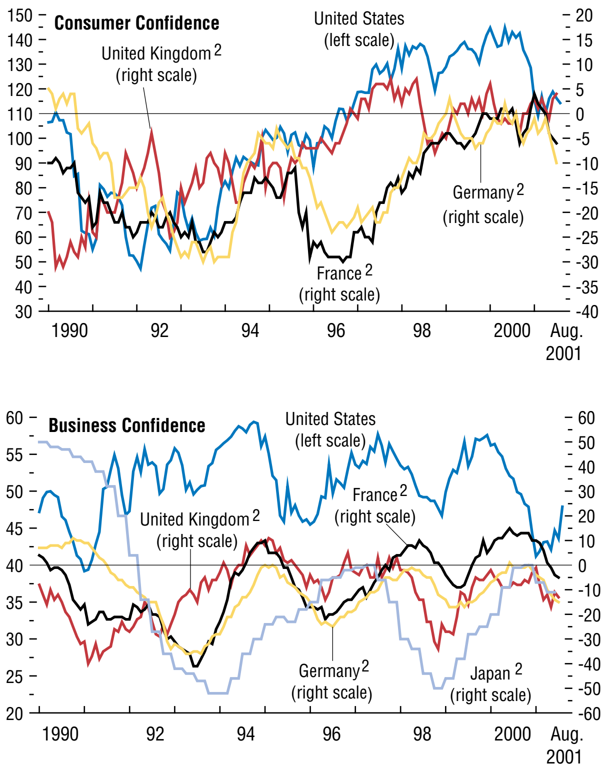
At press time, the situation was fluid, making it premature to try to quantify the implications of the attack for growth in the United States and elsewhere. There will clearly be a short-term effect on activity, particularly in the last part of this year, both in the United States and in other countries. However, there is still a reasonable prospect that a recovery will begin in the first half of next year. In terms of the projections in the *World Economic Outlook*, the effect on projected global growth in 2001 is likely to be moderate, since developments in the third and fourth quarters of the year have a limited impact on the average growth rate for the year as a whole. In 2002, however, global growth is likely to be lower than the 3.5 percent projected here.

In sum, the downside risks identified in the main text of this *World Economic Outlook* have now increased, even if the economic channels are largely the same. The task for policymakers has correspondingly become more challenging, both in industrial and in developing countries. The basic requirements remain those set out in the *World Economic Outlook*; in particular:

- The aggressive monetary policy response following the attack has been appropriate, and there remains room for maneuver, to varying extents, if additional action is needed. In particular, there remains room for a more aggressive monetary easing in Japan, even following the welcome steps after the September 11 attack. On the fiscal side, the automatic stabilizers should be allowed to operate. Beyond that, it is probably best to wait a little to see how events develop.
- Given the uncertainties in the United States, other countries—notably in Europe and Japan—will have to rely more on internally generated growth. This makes it even more important to press ahead with structural reforms.
- The weaker global outlook has clearly added to the difficulties facing emerging market countries. With markets increasingly differentiating according to policy performance, the central requirement remains to stay the course of prudent macroeconomic policies and structural reforms.

Figure 1.2. Selected European Union Countries, Japan, and United States: Indicators of Consumer and Business Confidence[1]

After falling sharply from late 2000, confidence in the United States has begun to stabilize. In Europe, business confidence has weakened, and recently consumer confidence has turned down.



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; and for Japan, Bank of Japan.

[1]Indicators are not comparable across countries.

[2]Percent of respondents expecting an improvement in their situation minus percent expecting a deterioration.

moderate additional easing in Japan, will be helpful in sustaining confidence and activity.

The global slowdown since early 2000 has been driven by a variety of interlinked factors, including a reassessment of corporate profitability and the associated adjustment in equity prices; the rise in energy prices in 2000, which proved more enduring than initially expected; and the tightening of monetary policy in late 1999 and 2000, particularly in the United States and the euro area, in response to rising demand pressures. Weakening global activity has been accompanied by a downturn in business and consumer confidence, starting in the United States but then spreading to Europe (Figure 1.2), a tightening of credit conditions for some key emerging markets, and heightened risk aversion. Among these factors, the boom and bust in the stock prices of information technology (IT) firms, and the associated sharp fall in IT investment and output, have played a particularly important role. As discussed in Chapter III, unsustainable financial booms have been a common feature of past technological revolutions, and have typically been associated with a significant degree of over investment in the sector concerned, and an ensuing correction. However, the latest episode has been distinguished by the globalization of IT production, so that the decline in IT spending—which as yet shows little sign of abating—has had a particularly widespread impact.

In response, policymakers have generally moved promptly to ease macroeconomic policies; nonetheless, given the size of the shocks, the impact has inevitably been substantial. Moreover, given the global nature of these shocks, as well as the increased trade and financial linkages among countries, their impact has been more rapid and widespread than many expected (and in a number of cases has been exacerbated by country specific factors). The net result is that growth has slowed in almost all major regions of the world, accompanied by a sharp decline in trade growth (Figure 1.3). While the latter has been evident in all regions, the falloff has been particularly steep for many Asian emerging markets, reflecting their heavy dependence on IT trade.

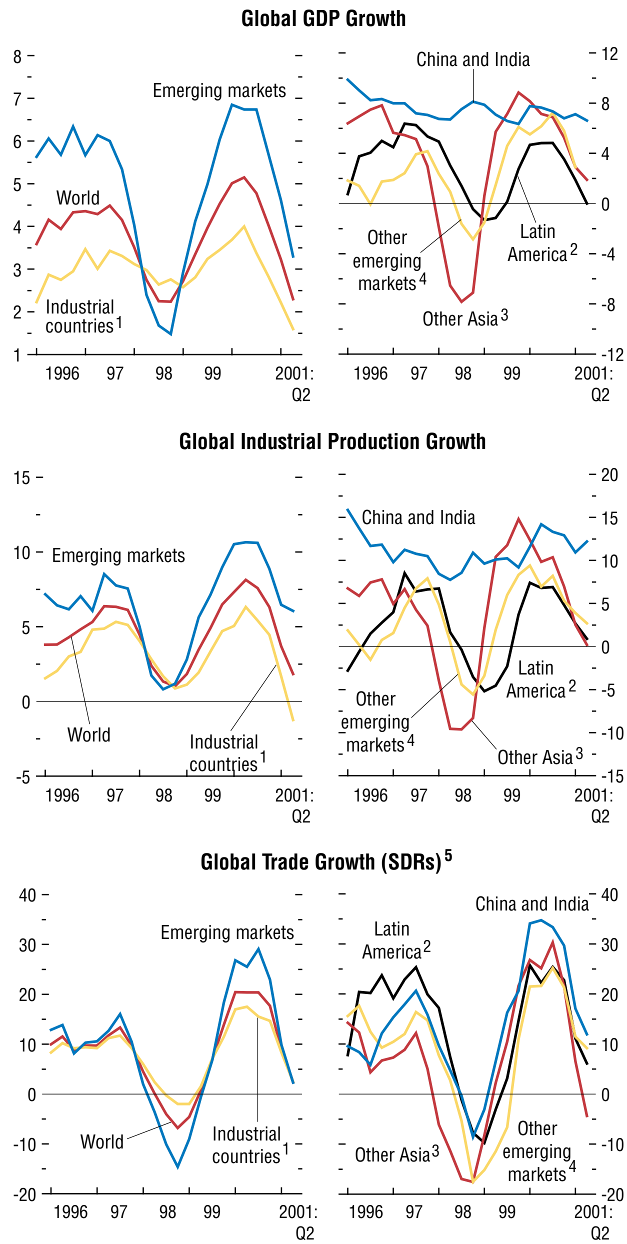
Financial markets have remained volatile, partly reflecting rapidly changing expectations about the duration and depth of the slowdown and recently rising risk aversion and broad-based flight to quality following the terrorist attack. In mature markets, equity prices rallied temporarily in April and May, but have since fallen significantly as incoming news on corporate profitability remained weak and growth prospects deteriorated, with equity markets in all major industrial countries falling sharply following the events of September 11 (Figure 1.4); yields on government bonds broadly mirrored these developments, but have risen lately at long maturities. With short-term rates declining in response to cuts in official rates in most industrial countries, yield curves have generally steepened, albeit to varying extents. In currency markets, the U.S. dollar continued to appreciate in nominal effective terms through July, apparently reflecting continued confidence in the relative strength of the U.S. economy, while the yen and the euro remained relatively weak.[3] In August and September, however, as concerns about U.S. growth prospects increased, the dollar depreciated moderately against most major currencies, with the euro returning close to its level against the dollar at the beginning of the year.

In emerging markets, financial developments have been influenced by mature markets, but also by country-specific factors. During the first half of 2001, the EMBI+ spread remained volatile, with the positive effect of lower U.S. interest rates offset by rising risk aversion and in some cases deteriorating economic fundamentals. While spreads for most emerging market countries declined through June, there were substantial increases in *Argentina*—which also affected *Brazil*—and *Turkey*. As difficulties in Argentina and Turkey intensified in July, their spreads widened sharply, with spillovers to other emerging markets, particularly in Latin America. But overall, contagion effects have so far proved

[3]See "What Is Driving the Weakness of the Euro and the Strength of the Dollar," Chapter II, *World Economic Outlook*, May 2001.

Figure 1.3. Global Output, Industrial Production, and Trade Growth
(Percent change from four quarters earlier)

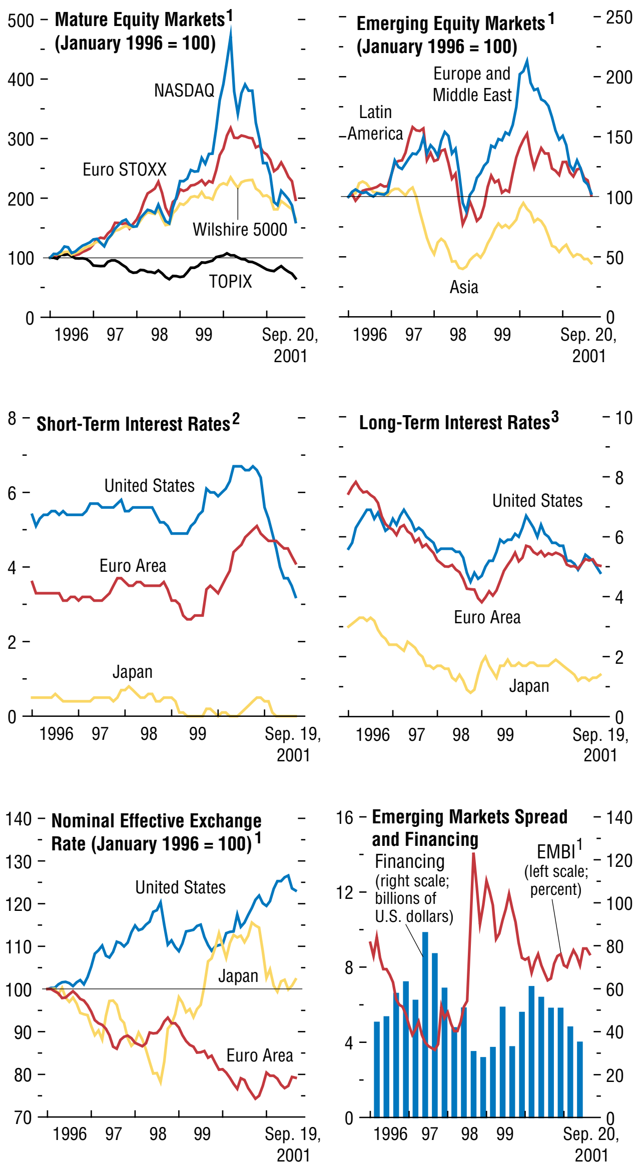
Growth in output and industrial production has weakened in almost every region of the globe, accompanied by a sharp slowdown in the growth of trade flows.



Sources: Central banks and ministries of finance; and European Central Bank, *Monthly Bulletin*.
[1]Canada, euro area, Japan, United Kingdom, and United States.
[2]Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.
[3]Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, and Thailand.
[4]Czech Republic, Hungary, Israel, Poland, Russia, Turkey, Pakistan, and South Africa.
[5]Defined as exports plus imports of the relevant region.

Figure 1.4. Financial Market Developments

Equity markets and interest rates have fallen significantly since 2000, including in the aftermath of the terrorist attack on September 11, 2001. Despite some recent strengthening, the euro and the yen remain relatively weak against the U.S. dollar.



Sources: Bloomberg Financial Markets, LP; European Central Bank; IMF Treasurer's Department, Nikkei Telecom; and WEFA, Inc.
[1]Average of the month.
[2]Three-month deposit rate; euro area data prior to January 1999 reflect Germany.
[3]Ten-year government bond rate. To December 1998, euro area yields are calculated on the basis of harmonized national government bond yields weighted by GDP. Therefore, the weights are nominal outstanding amounts of government bonds in each maturity band.

moderate, in part because increasingly risk averse investors had already tended to diversify away from all but the highest quality emerging market credits, and also because of the relatively low level of leverage in financial markets. As the *World Economic Outlook* went to press, high yield and emerging market spreads had risen markedly following the terrorist attack, reflecting a broad-based flight to quality, accompanied by significant declines in emerging equity markets. After a weak first quarter, gross financing flows held up relatively well in the second quarter, but have subsequently fallen again. For 2001 as a whole, net capital flows to emerging markets are projected to turn negative for the first time since the mid-1980s (Table 1.2).[4] Moreover, given the sharp deterioration in financing conditions since June and rising global risk aversion, there are downside risks to this outlook.

During the first five months of 2001, headline inflation continued to rise in most advanced economies (with the important exception of Japan), driven by the earlier sharp increase in energy prices, and—particularly in Europe—rising food prices due to animal diseases and bad weather. Core inflation also rose, but in most countries is still moderate. During the rest of the year, oil and food prices are expected to fall back (Appendix I) while underlying inflationary pressures are expected to remain modest, reflecting weak demand, increasingly competitive product markets, and the improved anti-inflation credibility of central banks in the past decade (see Box 1.2 on page 13). As a result, headline inflation in almost all advanced economies is projected to decline significantly by 2002 (Table 1.3), and recent inflation data for most advanced countries appear consistent with this expectation. Inflation could in some circumstances become more worrisome—for instance, if in the euro area higher headline inflation fed through into 2002 wage rounds, or if in the

[4]It should be noted, however, that this partly reflects the substantial current account surpluses in oil producing countries, and the corresponding net private capital outflows.

Table 1.2. Emerging Market Economies: Net Capital Flows[1]
(Billions of U.S. dollars)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total										
Private capital flows, net[2]	139.1	147.5	205.5	234.4	119.1	69.1	58.6	0.5	–1.4	71.0
Private direct investment, net	57.6	81.4	97.5	120.0	145.8	155.9	153.1	147.3	162.7	158.2
Private portfolio investment, net	87.6	112.8	43.8	87.8	48.1	–2.0	31.7	1.5	–0.2	24.0
Other private capital flows, net	–6.1	–46.8	64.2	26.7	–74.8	–84.9	–126.2	–148.3	–163.9	–111.2
Official flows, net	50.3	5.5	24.1	0.1	62.2	55.4	9.5	1.4	19.6	–3.5
Change in reserves[3]	–64.3	–69.8	–117.7	–109.1	–61.9	–44.4	–87.6	–112.7	–81.5	–83.8
Memorandum										
Current account[4]	–117.3	–72.7	–91.6	–95.7	–70.0	–52.6	39.1	128.1	69.6	14.5
Africa										
Private capital flows, net[2]	2.9	13.4	12.2	12.7	8.8	9.8	10.8	3.5	10.8	12.0
Private direct investment, net	3.2	3.3	2.9	4.8	8.4	6.9	8.4	7.6	11.8	11.4
Private portfolio investment, net	0.9	3.5	3.1	2.8	6.9	3.7	8.7	–1.7	3.1	3.8
Other private capital flows, net	–1.3	6.6	6.2	5.0	–6.5	–0.8	–6.2	–2.4	–4.1	–3.3
Official flows, net	4.4	3.2	4.1	–2.5	2.1	3.6	1.8	–0.3	–0.1	–7.1
Change in reserves[3]	2.8	–5.7	–1.9	–9.1	–10.6	1.9	–3.6	–13.3	–10.5	–9.3
Memorandum										
Current account[4]	–11.3	–11.8	–16.6	–6.0	–7.8	–20.6	–15.5	2.1	–3.9	–6.4
Developing Asia[5]										
Crisis countries[6]										
Private capital flows, net[2]	30.8	35.0	54.9	74.1	–5.9	–31.9	–18.3	–19.8	–28.9	–15.1
Private direct investment, net	6.7	6.5	10.3	11.7	10.2	11.4	8.9	5.1	6.6	6.0
Private portfolio investment, net	25.0	13.3	18.6	27.6	8.8	–9.0	13.1	6.9	–4.5	0.3
Other private capital flows, net	–0.8	15.2	26.0	34.7	–25.0	–34.3	–40.3	–31.9	–31.0	–21.5
Official flows, net	3.2	1.1	8.6	–4.4	14.1	17.3	–3.3	1.8	1.0	–2.7
Change in reserves[3]	–20.0	–6.5	–18.0	–5.3	39.4	–46.9	–39.3	–23.9	–0.2	–8.1
Memorandum										
Current account[4]	–13.5	–23.2	–39.1	–53.0	–25.5	69.7	62.9	46.0	31.6	28.6
Other Asian emerging markets										
Private capital flows, net[2]	21.6	34.1	36.5	49.8	22.3	–14.1	8.9	4.3	6.6	11.6
Private direct investment, net	26.4	38.2	39.6	45.6	49.6	48.5	43.0	41.8	44.5	43.8
Private portfolio investment, net	0.9	7.5	2.1	3.5	–0.1	–6.3	0.7	–3.3	–6.2	1.9
Other private capital flows, net	–5.7	–11.6	–5.2	0.6	–27.2	–56.2	–34.8	–34.2	–31.6	–34.1
Official flows, net	8.2	2.5	–3.7	–7.9	–7.2	0.2	2.1	–9.3	–2.5	1.6
Change in reserves[3]	–16.8	–51.6	–25.4	–41.6	–46.8	–16.8	–38.7	–25.8	–28.4	–27.2
Memorandum										
Current account[4]	–7.2	18.3	8.0	14.9	51.1	41.5	37.9	41.5	27.2	16.0
Memorandum										
Hong Kong SAR										
Private capital flows, net[2]	—	—	—	—	11.6	–8.5	1.0	3.8	1.6	–2.6

United States the economy were to rebound significantly more rapidly than expected, or if underlying productivity growth were to slow. Nonetheless, at the present juncture, the balance of risks still lies clearly on the side of weaker activity rather than higher inflation.

Overall, the current conjuncture is characterized by unusually large uncertainties and risks, both in advanced and emerging market economies. First, with the broadening of the economic slowdown, there is now no major region providing support to global activity. This has increased the vulnerability of the global economy to shocks, and heightened the risk of a self-reinforcing downturn whose consequences could prove difficult to predict, given the progressively stronger and more complex linkages across economies (Chapter II). Second, slowing growth will put increasing pressure on financial and corporate sectors in a number of countries, notably

Table 1.2 *(concluded)*

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Middle East, Malta, and Turkey[7]										
Private capital flows, net[2]	26.7	16.8	8.1	11.8	22.4	11.9	–1.1	–26.0	–34.0	–1.8
Private direct investment, net	3.2	4.9	6.6	4.9	5.6	6.8	5.8	7.3	5.7	11.2
Private portfolio investment, net	6.7	7.7	2.0	0.7	–0.9	–12.1	–4.4	–9.7	–4.2	1.8
Other private capital flows, net	16.9	4.2	–0.5	6.2	17.7	17.2	–2.4	–23.6	–35.5	–14.7
Official flows, net	5.1	3.1	4.3	6.5	4.3	1.9	1.4	1.5	8.8	–4.6
Change in reserves[3]	1.2	–4.7	–11.3	–22.0	–20.8	10.6	–6.3	–25.0	–26.5	–21.7
Memorandum										
Current account[4]	–31.4	–6.2	–5.2	5.0	3.0	–24.4	11.9	59.5	58.8	33.9
Western Hemisphere										
Private capital flows, net[2]	37.4	42.4	41.6	63.8	68.3	72.7	44.6	36.7	39.0	57.8
Private direct investment, net	12.2	23.2	24.9	40.5	56.5	60.8	63.4	62.8	67.2	54.5
Private portfolio investment, net	45.5	63.7	3.4	39.7	25.4	17.7	10.8	5.1	6.7	11.8
Other private capital flows, net	–20.3	–44.4	13.2	–16.4	–13.6	–5.8	–29.6	–31.2	–34.9	–8.5
Official flows, net	30.4	7.8	17.8	5.8	16.0	15.1	7.0	8.1	11.2	6.2
Change in reserves[3]	–20.7	4.0	–23.3	–29.0	–13.8	8.7	7.6	–3.1	6.0	–2.9
Memorandum										
Current account[4]	–45.9	–52.0	–37.1	–39.8	–66.8	–90.4	–56.3	–48.6	–57.9	–62.4
Countries in transition										
Private capital flows, net[2]	19.7	5.7	52.1	22.3	3.2	20.7	13.6	2.0	5.1	6.4
Private direct investment, net	6.0	5.3	13.1	12.4	15.6	21.6	23.6	22.7	26.9	31.3
Private portfolio investment, net	8.7	17.1	14.6	13.4	8.0	4.0	2.8	4.3	5.0	4.3
Other private capital flows, net	5.0	–16.8	24.5	–3.6	–20.3	–4.9	–12.8	–25.0	–26.7	–29.1
Official flows, net	–1.1	–12.2	–7.1	2.6	32.9	17.2	0.5	–0.4	1.3	3.1
Change in reserves[3]	–10.9	–5.3	–37.8	–2.1	–9.4	–1.9	–7.2	–21.6	–21.9	–14.6
Memorandum										
Current account[4]	–7.9	2.3	–1.7	–16.7	–24.0	–28.5	–1.9	27.5	13.9	4.8

[1]Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing. Emerging markets include developing countries, countries in transition, Korea, Singapore, Taiwan Province of China, and Israel.
[2]Because of data limitations, "other net investment" may include some official flows.
[3]A minus sign indicates an increase.
[4]The sum of the current account balance, net private capital flows, net official flows, and the change in reserves equals, with the opposite sign, the sum of the capital account and errors and omissions.
[5]Includes Korea, Singapore, and Taiwan Province of China.
[6]Includes Indonesia, Korea, Malaysia, the Philippines, and Thailand.
[7]Includes Israel.

Japan where banks remain exposed to equity and bond markets. Third, while emerging markets benefit from lower global interest rates, financing conditions remain volatile, partly reflecting continued uncertainties in Argentina and Turkey. The implications of a serious slowdown in industrial countries for emerging market financing, whose structure has increasingly shifted from bank finance to equity and bond markets during the 1990s, have also yet to be seen. Finally, as already mentioned, the terrorist attack on the United States on September 11 exacerbates all of these risks and adds a further one, namely uncertainty and volatility in oil prices.

The outlook needs also to be viewed against the backdrop of the substantial imbalances that have developed in the global economy during the recent expansion, including the large U.S. current account deficit matched by relatively strong current account positions in a number of other major countries (Table 1.4); the apparent overvaluation of the U.S. dollar, particularly vis-à-vis the euro; low U.S. personal savings rates; and equity markets that—at least prior to the terrorist attack—still appeared richly valued by historical standards. In particular, the question arises whether short-term developments and policies are likely to be consistent with an orderly resolution of these imbalances, or whether they could actually make them worse, increasing the risk of a larger and more disorderly adjustment later on. Such concerns are heightened by

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

	Real GDP				Consumer Prices				Unemployment			
	1999	2000	2001	2002	1999	2000	2001	2002	1999	2000	2001	2002
Advanced economies	**3.4**	**3.8**	**1.3**	**2.1**	**1.4**	**2.3**	**2.4**	**1.7**	**6.4**	**5.8**	**6.0**	**6.2**
Major advanced economies	3.0	3.4	1.1	1.8	1.4	2.3	2.3	1.6	6.1	5.7	5.9	6.3
United States	4.1	4.1	1.3	2.2	2.2	3.4	3.2	2.2	4.2	4.0	4.7	5.3
Japan	0.8	1.5	–0.5	0.2	–0.3	–0.6	–0.7	–0.7	4.7	4.7	5.0	5.6
Germany	1.8	3.0	0.8	1.8	0.7	2.1	2.5	1.3	8.2	7.5	7.5	7.9
France	3.0	3.4	2.0	2.1	0.6	1.8	1.8	1.1	11.2	9.5	8.7	8.5
Italy	1.6	2.9	1.8	2.0	1.7	2.6	2.6	1.6	11.4	10.6	9.5	9.1
United Kingdom[1]	2.3	3.1	2.0	2.4	2.3	2.1	2.2	2.4	6.0	5.6	5.2	5.3
Canada	5.1	4.4	2.0	2.2	1.7	2.7	3.1	2.3	7.6	6.8	7.4	7.3
Other advanced economies	4.9	5.3	1.9	3.3	1.3	2.4	3.0	2.2	7.3	6.2	6.3	6.1
Spain	4.0	4.1	2.7	2.8	2.2	3.4	3.6	2.5	15.9	14.1	13.0	12.6
Netherlands	3.7	3.5	1.4	2.2	2.0	2.3	4.9	2.5	3.2	2.8	3.6	3.9
Belgium	2.7	4.0	1.7	2.0	1.1	2.7	2.5	1.7	8.8	7.0	7.1	7.3
Sweden	4.1	3.6	1.7	2.5	0.5	1.0	2.5	2.2	5.6	4.7	4.1	4.1
Austria	2.8	3.3	1.6	2.6	0.5	2.0	2.3	2.0	3.9	3.7	3.7	3.6
Denmark	2.1	3.2	1.4	2.0	2.5	3.0	2.4	2.3	5.6	5.2	5.2	5.4
Finland	4.0	5.7	2.0	2.6	1.3	3.0	2.6	1.9	10.3	9.8	9.9	10.4
Greece	3.4	4.3	4.3	3.8	2.2	2.9	3.5	3.1	12.0	11.3	10.9	10.7
Portugal	3.4	3.4	1.6	1.7	2.2	2.8	4.3	2.5	4.4	4.0	3.9	4.1
Ireland	10.9	11.5	6.3	4.9	2.5	5.2	4.0	3.2	5.6	4.3	3.7	4.0
Luxembourg	7.3	8.5	4.2	4.3	1.0	3.2	1.5	1.3	2.9	2.6	2.7	2.6
Switzerland	1.5	3.5	1.6	1.7	0.8	1.6	1.4	1.5	2.7	1.9	1.8	1.9
Norway	1.1	2.3	1.9	2.2	2.3	3.1	3.5	2.9	3.2	3.4	3.3	3.3
Israel	2.6	6.2	0.7	5.4	5.2	1.1	1.0	2.0	8.9	8.8	9.0	8.6
Iceland	4.1	3.6	1.7	0.7	3.4	5.1	6.3	5.7	1.9	1.4	1.4	2.0
Cyprus	4.5	5.1	4.2	4.0	1.8	4.1	2.2	2.5	3.6	3.5	3.6	3.8
Korea	10.9	8.8	2.5	4.5	0.8	2.3	4.4	3.4	6.3	4.1	4.0	3.5
Australia[2]	4.7	3.8	2.3	3.8	1.5	4.5	4.2	2.0	7.0	6.3	6.8	6.7
Taiwan Province of China	5.4	6.0	–1.0	4.0	0.2	1.3	0.1	0.8	2.9	3.0	4.6	4.8
Hong Kong SAR	3.0	10.5	0.6	4.0	–4.0	–3.7	–1.4	0.6	6.3	5.0	5.6	5.3
Singapore	5.9	9.9	–0.2	4.0	0.1	1.4	1.5	1.7	3.5	3.1	3.2	3.1
New Zealand[2]	3.8	3.7	1.8	2.9	1.1	2.7	2.7	2.2	6.8	6.0	5.5	5.7
Memorandum												
European Union	2.7	3.4	1.8	2.2	1.4	2.3	2.6	1.8	9.1	8.1	7.7	7.7
Euro area	2.7	3.5	1.8	2.2	1.2	2.4	2.7	1.7	9.9	8.8	8.4	8.4

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

the weakening of growth outside the United States and—partly associated with that—the present constellation of exchange rates. Notwithstanding recent developments, the continued strength of the U.S. dollar against the euro may inhibit recovery in the United States while reducing the scope for monetary policy easing in the euro area, constraining a desirable rebalancing of external and domestic sources of growth in both areas and making an orderly resolution of global imbalances more difficult.

As discussed in several recent issues of the *World Economic Outlook*, an important factor underlying these imbalances appears to have been a belief that the underlying rate of productivity growth in the United States has increased relative to other countries, making the United States a relatively more attractive environment for new investment. This, in turn, contributed to larger capital inflows, rising equity prices, and an appreciation of the U.S. dollar, which led to a widening U.S. current account deficit and a drop in U.S. personal saving. To the extent that these imbalances have been driven by such factors, their evolution in the period ahead—and the risks associated with them—will depend importantly on how

Table 1.4. Selected Economies: Current Account Positions
(Percent of GDP)

	1999	2000	2001	2002
Advanced economies	**–0.5**	**–1.0**	**–0.9**	**–0.8**
Major advanced economies	–1.0	–1.6	–1.5	–1.4
United States	–3.5	–4.5	–4.0	–3.8
Japan	2.4	2.5	2.2	2.6
Germany	–0.9	–1.0	–0.8	–0.5
France	2.6	1.8	2.5	2.6
Italy	0.5	–0.5	–0.1	0.1
United Kingdom	–1.1	–1.7	–1.7	–2.0
Canada	0.2	2.5	1.9	0.9
Other advanced economies	2.0	2.1	2.1	2.1
Spain	–2.1	–3.2	–2.3	–2.1
Netherlands	4.1	4.4	4.8	4.6
Belgium-Luxembourg	5.0	4.8	4.6	4.8
Sweden	3.5	2.6	2.2	2.1
Austria	–3.2	–2.9	–2.9	–2.6
Denmark	1.5	1.7	2.2	2.5
Finland	6.0	7.4	5.9	5.3
Greece	–4.1	–6.8	–6.5	–6.4
Portugal	–8.8	–10.1	–9.4	–8.7
Ireland	0.4	–0.7	–1.2	–2.2
Switzerland	11.6	12.9	10.7	10.9
Norway	4.0	14.3	15.0	14.4
Israel	–3.0	–1.3	–3.1	–2.7
Iceland	–7.0	–10.3	–9.6	–6.5
Cyprus	–2.4	–5.0	–3.6	–3.0
Korea	6.0	2.4	2.6	2.1
Australia	–5.8	–4.0	–3.0	–2.8
Taiwan Province of China	2.9	2.9	2.5	2.6
Hong Kong SAR	7.3	5.4	6.6	7.5
Singapore	25.9	23.7	21.0	19.8
New Zealand	–6.7	–5.6	–4.0	–3.8
Memorandum				
European Union	0.3	–0.3	—	0.1
Euro area[1]	0.4	–0.1	0.3	0.4

[1]Calculated as the sum of the balances of individual euro area countries.

expected and *actual* productivity growth unfolds in the United States and elsewhere. Clearly, this issue is—and will no doubt remain—subject to debate and considerable uncertainty. In the United States, some part of the recent increase in actual productivity has likely been cyclical, but a portion may well be more enduring in nature, reflecting the benefits of the information technology revolution (Chapter III). In most other advanced countries—with *Australia* being an important exception—there is much less evidence of an underlying increase in productivity, suggesting that developments in the future will depend importantly on progress with structural reform.

Despite these risks and uncertainties, there remains a reasonable prospect of a pickup in global growth in the coming period, although more slowly than earlier envisaged, especially following the terrorist attack. Most importantly, since the beginning of the year macroeconomic policies have been eased in most advanced countries, and in the United States in particular there is now substantial stimulus in the pipeline. At the same time, activity is likely to be bolstered by the abatement of oil and food price shocks, which appear to have had a particularly important effect in the euro area; the completion of ongoing inventory adjustments; and, as past overinvestment is worked off, a recovery in the IT sector (although the timing of this remains very uncertain). Against this background, in the IMF's baseline scenario, GDP growth in the United States and the euro area is projected to begin to strengthen mildly in the coming period, although the pace will be dampened by the lagged impact of past wealth losses on consumption, as well as by the continued unwinding of IT overinvestment, particularly in the United States, and the impact of the terrorist attack. Stronger demand in industrial countries, along with the pickup in the IT sector, would support improved growth in emerging market economies and a gradual improvement in external financing conditions. As a result, global growth in 2002 is projected to increase to 3.5 percent, although—especially if the timing of recoveries in major countries is delayed or confidence weakens sharply as a result of the terrorist attack—there are downside risks to this projection.

In this baseline scenario, the moderation in global imbalances in the short-term would be limited, with the U.S. current account deficit falling only modestly in 2001–02. Provided that the future growth outlook in the United States was still perceived as solid, there would be a reasonable prospect that capital inflows would be sustained. Thereafter, provided structural reforms to boost potential growth and productivity in Japan and the euro area are put in place, investment opportunities outside the United States are likely to become increasingly attractive.

Box 1.2. How Much of a Concern Is Higher Headline Inflation?

With global growth weakening, how far should monetary policy be eased to support activity? The scope for such monetary easing must be weighed against both near-term inflation prospects and longer-term concerns about anti-inflationary credibility. A current complication is that inflation developments have been obscured by price shocks that have boosted “headline” (or overall) inflation rates in many countries (including the euro area and United States), despite slowing real growth. Abstracting from these shocks, inflationary pressures appear to have remained subdued. Should policymakers be concerned about rising headline inflation, or instead focus on underlying price measures?

The argument for focusing on core as opposed to overall inflation is based on what drives prices across markets.[1] In some markets, especially for commodities, sharp price movements tend to be associated with supply and demand developments that are specific to those markets without reflecting generalized inflationary pressures. Labor markets, in contrast, tend to adjust sluggishly in response to broader-based imbalances between aggregate supply and demand. Hence, shocks specific to commodity markets will tend to generate one-off changes in the price level, while labor market imbalances may be associated with much longer-lived changes in prices.

There are also arguments for looking at overall inflation. Firstly, price *level* shocks can lead to higher wage *growth* if the inflation expectations of wage-setters are affected. Secondly, what appear to be isolated price shocks may instead reflect general conditions of excess demand that show up first in markets where prices are flexible. These phenomena were apparent in the 1970s, when price shocks in specific markets were accompanied by an acceleration in underlying inflation that persisted until the 1980s.

[1]Core inflation is defined here as the overall CPI less food and energy prices to abstract from temporary supply shocks in these markets. This measure can still be influenced by price shocks. For instance, the weak euro has boosted import prices in the euro area, while the reverse has been true in the United States.

Regression Results for Overall and Core CPI Inflation

Dependent variable	Parameter on 12-month lagged inflation[1]	
	Overall	Core
	1965M1–1982M12	
U.S. overall	1.51 (6.7)	–0.94 (3.6)
U.S. core	1.22 (7.9)	–0.54 (3.1)
	1983M1–2001M4	
U.S. overall	0.14 (0.5)	0.15 (0.6)
U.S. core	0.14 (0.6)	0.40 (1.6)
	1997M1–2001M2	
Euro area overall	0.30 (1.0)	–1.40 (2.0)
Euro area core	0.26 (0.4)	–0.37 (2.3)

[1]Absolute values of t-statistics in parentheses, adjusted for MA (12) error terms. Constant terms in the regressions have been suppressed.

Since then, the anti-inflationary credibility of monetary policymakers has become better established, as they have responded firmly to forestall any signs of emerging pressures. With the enhanced credibility of policy, specific price shocks, such as the oil price surge during the Gulf War, have not triggered generalized inflation. Indeed, during the 1990s, industrial countries have enjoyed the lowest sustained inflation rates since the 1950s. Such anecdotal evidence suggests that price shocks should be of less concern now than at times in the past.

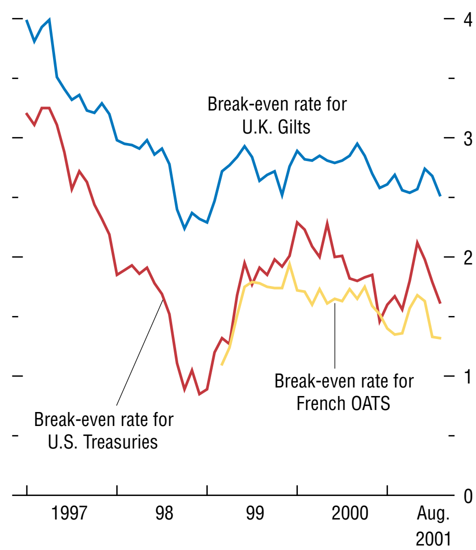
Statistical evidence on the relationship between overall and core inflation also supports the view that price shocks are now of less concern. During 1965–82, the dominant factor explaining U.S. inflation (either overall or core) was past *overall* inflation, while the effect of lagged core inflation was actually negative (see the Table). In other words, price shocks that drove a wedge between overall and core inflation tended to cause long-lived increases in both measures of inflation. The results for 1983–2001 are quite different—the parameters on both lagged inflation rates are small and statistically insignificant, with the borderline exception of that on lagged core inflation in its own equation. While data limitations for the euro area preclude a comparison over the same time peri-

Box 1.2 *(concluded)*

ods, over a relatively short 1997–2001 sample, lagged overall inflation in the euro area again plays a much smaller role than during the 1965–82 period for the United States.

What lessons can be drawn for monetary policy from these results? The apparent change in the behavior of inflation since the early 1980s supports downplaying shocks to headline prices. Moreover, indicators of inflation expectations suggest that recent price shocks will have temporary effects: consensus forecasts point to significant declines in U.S. and euro-area inflation next year; market forecasts of longer-term inflation implicit in index-linked bond yields remain subdued (see the Figure); and other traditional inflation indicators, such as gold and commodity prices, have not suggested inflationary pressures. At the same time, the change in the behavior of inflation since the early 1980s also reflects changes to the policymaking process, in particular the determination of central banks to contain inflation by resisting any second-round impacts of temporary price shocks. The continued credibility of such policies depends on the willingness to tighten policies given any signs that price shocks are fuelling underlying inflationary pressures.

Inflation Expectations Derived from Index-linked Bonds
(Percent)



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

Capital flows to the United States, and the U.S. dollar, would then fall back, ideally in a gradual fashion, consistent with an orderly resolution of global imbalances.[5]

However, given the risks already described, there remains a significant danger of a worse outcome. For instance, if U.S. productivity growth were to disappoint, and overinvestment during the recent boom turned out to have been more extensive and widespread than presently believed, equity markets in the United States could weaken markedly, accompanied by a sharp fall in fixed investment and in private consumption (which has so far remained relatively resilient). As discussed in Appendix II, this could result in a much deeper and more protracted global downturn—similar to that experienced in the early 1980s and early 1990s—especially if also accompanied by continuing structural weaknesses and consequently weaker-than-projected productivity growth in Europe and Japan. There would also be a possibility of substantial financial market turbulence, including in some circumstances a possible abrupt decline in the value of the U.S. dollar. The impact on developing countries would be substantial, including through a further deterioration in external financing conditions; this could both aggravate and be aggravated by country-specific risks.

[5]Since the baseline projections in the *World Economic Outlook*, like those of a number of other forecasters, assume constant real exchange rates, there is only a small reduction in imbalances in the baseline scenario. See Appendix II for a more detailed discussion.

In this environment, policymakers across the globe face a particularly challenging task. With the slowdown becoming increasingly synchronized, and significant downside risks, short-term macroeconomic policies need to remain supportive of activity and confidence, and in some cases a more proactive stance would be desirable:

- In the *United States*, recent tax cuts and monetary policy easing—along with the higher expenditures in the wake of the terrorist attack—should provide support to activity in the second half of 2001 and beyond, but this has been partly offset by the strength of the U.S. dollar. The U.S. monetary authorities have already cut rates substantially, although some limited room for further reductions remains were the outlook to weaken significantly further.
- In *Japan*, the scope for further macroeconomic policy stimulus remains limited. Recent monetary easing is welcome, but there remains room to exploit the flexibility afforded by the new monetary framework more aggressively, even if this results in some depreciation of the yen. On the fiscal side, a modest supplementary budget is appropriately being considered, as the authorities should avoid too rapid a withdrawal of stimulus (Table 1.5).
- In the *euro area*, the recent cuts in interest rates were appropriate. If the outlook were to weaken materially further, provided that inflation developments remain favorable, there would be scope for additional easing. Tax cuts in some countries are providing modest support to activity, and automatic stabilizers should be allowed to operate fully to buffer weaker activity.

At the same time, it will be important that policies are consistent with an orderly resolution of the global imbalances over the medium term. While these imbalances have been largest and perhaps of most concern in the United States, it does not follow that it is the sole responsibility of the United States to correct them. Indeed, as suggested above, they are a reflection not just of strong growth in the United States—and some excesses associated with it—but also of relatively weak growth elsewhere, in turn partly the result of delays in addressing long standing structural problems. Therefore, from both a national and global perspective, policymakers—particularly, but not only, in the euro area and Japan—must move quickly to implement the structural reforms necessary to achieve sustainably higher potential growth rates. The announcement by the new Japanese government of a timetable for the reform process is therefore particularly encouraging, even if such reforms were to involve some short-term cost in output growth.

In emerging market economies, the outlook inevitably remains heavily dependent on developments in the major industrial countries, underscoring the need for the latter to implement policies along the lines described above. At the present conjuncture, emerging market policymakers face a difficult balance between seeking to offset—to the extent possible—the impact of the global slowdown and maintaining external confidence in an increasingly fragile environment. While vulnerabilities have in most cases been reduced following the 1997–98 crises, including through the widespread adoption of flexible exchange rate regimes, significant risks remain. On the macroeconomic side, there is in some cases room for countercyclical policies, but in many countries the scope is constrained, especially where external financing requirements or fiscal imbalances are large. Slowing growth is also likely to add to pressures on corporate sectors and financial systems, and it will be essential to press ahead with structural reforms in these areas, especially in those countries that have been lagging in the process. The international community will also need to stand ready to support these efforts and to help address contagion pressures if they intensify, including through support for strengthened policy packages and through the use of the IMF's Contingent Credit Line Facility.

With past experience suggesting that slowing growth is likely to have a disproportionate impact on the poor, the global effort to reduce poverty becomes of even higher priority. The central re-

Table 1.5. Major Advanced Economies: General Government Fiscal Balances and Debt[1]
(Percent of GDP)

	1985–94	1995	1996	1997	1998	1999	2000	2001	2002	2006
Major advanced economies										
Actual balance	–3.8	–4.1	–3.4	–2.0	–1.3	–1.0	—	–0.8	–0.7	0.6
Output gap[2]	–0.5	–2.2	–2.0	–1.4	–1.2	–0.8	—	–1.4	–2.1	–0.1
Structural balance	–3.4	–3.2	–2.6	–1.3	–0.8	–0.7	–0.5	–0.4	0.1	0.7
United States										
Actual balance	–4.7	–3.3	–2.4	–1.3	—	0.7	1.9	1.2	1.2	1.3
Output gap[2]	–1.3	–3.2	–2.8	–1.6	–0.5	0.4	1.3	–0.5	–1.4	—
Structural balance	–4.2	–2.3	–1.5	–0.7	0.2	0.6	1.5	1.3	1.6	1.5
Net debt	51.4	59.6	59.2	57.0	53.4	48.9	43.6	40.9	38.0	25.8
Gross debt	65.7	72.9	72.8	70.3	66.7	63.4	57.3	54.1	50.7	35.9
Japan										
Actual balance	0.6	–3.5	–4.2	–3.2	–4.5	–7.0	–8.2	–7.4	–6.5	–1.3
Excluding social security	–2.5	–6.3	–6.7	–5.8	–6.5	–8.8	–9.5	–8.2	–7.0	–2.3
Output gap[2]	1.1	–1.2	0.4	0.4	–2.5	–3.1	–3.1	–4.8	–5.7	–0.2
Structural balance	0.3	–3.2	–4.3	–3.4	–3.6	–6.0	–7.3	–5.9	–4.7	–1.3
Excluding social security	–2.9	–6.0	–6.9	–5.9	–6.0	–8.2	–9.0	–7.4	–6.1	–2.4
Net debt	13.5	12.7	16.0	17.5	29.5	36.0	43.5	51.0	57.2	59.6
Gross debt	70.6	87.1	92.5	96.8	110.2	120.4	130.7	142.1	150.9	150.3
Euro area										
Actual balance	–4.9	–5.3	–4.4	–2.7	–2.2	–1.3	0.2	–1.0	–1.0	0.3
Output gap[2]	–0.3	–1.3	–2.0	–1.9	–1.3	–1.1	–0.1	–0.8	–1.2	—
Structural balance	...	–4.3	–3.1	–1.5	–1.3	–0.7	–0.7	–0.7	–0.4	0.2
Net debt	46.1	65.2	65.8	65.6	64.0	63.0	60.7	59.6	58.4	50.4
Gross debt	60.8	76.7	77.7	76.9	75.0	73.9	71.4	69.7	68.4	58.6
Germany[3]										
Actual balance[4]	–1.9	–3.3	–3.4	–2.7	–2.2	–1.6	1.2	–2.2	–1.8	—
Output gap[2]	–0.2	0.2	–0.9	–1.4	–1.3	–1.4	–0.3	–1.5	–1.7	—
Structural balance	–1.4	–3.3	–2.7	–1.6	–1.2	–0.7	–1.1	–1.4	–0.8	—
Net debt	24.9	49.4	51.1	52.2	52.0	52.4	51.6	50.9	50.9	44.9
Gross debt	43.8	58.3	59.8	60.9	60.7	61.1	60.3	59.6	59.6	53.6
France										
Actual balance[4]	–3.3	–5.5	–4.1	–3.5	–2.6	–1.6	–1.4	–0.8	–1.6	0.6
Output gap[2]	–0.3	–2.7	–3.3	–3.1	–1.8	–1.2	–0.3	–0.8	–1.2	—
Structural balance	–2.9	–3.7	–1.9	–1.5	–1.4	–0.9	–1.1	–1.0	–1.0	0.6
Net debt	28.3	45.8	48.1	49.6	49.8	48.9	48.0	48.8	47.4	41.5
Gross debt	36.9	54.6	57.1	59.3	59.5	58.5	57.5	57.8	57.8	51.8
Italy										
Actual balance[4]	–10.5	–7.6	–7.1	–2.7	–2.8	–1.8	–0.3	–1.3	–0.9	–0.3
Output gap[2]	–0.1	–1.1	–2.0	–2.3	–2.4	–2.7	–1.8	–2.0	–2.0	—
Structural balance	–10.4	–7.0	–6.2	–1.7	–1.8	–0.6	–0.7	–0.5	–0.1	–0.2
Net debt	93.2	116.6	116.0	113.7	110.1	108.4	104.4	101.9	99.9	84.8
Gross debt	99.5	123.2	122.6	120.1	116.2	114.5	110.2	107.6	105.6	89.8
United Kingdom										
Actual balance[4]	–3.2	–5.4	–4.1	–1.5	0.3	1.5	4.0	0.7	0.2	—
Output gap[2]	0.4	–1.1	–0.9	–0.4	—	–0.1	0.3	–0.3	–0.6	–0.2
Structural balance	–2.5	–4.4	–3.4	–1.0	0.5	1.5	1.6	0.7	0.5	0.2
Net debt	26.6	37.0	46.5	45.0	42.3	39.5	35.1	31.5	29.4	26.1
Gross debt	43.5	52.0	52.2	49.9	47.0	44.4	41.3	38.6	36.3	31.6
Canada										
Actual balance	–6.9	–5.3	–2.8	0.2	0.5	1.6	3.2	2.8	2.9	2.3
Output gap[2]	–2.0	–4.4	–5.3	–3.6	–3.3	–1.6	0.2	–0.6	–1.3	–0.7
Structural balance	–5.6	–2.8	0.1	2.1	2.1	2.5	3.1	3.2	3.6	2.6
Net debt	66.3	88.6	87.8	84.1	81.2	74.9	66.3	60.0	54.7	36.3
Gross debt	98.0	120.4	120.3	117.6	115.7	112.3	102.6	95.3	88.5	64.3

Note: The methodology and specific assumptions for each country are discussed in Box A1.

[1]Debt data refer to end of year; for the United Kingdom they refer to end of March.

[2]Percent of potential.

[3]Data before 1990 refer to west Germany. For net debt, the first column refers to 1988–94. Beginning in 1995, the debt and debt-service obligations of the Treuhandanstalt (and of various other agencies) were taken over by general government. This debt is equivalent to 8 percent of GDP, and the associated debt service to ½ to 1 percent of GDP.

[4]Includes one-off receipts from the sale of mobile telephone licenses equivalent to 2.5 percent of GDP in 2000 for Germany, 0.5 percent of GDP in 2001 for France, 1.2 percent of GDP in 2000 for Italy, and 2.4 percent of GDP in 2000 for the United Kingdom.

sponsibility for addressing poverty must of course lie with national governments of the countries concerned, and in this regard the New African Initiative announced by the Organization of African Unity—and supported by the G-8 at the Genoa summit—is a welcome step forward. Such efforts should be accompanied by increased support from the industrial countries, including further trade liberalization; debt relief under the enhanced HIPC initiative; a fully-funded strategy to fight the AIDS pandemic and other diseases; and increased efforts to achieve the U.N. target for official aid flows, which, as a percentage of donor country GDP, have declined steadily over the past decade (Figure 1.5).

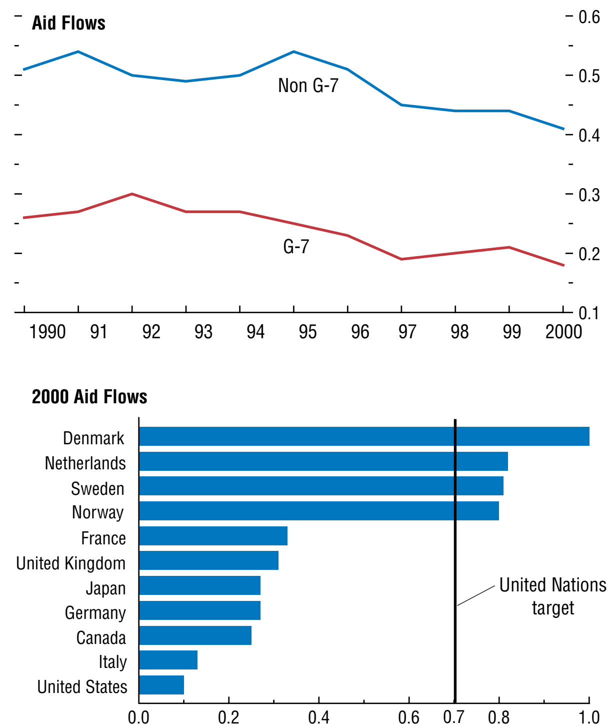
In this connection, an increase in aid flows by 0.1 percentage points from today's average level of 0.24 percent of GNP would substantially exceed the $10 billion the United Nations has identified as needed to begin a comprehensive program of HIV/AIDS prevention and treatment.[6] Moreover, with only one-fifth of total overseas development aid flows now going to the least developed countries, there should be scope to direct more of the increased aid to the poorest nations.

Finally, the successful launch of new multilateral trade negotiations, possibly at the upcoming WTO Ministerial meeting in Doha, would boost global growth prospects and help strengthen the trading system. As discussed in Chapter II, the potential gains for both advanced and developing countries from further trade liberalization are substantial (for developing countries, the benefit is estimated at twice the present level of official aid flows). A failure to make progress toward a new round could reduce confidence in the multilateral trading system, a development that would likely hurt the poorest countries most of all. Moreover, in an environment of slowing global growth, protectionist pressures—which are never far below the surface, and signs of which have already begun

[6]"A Global Partnership for African Economic Development," address by IMF Managing Director Horst Köhler to the United Nations Economic and Social Council, Geneva, July 16, 2001. The text can be found at http://www.imf.org/external/np/speeches/2001/071601.htm.

Figure 1.5. Net Overseas Aid Disbursement by Major Development Assistance Committee (DAC) Countries[1]
(Percent of GNP)

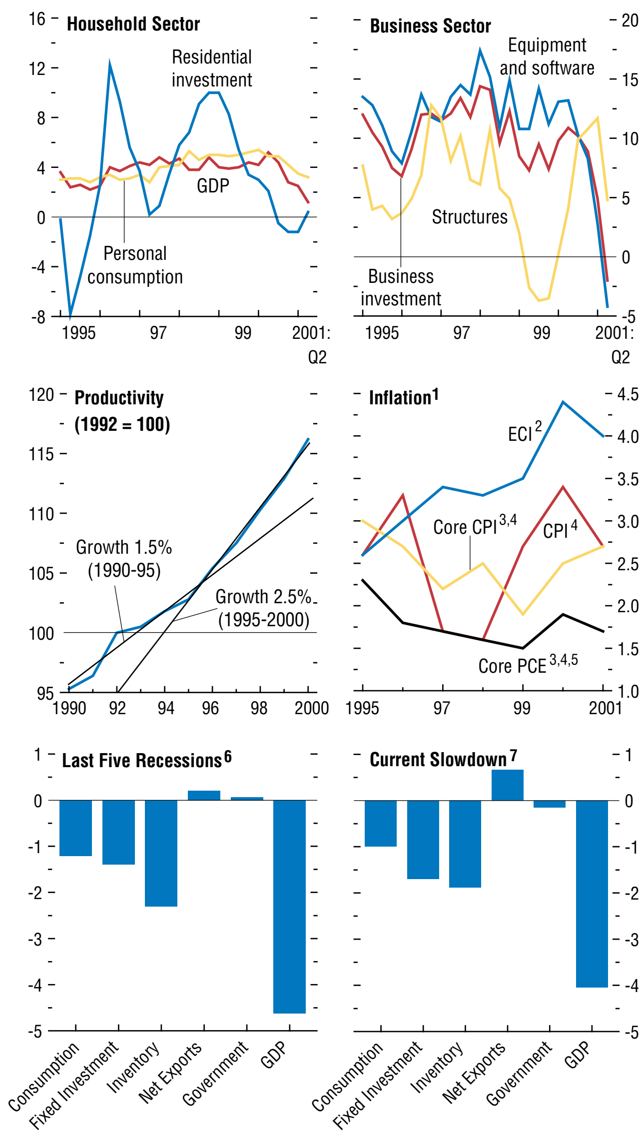
Aid flows have steadily declined as a percentage of GNP in recent years, and—apart from Denmark, Netherlands, and Sweden—most countries are well below the United Nations target.



[1]Based on total amounts provided by donors, excludes debt forgiveness of non-ODA claims. 2000 data are provisional.

Figure 1.6. United States: A Sharp Slowdown in the Business Sector
(Percent change from four quarters earlier unless otherwise indicated)

The current slowdown has been marked by a sharp fall in business investment, especially in equipment and software. Core inflation remains subdued.



Sources: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; and IMF staff estimates.
[1]Data for 2001 CPI, Core CPI, and core personal consumption expenditure (PCE) refer to percent change from July 2001 over July 2000; employment cost index (ECI) refers to change from 2001:Q2 over 2000:Q2.
[2]Employment cost index, fourth quarter over fourth quarter.
[3]Core inflation rates exclude changes in food and energy prices.
[4]Percentage change from December-over-December.
[5]Chain type price index for personal consumption expenditures.
[6]Difference in average percent contribution to growth, comparing the year before the last five cyclical peaks with the period between these peaks and subsequent troughs.
[7]Difference in percent contribution to growth between 1999:Q2 to 2000:Q2 and 2000:Q2 to 2001:Q2, annualized.

to emerge—would prove considerably more difficult to contain.

How Quickly Can Growth Pick Up in North America?

The sharp slowdown in U.S. economic activity that began in mid-2000 continued through the first eight months of 2001, and the September 11 terrorist attack has further increased downside risks, although at the time of writing it is too early to assess the economic consequences. The downturn through early September has been driven primarily by a significant weakening in business investment, marked by a sharp falloff in equipment and software purchases and a rapid depletion of inventories. Exports have also weakened substantially, although, with imports also falling sharply, the negative contribution of net trade to growth has diminished. In contrast, private consumption growth—while weakening—has remained relatively robust; and residential construction growth has also picked up, aided by the reduction in long-term interest rates since mid-2000. The decline in growth so far has been about the same as the average peak-to-trough decline in previous downturns, with broadly similar relative contributions of consumption, investment, and other demand components (Figure 1.6). Within investment, the contribution of business equipment and software to the slowdown has been substantially larger than in the past, reflecting the technology downturn, and that of construction (residential and nonresidential) has been somewhat smaller.[7]

The baseline projection, which was completed before the September 11 terrorist attack, envisages a modest recovery in the coming period, with GDP growth of 1.3 percent for the year as a

[7]In addition, recent revisions to historical national accounts data for 1998 to 2000 have led to a significant reduction in estimated GDP growth in 2000, from 5 percent to 4.1 percent, because of lower inventory and software investment. These same revisions also lifted the personal saving rate to 1 percent (from –0.1 percent) because of a reduction in corporate profits and increase in personal income.

Box 1.3. An Historical Analogy to the Terrorist Attack on the United States: The Kobe Earthquake

The 1995 earthquake in Kobe, Japan was the most costly natural disaster in modern history. Striking on January 17, it resulted in over 5,000 deaths, 35,000 casualties, and property damage of around $120 billion (or about 2½ percent of Japan's annual GDP). In addition to the direct impact on life and property, the regional economy (accounting for about 4 percent of Japan's total output) was severely affected by the disruption of transportation, including the closure of Kobe's important port facilities. In terms of the financial impact, Japanese stock prices fell by about 6 percent following the earthquake.

In the event, the direct impact on activity, as measured by indicators such as industrial production, was relatively small. The more important hit to overall output came through a contraction in consumer spending in the first quarter of 1995, leading to a decline in real GDP of 0.3 percent (quarterly rate). Activity recovered in subsequent quarters, however, and GDP for the year as a whole expanded by 1½ percent compared with slightly over ½ percent in 1994.

Comparing the Kobe earthquake with the recent terrorist attack in the United States, the direct impact of the earthquake was larger, both in absolute terms and relative to Japan's economy. The second-round effects on other industries are harder to assess. The earthquake caused immense dislocation in the surrounding area, but the terrorist attack may have a more far-reaching impact by disrupting U.S. financial activity and air transportation. Finally, since the terrorist attack was a deliberate action with long-term security implications, the effects on consumer psychology may well not be comparable.

whole, picking up to 2.2 percent in 2002. Such a scenario could—if accompanied by improved growth performance in other major countries and an orderly depreciation of the U.S. dollar—be consistent with a gradual reduction in the current account deficit to more sustainable levels, accompanied by a steady improvement in the household savings ratio. But, as emphasized earlier, there are also significant downside risks in the outlook, generally stemming from interrelated uncertainties about the extent of overinvestment in the economy, the medium-term outlook for productivity growth, and the robustness of household balance sheets, confidence, and consumer spending. The September 11 terrorist attack will have a short-term effect on activity, and has clearly exacerbated these risks, particularly with respect to confidence and consumer spending (Box 1.3 considers some possible parallels between the economic consequences of this attack and the Kobe earthquake in Japan).

Macroeconomic policies have been significantly eased. Since the beginning of the year, the U.S. Federal Reserve has reduced interest rates by 350 basis points, including a 50 basis points cut as part of a global monetary easing on September 17, accompanied by other measures to ensure adequate liquidity in financial markets for settlement of transactions. Fiscal policy has also been eased, initially by the implementation of a tax cut package in mid-year and by the recent approval of an emergency $40 billion spending package following the terrorist attack. This macroeconomic stimulus should support activity in the period ahead, allowing demand to recover modestly by the end of the year as assumed in the baseline. However, confidence has been further shaken by the terrorist attack, exacerbating risks that the pace of recovery may be slowed by the lagged effect on consumption of the decline in equity market valuations over the last year—possibly offset in part by rising house prices—as well as by the need to work off past overinvestment in the technology sector.

As in most other industrial countries, headline inflation has risen in the United States, mainly due to higher energy costs, and some measures of core inflation have edged up (though others, notably the personal consumption deflator, have remained relatively muted). At the same time, the combination of weakening productivity as activity slowed and a pickup in employment costs has led to a sharp rise in unit labor costs since mid-2000. With energy prices declining, product markets remaining highly competitive, and with activity slowing, the risks of sustained inflationary pressures appear relatively modest at the present juncture. Such pressures could become more of a concern, however, if underlying productivity growth—which has played a key role in absorbing wage increases in recent years—were to slow sharply, especially if accompanied by a sharp downward adjustment in the U.S. dollar.

With underlying inflation subdued, there is scope for further monetary easing to support the economy if weakness persists. On the fiscal side, policy is expected to be more expansionary, reflecting the approved $40 billion in extra spending and other measures that may be taken to meet assistance and reconstruction needs and the expenses of U.S. efforts to combat terrorism in the wake of the September 11 attack. The automatic stabilizers can also be allowed to work to cushion the impact of a weaker U.S. economy. However, at present, the need for and the potential effectiveness of other discretionary fiscal actions is not clear. Beyond the immediate aftermath of recent developments, both multi-year tax cuts and spending increases will have to be implemented flexibly over the medium term to ensure that sufficient resources are available to finance these measures and to meet fiscal obligations associated with the aging of the population.

Growth in *Canada* is expected to slow to 2 percent in 2001 and 2.2 percent in 2002, with the outlook largely reflecting Canada's close trade and financial linkages with the United States. Household spending has remained relatively robust, underpinned by tax cuts earlier in the year and generally firm labor market conditions, while business investment—especially in machinery and equipment—has declined sharply. Reflecting the latter trend, imports have also fallen, more than offsetting a decline in exports and propelling the current account position to a record surplus. In the event of further slowing in activity, monetary easing would continue to be the preferred response—official interest rates having already been lowered by 175 basis points between January and August 2001 and a further 50 basis points on September 17. In addition, with Canada's fiscal surplus remaining proportionately the largest among the Group of Seven (G-7) countries, the automatic stabilizers should be allowed to work fully during the current slowdown. Over the medium term, continued emphasis needs to be given to reducing debt and preparing to meet rising public pension and health care costs associated with population aging.

Japan: A Somber Short-Term Outlook, But a New Opportunity for Reform

In Japan, the economic situation has continued to deteriorate, and it is now likely that the economy has, for the fourth time in the last 10 years, slipped back into recession. For 2000 as a whole, activity increased by 1.5 percent, close to the average during the 1990s. This expansion was underpinned by relatively strong investment and export growth, reflecting rising profits and buoyancy in the high tech sector. However, even though the pattern of growth is difficult to interpret given data problems,[8] the underlying pace of activity appears to have slowed from mid-2000 as external demand weakened and global electronics demand fell back. While real GDP rose marginally in the first quarter of 2001, reflecting a temporary boost to private consumption from increased purchases of household appliances in advance of environmental regulations introduced on April 1, 2001, output fell sharply in the second quarter, with significant falls in public and private investment offsetting a rise in private consumption. These deteriorating prospects, along with concerns about the pace of corporate restructuring, have been reflected in a sharp weakening in equity markets, exacerbated by the September 11

[8]See Box 1.2, October 2000 *World Economic Outlook*, for a discussion of measurement problems in the Japanese national accounts.

terrorist attack, while unemployment has reached an all time high of 5 percent. The yen has also depreciated significantly since late 2000, although this has been partly reversed since July.

The outlook for the remainder of the year remains very uncertain. On the positive side, the adoption of the new monetary framework in March—which has brought overnight interest rates back to zero—has been supportive, and the August and September increases in the target for reserves held at the central bank are further welcome steps, as are plans for a modest supplementary budget. However, private consumption remains extremely weak, reflecting declining incomes and concerns about rising unemployment and future corporate restructuring; business confidence continues to deteriorate; private credit is still declining; and moderate deflation persists. GDP is projected to decline by 0.5 percent in 2001—well below the 0.6 percent increase expected at the time of the May 2001 *World Economic Outlook*—followed by a modest recovery of growth to 0.2 percent in 2002. Moreover, significant downside risks remain, associated both with the possibility of a slower global recovery and with the future path of domestic policies—both fiscal and structural—which are discussed further below. These risks are of particular concern in a climate where growth in the other main currency areas is weakening, and will adversely affect the rest of the region (Box 1.4).

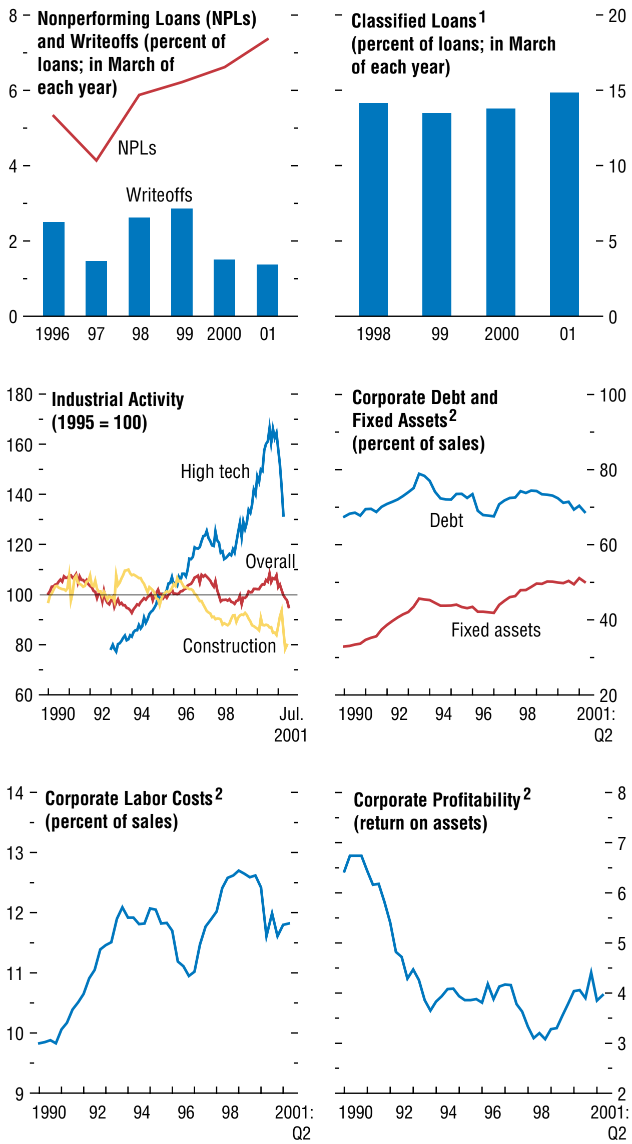
Japan's disappointing performance over the past decade has been aggravated by a series of macroeconomic shocks, but the roots of its problems can be found in the failure to address the excess stocks of capital and debt created in the bubble years and more broadly in a slow pace of adjustment to globalization and technological change. The financial situation of the banking system remains difficult: banks have substantial exposure to financial risks on holdings of equities and government paper, exacerbated by the further sharp decline in equity markets in recent weeks and the introduction of mark to market accounting at the end of September; credit risks remain on so-called "gray-zone" loans, for which limited provisioning has so far been made; and core profitability is weak. In the corporate sector, there has been some shift toward more dynamic sectors—notably high tech, electrical machinery, and parts of transportation and communications—but little progress in addressing debt and capital overhangs and reducing labor costs, or in strengthening profitability (Figure 1.7).

Despite this somber outlook, a new and reformist government that enjoys strong popular support recently took office and there is now a renewed opportunity for change. In March, the authorities announced a package of banking and corporate reforms—including accelerated disposal of nonperforming loans by the major banks, measures to reduce banks' equity holdings, and guidelines to aid corporate restructuring and debt forgiveness—followed in June by a seven point plan of action focusing on fiscal consolidation and reform plus some regulatory improvements, and in September by the announcement of a concrete timetable for a number of structural measures. Although many details remain to be fleshed out, policymakers will need to resist pressures from vested interests, and to take full advantage of this opportunity to decisively address Japan's structural problems. On the banking and corporate side, the priorities are to extend debt writeoffs to regional banks; further strengthen implementation of classification and provisioning standards, especially for "gray-zone" loans; provide targeted public capital injections if and where necessary to avoid systemic concerns; and ensure that restructuring plans are sufficiently rigorous to force a turnaround in distressed corporates. These measures should be accompanied by reforms to boost flexibility and productivity, including strengthening competition policy and increasing labor mobility.

As the authorities have stressed, such a program is likely to have an adverse impact on growth and employment in the short run, although the impact would be reduced if rapid and thorough reforms boost confidence in longer-term prospects, and some reforms (for instance in the property sector) could enhance growth. Against this background, macroeco-

Figure 1.7. Japan: Banking and Corporate Sector

The financial position of the banking system remains very weak, especially given credit risks on classified loans, while limited progress has been made in corporate restructuring.



Sources: Ministry of Finance; Ministry of International Trade and Industry; Nikkei Telecomm; Nomura database; and IMF staff calculations.
[1]Defined as the sum of watch list loans (Class 2), doubtful loans (Class 3), and unrecoverable loans (Class 4), net of collateral, guarantees, and specific loan loss provisions.
[2]Seasonally adjusted data.

nomic policies should be supportive, although the room for maneuver is clearly limited, with short-term interest rates already close to zero and public debt very high. While the monetary easings in August and September should help to support activity, there remains scope for more aggressive use of the flexibility available under the new monetary framework with the aim of achieving a rapid end to deflation, even if this were to result in some moderate weakening of the yen. On the fiscal side, it will be important that the withdrawal of fiscal stimulus remains moderate until a recovery is clearly under way, and the authorities' intention to introduce a modest supplementary budget in the fall is therefore welcome. In this connection, it would be desirable to shift the composition of government outlays from public works toward expenditures that would be supportive of restructuring, including a strengthened social safety net, and the recently announced expenditure guidelines include an important step in that direction. This should be accompanied by the development and announcement of a clear and credible medium-term plan to put the government finances on a sounder footing, which could encompass a medium-term debt target, enunciation of the broad objectives and directions of tax, expenditure, and social security policy, and greater fiscal transparency.

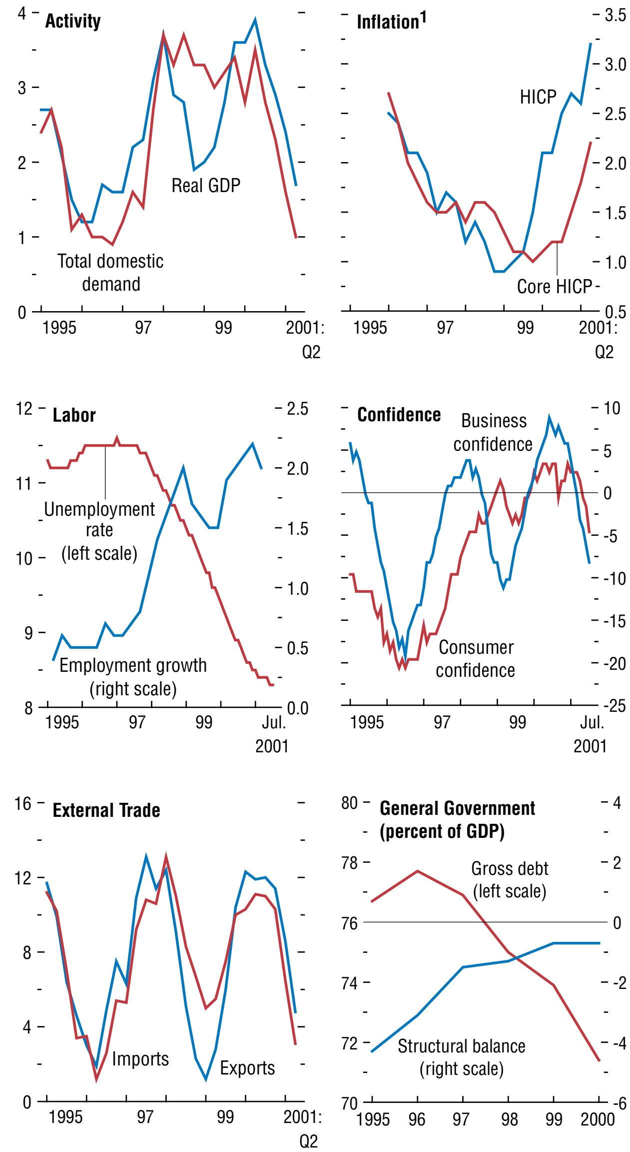
How Serious Is the Slowdown in Western Europe?

In the euro area, the slowing in growth that began in the second half of 2000—most markedly in Germany—has continued and spread more widely in 2001. While interpretation of developments is complicated by recent data revisions, particularly in Germany, the slowdown appears to have been driven by weakening domestic demand growth, resulting in part from higher oil and food prices which have squeezed real incomes; downturns in equity markets and the technology sector (in particular telecommunications); and, in some countries, weakening employment growth (Figure 1.8). On the external side, export growth has slowed in response to weaker global demand—both in the United States and in Asia—and import growth has also turned down sharply. In addition to the direct impact of the global slowdown through trade channels, activity is also likely to have been affected by spillovers through corporate and financial linkages—including the expansion of U.S. operations by euro-area businesses and the rapid growth in European investors' holdings of U.S. equities (Chapter II). As the outlook deteriorated, the euro weakened further in the first half of 2001 and moved close to a record low against the U.S. dollar, before firming since July. The reasons for the euro's persistent weakness are still not well understood, but recent evidence suggests that differences in economic performance in the euro area and the United States, and portfolio adjustments as a result of the advent of the euro, have played an important role.

Underlying these overall trends have been some divergences in economic developments in individual euro-area economies (see Box 1.5). Among the three largest economies, gross fixed investment has weakened particularly sharply in Germany, where construction activity has fallen off significantly. More recently, destocking has contributed to stagnant overall activity in Germany—and possibly also in Italy, where a buildup of inventories led to relatively strong growth in the first quarter. The French economy initially appeared to be holding up relatively well against the global slowdown, supported by tax cuts and ongoing employment growth. With consumer and business confidence having fallen significantly, however, and unemployment recently moving up, the pace of activity has weakened and is expected to be similar to that of Germany and Italy during the second half of 2001 and in 2002. In the periphery, growth prospects remain generally stronger, notably in *Greece* and *Ireland*. Indeed, in Ireland the global slowdown has—somewhat fortuitously—helped to reduce the danger of overheating. Current account deficits are expected to remain relatively

Figure 1.8. Euro Area: Weakening Growth, Rising Inflation
(Percent change from four quarters earlier unless otherwise noted)

Business confidence and domestic demand have weakened sharply in the current slowdown and inflation has increased.



Sources: Eurostat; European Central Bank; European Commission; IMF, *International Financial Statistics;* and IMF staff estimates.
[1]Harmonized index of consumer price index.

Box 1.4. The Japanese Economic Slowdown and East Asia

The short-term outlook for Japan has worsened steadily since mid-2000 as the high-tech driven expansion succumbed to the slump in global electronics demand, while domestic demand remained weak. Real GDP is now expected to decline by 0.5 percent in 2001, followed by a modest rebound in 2002, fueled by a pickup in global growth. This represents a significant change from expectations a year ago, when the recovery seemed likely to continue in 2001, with the IMF forecasting growth of 1¾ percent. Given the size of the Japanese economy, this 2¼ percentage point markdown of the growth outlook has significant implications for the world economy, and East Asia in particular.

The transmission channels from Japan to the rest of the region include:

Trade. While the region has become relatively less reliant on trade with Japan in recent years, the linkages remain significant, with around 12 percent of East Asian exports being sold to Japan and 20 percent of imports coming from Japan (see the Table). A slowing Japanese economy would reduce trade turnover with regional partners, thus impacting their growth outlook. In the region, Indonesia has the most significant trade links with Japan (about one-half of this is petroleum), followed closely by China (which sells mostly lower-end goods to Japan). Hong Kong SAR and Singapore have the lowest reliance.

Stock market pullback. Given the relatively strong linkages between Japan and a number of East Asian markets, a further decline in the already depressed Japanese stock markets could push regional equity markets down, with investors scaling back their exposures to East Asian equity as an asset class. The linkage is particularly strong with Hong Kong SAR, but Korea, Singapore, and Thailand also have significant linkages. However, if investors see differing prospects between Japan and the rest of East Asia, then it is possible that funds may be pulled out of Japan and put into other Asian markets, thus boosting stock prices there.

Problems related to the banking sector. As the economy slows down, it is likely that the lending capacity of banks would be restricted by capital constraints as loan-loss charges are increased. Given that Japanese banks remain major lenders to the region, reports of further banking sector distress could be destabilizing, with Thailand having the highest exposure.

Continued stagnation or contraction in the corporate sector. While Japanese foreign direct investment (FDI) has declined and its banks have reduced lending to many East Asian countries since the Asian crisis, Japan nonetheless remains an important source of capital. Firm-level difficulties could impact Japan's FDI to the rest of East Asia.

Indicators of Linkages Between Japan and East Asia

(In percent, data as of 2000 unless otherwise stated)

	Share of Exports to Japan	Exports to Japan (percent of GDP)	External Debt/GDP	Share of Debt Denominated in Yen	Stock Market Correlation[1]	Share of Bank Lending from Japanese Banks	Share of FDI from Japan
Indonesia	22	8	97	21	0.03	25	13
Thailand	16	9	66	32	0.21	37	25
Korea	11	4	28	17[2]	0.32	18	16
Hong Kong SAR	6	7	. . .	. . .	0.40	32	. . .
Malaysia	13	13	48	30[2]	0.12	27	14
Philippines	14	7	76	27	0.09	18	7
Singapore	7	11	. . .	. . .	0.30	27	23
China	16	4	14	16[2]	0.00	18	7

Sources: CEIC Database; IFS; WEO; and IMF staff calculations.
[1]Daily correlation with the Nikkei 225 after controlling for the impact of the S&P 500, using data from January 1999 to June 2001.
[2]Refers to long-term debt in 1998.

The impact of the Japanese economy on East Asia can be analyzed through multicountry macroeconomic models, such as the Oxford Economic Model (OEM) and the G-cubed (Asia Pacific) model (Callen and McKibbin, forthcoming). Simulation results from the OEM, which highlight the trade linkages between countries, suggest that a 2 percentage point decline in Japan's growth outlook for 2001 (from the October 2000 baseline) would reduce growth rates of the East Asian economies, ranging from one-fifth of a percentage point in China, Korea, Malaysia, and the Philippines to about one-third of a percentage point in Indonesia, Hong Kong SAR, Singapore, and Thailand. Results from the G-cubed model, which incorporates intertemporal optimizing behavior of agents and explicit financial market linkages, highlight that the factors underlying the growth slowdown are crucial, as demand shocks like fiscal consolidation may have a negative short-term impact for the region, but would be ultimately beneficial by lowering interest rates and stimulating demand. If the slowdown results from a supply shock, such as a decline in productivity, however, the region's trade dynamics could be affected in a prolonged manner.

Weaker Japanese growth could also have implications for the exchange rate of the yen, although since the Asian crisis, reduced levels of external debt and more flexible exchange rate arrangements have reduced vulnerability to external shocks. It is possible that a depreciating yen would exert pressure on regional currencies, especially on countries competing with Japan in third markets or with major yen exposure. However, a more depreciated yen would have the beneficial effect of reducing the yen component of the East Asian countries' external debt.

Simulation results from the OEM suggest a modest initial negative impact on the region from a depreciation of the yen, and subsequent positive impact as Japan's growth and regional trade pick up. The impact could be somewhat different if the depreciation is induced by an increase in Japan's risk premium. Incorporating this channel into the G-cubed model shows a net positive impact on the region, with the negative impact on net exports (due to competitive pressure) more than offset by the reduced cost of capital and higher capital inflows (that mirror the capital outflows from Japan following the rise in its risk premium).

high in Greece and *Portugal* in 2001, coming down gradually in 2002.

Recent data suggest that activity and confidence are continuing to weaken in the major countries, and, in contrast to the United States, there is relatively little policy easing in place. Nevertheless, interest rates have been cut by 100 basis points since May. Moreover, although fiscal policy is broadly neutral in the area as a whole, tax cuts in some countries are providing a boost to consumption. Demand is also likely to be supported by the abatement of earlier oil and food price shocks, completion of inventory corrections, a still quite favorable exchange rate, and a modest strengthening of activity in the United States. Against this background, euro-area GDP growth is projected to average 1.8 percent in 2001—still the highest of the three major currency areas—and to rise to 2.2 percent in 2002. But the downside risks to this forecast have been increased by the September 11 terrorist attack, particularly if the global recovery is slower than expected or consumer confidence continues to weaken. The strong intraregional linkages would transmit these risks throughout the euro area. Furthermore, individual euro-area countries face particular risks: for example, *Finland* and Ireland are vulnerable to the high technology slowdown.

The oil and food price shocks that have dampened domestic demand have also led to a sharp rise in headline inflation, peaking at 3.4 percent in May. Core inflation has also risen, albeit more moderately, to just over 2 percent. Some of the

Box 1.5. Relative Euro-Area Growth Performances: Why Are Germany and Italy Lagging Behind France?

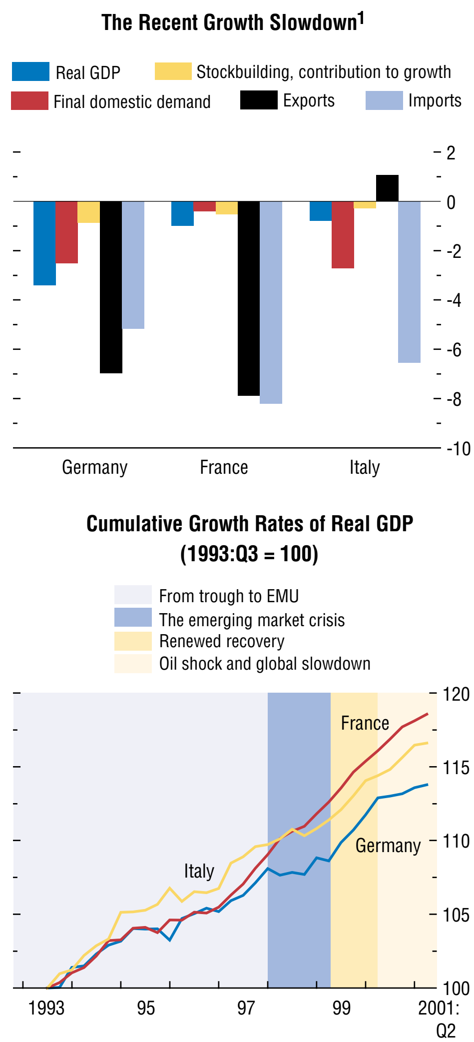
Since mid-2000, domestic demand growth has been weaker in Germany and Italy than in France (see the Figure).[1] These developments mirror a pattern of divergence among the three largest euro-area economies. Since the last area-wide recession in 1992–93, output growth has averaged about 2 percent for France, 1.7 percent for Italy, and 1.5 percent for Germany. The small, but cumulatively important, differences in growth over this horizon can largely be traced back to differences in potential growth—linked, among other factors, to the rate of growth in the labor force, which in France was twice as high as that in the other two countries, together with somewhat greater effectiveness in pursuing supply-side friendly structural reforms. Moreover, disappointing potential growth through most of the 1990s suggests that Germany has yet to fully shake off the lingering effects of unification.

Against this backdrop, developments can be analyzed by focusing on four subperiods:

- *From trough to Stage 3 of EMU:* Starting from the cyclical trough in 1993 to early 1997, France and Germany—linked through the de facto fixed exchange rate in the ERM—moved mostly in lockstep. By contrast, the depreciation of the lira upon Italy's exit from the Exchange Rate Mechanism (ERM) in September 1992 provided a boost to exports. Growth in all countries was dampened by macroeconomic policies geared toward promoting disinflation and convergence to Maastricht criteria. The negative fiscal impulse was about 2 percentage points of GDP in both Germany and France, and over 3 percent in Italy. Employment growth was weak in all three countries, but especially in Germany, reflecting the lack of labor market reforms, confidence effects, and less than exemplary output performance.

[1]Care should be taken in analyzing such short-term trends in growth rates. For example, the rapid upswing in German growth in early 2000 has to some extent created base effects that tend to exaggerate the degree of the current downturn.

Euro Area: Growth Performance



[1]Differences in annualized average growth during the last four quarters (2000:Q3–2001:Q2) compared with the previous four quarters (1999:Q3–2000:Q2).

- *The emerging market crises:* After four years of fitful recovery, growth resumed by late 1997. France, in particular, benefited from strong domestic demand led by an investment boom—linked to improved profitability and increased capacity utilization—and employment-friendly tax relief that supported consumption. German growth continued to sputter as the lack of wage moderation and labor market reforms prolonged the labor shakeout begun in the early 1990s. Italy also did less well than France, as lagged effects of the earlier fiscal tightening, lack of progress in structural reforms, and initial uncertainties about membership in the monetary union all combined to weaken demand. Supported by strong U.S. demand and falling oil prices, the recovery started to pick up steam in all countries by mid-1998, but stalled in Germany and Italy as the spillovers from the emerging market crises hit Europe. These spillovers were particularly damaging for Germany and Italy because of their relatively larger manufacturing sectors and higher dependence on extra euro-area exports to emerging markets, and on cyclically sensitive capital and intermediate investment goods.

- *Renewed recovery:* As global activity rebounded following the Asian and Russian crises, the expansion took off again in mid-1999 and kept a sound footing for about one year, underpinned by lower energy prices and a depreciating euro. By this time, fiscal policy had turned roughly neutral in all three countries, while monetary conditions remained accommodative, as the tightening cycle initiated by the European Central Bank (ECB) had been offset by further declines in the euro. However, indicators of cost competitiveness—including ULC-based real effective exchange rates, export shares, and profitability indexes—suggest that conversion rates at the euro's launch may have provided France with a relative competitive advantage vis-à-vis Germany and Italy.
- *The oil shock and global slowdown:* By mid-2000 the persistent jump in energy prices started to sap the recovery in all three economies. Final domestic demand faltered in the latter half of 2000, particularly in Germany and Italy, as oil and food price shocks eroded disposable income and gradually dragged down business confidence.[2] As the global economy slowed in the second half of 2000, exports fell back in both Germany and France, albeit from relatively high rates, but have held up surprisingly well in Italy where favorable movements in external competitiveness have sustained gains in market share. In most cases, previously legislated tax cuts turn out to have been fortuitously timed to provide some countercyclical support. At the same time, the continuation in the ECB's tightening cycle contributed to the slowdown felt throughout the euro area in the first half of 2001.

Looking ahead, as the effects of external shocks dissipate and European economic integration deepens, growth differences between Germany, France, and Italy should gradually narrow. At the same time, however, disparities in the pace of structural reforms, particularly in labor markets, will continue to create a potential for new divergences in economic performance, as fresh external shocks buffet the euro area.

[2]The term-of-trade loss in 2000 was equivalent to around 1.7 percent of GDP in both Germany and Italy but only 0.9 percent of GDP in France.

forces driving headline inflation—notably higher energy and food prices—now appear to be dissipating and, with demand pressures also easing, both headline and core inflation are expected to fall below 2 percent in 2002. Citing the improved outlook for prices, the ECB reduced interest rates by 25 basis points in August (following a similar cut in May), and rates were lowered by a further 50 basis points on September 17 in conjunction with other major central banks. There would be scope for additional reductions if there is a further material weakening in demand and inflation developments remain favorable. The scope for monetary policy flexibility will also depend on prospects for continued wage moderation—especially in the key German wage rounds in early 2002—as well as developments in the exchange rate.

On the fiscal side, the structural balance in the euro area is expected to remain broadly constant, with fiscal stimulus in some countries (notably Germany) offset by tightening elsewhere (including in Austria, Spain, and Greece). Actual fiscal balances are projected to weaken, reflecting slowing growth and the assumed unhindered operation of the automatic stabilizers. Some countries—including France, Germany, and Italy—will have difficulty reaching the fiscal targets for 2001 set by their respective national stability programs. From a short-term cyclical perspective, a tightening of fiscal policy would generally be inappropriate at the present stage. At the same time, however, it is essential to maintain the credibility of the fiscal framework in the Stability and Growth Pact, especially given the substantial fiscal challenges from aging populations in coming years. One way to address this dilemma could be to allow revenues to fluctuate with the cycle, while emphasizing and maintaining expenditure targets in medium-term stability programs—implying greater focus of policy on structural rather than actual fiscal balances. Such an approach would avoid promoting procyclical fiscal impulses; had it been applied in the past, this policy would have encouraged a faster reduction in structural deficits in 1999 and 2000, when cyclical conditions were more favorable.

The relatively disappointing growth performance of the euro area, with the unemployment rate seemingly stabilizing well above the 8 percent mark, points to the need to boost productive potential through a reinvigoration of the structural reform effort. Although important progress has been made, there remains a substantial unfinished agenda, including in reforming labor markets, especially tax and benefit systems, and linking wages more closely to productivity; promoting effective integration of euro area capital markets, together with strengthening mechanisms for financial crisis management; reforming pension and healthcare arrangements; and ensuring effective competition and completing the internal market. Recent developments have been mixed. Important pension system reforms have been enacted in Germany. But other measures—including new labor market restrictions in Germany and France, and delays in product market reform in France—tend to convey the opposite signals regarding prospects for structural adjustment.

Domestic demand has remained surprisingly strong in the *United Kingdom*, partially offsetting the effects of a weak manufacturing sector and slowing exports. Robust demand growth and household confidence have been underpinned by record low unemployment and buoyant growth in earnings, while fiscal measures have added support to spending. Inflation, which had been declining, has risen back closer to the 2½ percent target; labor markets remain tight; and property prices have been increasing rapidly. Given the weakening of global demand and the persistent strength of sterling, however, the Bank of England lowered interest rates by 25 basis points in August and a further 25 basis points on September 18 in the aftermath of the terrorist attack, bringing this year's interest rate cuts to 1¼ percentage point. The monetary policy stance is finely balanced: if domestic demand weakens or the external outlook deteriorates further, there could be scope for additional monetary easing, but if domestic demand remains strong and labor market conditions tighten, an increase in interest rates may be warranted.

Growth in *Denmark*, *Norway*, and *Sweden* is expected to slow to under 2 percent in 2001, largely in response to weaker export market conditions. Inflation has also picked up, partly the result of increases in energy and food prices, and this has constrained real income growth. Although inflation concerns had militated against further easing, interest rates were cut by 50 basis points in Denmark and Sweden on September 17 in conjunction with other central banks. Sweden—which is particularly exposed to the global electronics slowdown (largely through the telecommunications sector)—has experienced sharp falls in stock prices and weakness in the krona. Concerned about increased inflation risks, the Riksbank has inter-

Table 1.6. Selected Western Hemisphere Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	1999	2000	2001	2002	1999	2000	2001	2002	1999	2000	2001	2002
Western Hemisphere	**0.2**	**4.2**	**1.7**	**3.6**	**8.8**	**8.1**	**6.2**	**4.9**	**–3.2**	**–2.5**	**–3.0**	**–3.0**
Mercosur[3]	**–0.3**	**3.1**	**1.4**	**3.2**	**3.4**	**5.0**	**4.5**	**3.9**	**–4.5**	**–3.8**	**–4.2**	**–3.8**
Argentina	–3.4	–0.5	–1.4	2.6	–1.2	–0.9	–0.6	0.6	–4.2	–3.2	–2.9	–2.8
Brazil	0.8	4.5	2.2	3.5	4.9	7.0	6.2	4.8	–4.8	–4.2	–5.0	–4.5
Uruguay	–2.8	–1.3	1.0	2.5	5.7	4.8	5.4	9.5	–2.4	–2.9	–2.7	–2.2
Andean region	**–3.3**	**3.5**	**2.7**	**3.5**	**13.0**	**12.8**	**8.9**	**6.8**	**0.8**	**3.2**	**0.3**	**–0.1**
Chile	–1.1	5.4	4.0	4.7	3.3	3.8	3.4	3.3	–0.1	–1.4	–2.2	–2.3
Colombia	–4.1	2.8	2.1	2.8	10.9	9.2	7.8	6.6	—	–0.2	–2.3	–2.7
Ecuador	–7.3	2.3	4.0	4.0	52.2	96.2	40.6	11.9	6.9	5.3	–1.3	–3.0
Peru	0.9	3.1	0.5	4.0	3.5	3.8	3.1	2.6	–3.8	–3.1	–2.9	–3.4
Venezuela	–6.1	3.2	3.3	2.8	23.6	16.2	12.8	12.9	3.6	10.8	4.9	4.6
Central America and Caribbean	**3.9**	**6.4**	**1.4**	**4.1**	**14.0**	**8.9**	**6.5**	**4.8**	**–3.4**	**–3.5**	**–3.1**	**–3.5**
Dominican Republic	8.0	7.8	3.0	5.6	6.5	7.7	9.7	4.7	–2.5	–5.4	–4.1	–4.4
Guatemala	3.5	3.3	2.0	3.7	5.3	6.0	6.2	4.0	–5.6	–4.5	–4.9	–4.3
Mexico	3.7	6.9	0.8	4.0	16.6	9.5	6.3	4.8	–2.9	–3.1	–2.8	–3.3

[1]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.
[2]Percent of GDP.
[3]Includes Argentina, Bolivia, Brazil, Paraguay, and Uruguay.

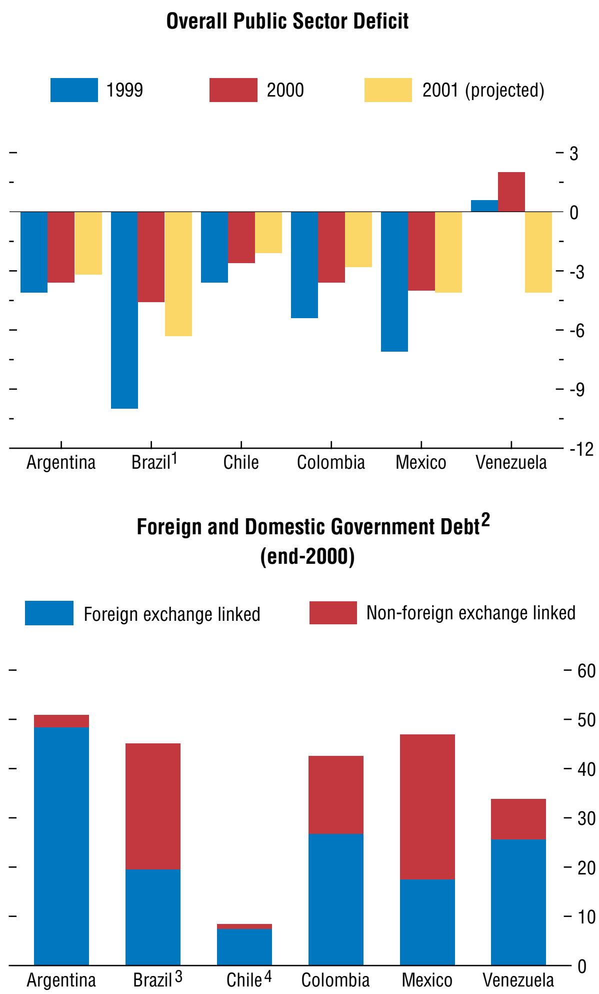
vened directly in the foreign exchange market several times since June 2001 and, in July, raised its official interest rate. However, substantial foreign ownership of equity in the high-technology sector in Sweden, as in Finland, should help to limit the downturn in domestic wealth and demand. In Norway, high oil prices are offsetting weakness in the non-oil economy, through, among other things, a resurgence of oil-related investment. Elsewhere in Europe, growth in *Switzerland* is expected to slow to below 2 percent in 2001 and 2002, largely due to weaker exports and investment activity. With inflation still subdued, the Swiss National Bank has been able to lower interest rates—including on September 17. Further cuts would be warranted should evidence of a marked slowing of activity persist. Ongoing public expenditure restraint will be needed to support planned tax cuts and rising costs associated with population aging, together with further structural reforms—including in the network industries—to raise the trend rate of growth. In *Iceland*, growth is projected to slow sharply, due mostly to a weakening of private consumption, and this should contribute to some lowering of the still-high current account deficit. The authorities should continue to strengthen the financial system's ability to absorb shocks.

Latin America: How Will Argentina's Crisis Affect the Region?

In Latin America, following a strong recovery in 2000, GDP growth is projected to decline by 2.5 percentage points to 1.7 percent in 2001, 2 percentage points lower than projected at the time of the May 2001 *World Economic Outlook* (Table 1.6). Growth projections have been revised downwards for most countries, reflecting the increasing impact of the global economic slowdown, particularly for *Mexico* and *Chile*; the economic difficulties in *Argentina*, which have adversely affected a number of neighboring countries; and exogenous factors, including political uncertainties and the energy crisis in *Brazil*. Reflecting these developments, capital flows to the region weakened in the first half of the year, and—with the important exception of the Mexican peso—most regional currencies

Figure 1.9. Selected Western Hemisphere Countries: Overall Public Sector Deficit and Public Debt
(Percent of GDP)

Fiscal consolidation remains essential in many countries in Latin America, especially those where domestic debt remains high and vulnerable to exchange rate developments.



Source: IMF staff estimates.
[1]About 4 percentage points of Brazil's deficit in 1999 were accounted for by the impact of the depreciation of the *real* on public sector debt.
[2]Unless noted otherwise, data refer to gross stocks of government debt, including that of public enterprises, but excluding central bank liabilities.
[3]Includes also central bank liabilities (monetary base) net of liquid foreign exchange assets.
[4]Adding debt owed by the central bank net of liquid foreign exchange assets would substantially raise the domestic debt component, while taking the (net) foreign exchange linked component into the negative range. Figures do not include recognition bonds related to pension system conversion.

were under downward pressure. As the crisis deepened in Argentina from early July, accompanied by signs of contagion within the region, these pressures have significantly increased. Sentiment remains very fragile, particularly following the September 11 terrorist attack on the United States and the associated possibility of increasing flight to quality in financial markets. As a result, there is substantial downside risk to the outlook.

In many countries, the central vulnerability remains a high external financing requirement, typically linked to a large public sector deficit and high public debt (Figure 1.9). With a substantial share of public debt denominated in foreign exchange, and in some cases a considerable proportion being short term, depreciating exchange rates and higher interest rates have—along with slowing growth—put additional pressures on fiscal positions across the region. Given the need to maintain external confidence, most countries have little scope to allow the automatic stabilizers to operate, and some will need to tighten the underlying stance of fiscal policy to avoid adverse debt dynamics. At the same time, with exchange rates weakening, the scope for monetary easing is in several cases also constrained. This will, unfortunately, add to pressures on activity and exacerbate the already high level of unemployment across much of the region.

Developments in the region have continued to be overshadowed by the situation in *Argentina*. Following the crisis in November 2000, economic conditions temporarily improved, but sentiment deteriorated sharply once again in March 2001, due to a further weakening of the fiscal position, political turmoil, and renewed concerns about Argentina's high external financing requirement, accompanied by a sharp rise in spreads, which also affected neighboring countries. The deteriorating situation in the region, and particularly the depreciation of the Brazilian *real*, in turn adversely affected Argentina. In response, the authorities further strengthened their program through revenue and expenditure measures designed to bring the fiscal position back on track, along with a series of initiatives to boost productivity and competitiveness; a $29.5 billion debt swap, which—while effectively locking in prevailing market rates—substantially reduced financing needs in 2001–05; and, in late June, a package of tax reforms, including trade measures that resulted in a modest effective depreciation of the peso for non-energy trade, and linked the value of the peso for non-energy trade to a basket of the U.S. dollar and the euro.

The authorities' program, along with the more general improvement in sentiment in international markets since April, resulted in a reduction in spreads through mid-June. In early July, however, confidence weakened seriously, prompted initially by concerns about the late June reforms, and then by increasing difficulties in raising domestic financing. As a result, interest rate spreads rose sharply, there was a substantial outflow of deposits from the banking system, and the stock market plummeted. In response, the authorities have committed to strengthening fiscal adjustment, and ensuring that it is sustainable over the medium term, through full implementation of the zero deficit law approved by the Argentine Congress on July 29; the introduction of legislation to reform the revenue sharing arrangement with the provinces; and measures to strengthen tax administration and the public banks. This has been supported by an augmentation of Argentina's program with the IMF, part of which will be available to support a voluntary and market-based operation to increase the viability of Argentina's debt profile. But, while private sector deposits have begun to recover, economic activity and confidence are still weak. The situation remains very difficult, and it will be critical now to focus on prompt and full implementation of the measures that have been announced.

Following a strong recovery from the 1998–99 recession, Brazil was buffeted by a series of adverse shocks in the first half of 2001, including contagion from Argentina, political uncertainties, and the emergence of a serious energy crisis requiring stringent electricity rationing. While the impact of these shocks is difficult to gauge—the duration of electricity rationing, for example, will depend in part on the autumn rainfall—output fell in the second quarter and there are downside risks to activity in the period ahead. External confidence also weakened, reflected in widening yield spreads and slowing capital inflows, and the *real* depreciated steadily, putting upward pressure on inflation. In response, the authorities appropriately raised interest rates, and also undertook additional foreign borrowing to boost reserves and support the currency. As the situation in Argentina worsened in early July, these pressures markedly increased, with spreads rising above 1000 basis points, and the *real* plumbing new lows against the U.S. dollar. Against this background, the authorities have further tightened fiscal and monetary policies, including by increasing their target for the primary surplus from 3 percent to 3.35 percent for 2001 and 3.5 percent for 2002, and by accelerating structural reforms. These policies have been supported by a new $15 billion Stand-By Arrangement with the IMF, and the authorities have indicated that they do not intend to draw on IMF resources unless it is deemed necessary owing to changes in external economic and financial market conditions. In *Uruguay,* prospects have also weakened due to developments in Argentina and Brazil, as well as a serious outbreak of foot and mouth disease. To absorb external shocks and protect competitiveness, the authorities have increased the pace of depreciation of the exchange rate band, and widened the band. Additional fiscal tightening to control public debt dynamics, as well as an intensification of structural reforms, will also be needed.

Mexico's main vulnerability continues to be the possibility of a further weakening of activity in the United States. Through the first three quarters of 2000, with growth running at over 7 percent, the central policy concern was to avoid overheating; however, GDP and domestic demand growth have since weakened markedly as the growth of exports to the United States—which account for 25 percent of GDP—declined sharply. With GDP having fallen in the first two quarters of 2001 on a seasonally adjusted basis, output growth is projected to decline to under 1 percent for the year as a whole, recovering thereafter in tandem with activity in the United States. The current account deficit is now expected to decline to 2.8 percent of GDP in 2001, and capital inflows have remained strong—reflecting the continuing impact of North American Free Trade Agreement membership on direct investment, including the purchase of a major domestic bank by a foreign bank. Correspondingly, the peso appreciated significantly and inflation pressures declined, providing room for some monetary policy easing. Following the renewed crisis in Argentina, a portion of this appreciation has been reversed, and spreads have risen moderately. With lower growth resulting in a revenue shortfall, the authorities have taken offsetting measures to protect their fiscal targets; early passage of the tax reform remains critical to reduce medium-term fiscal vulnerabilities.

GDP growth in the Andean region is also expected to moderate as a result of the deteriorating external and regional environment, and some countries have experienced moderate contagion from Argentina. Growth in *Chile* has slowed and the outlook remains vulnerable to further slowing in the global economy (which would also depress export prices). Concerns about external financing are rather lower than elsewhere in the region, reflected in a continued relatively low yield spread. The authorities have lowered interest rates, and the new practice of targeting the structural fiscal balance will allow the automatic stabilizers to function. However, the recent depreciation of the peso may constrain monetary policy easing in the future (although so far it does not appear to have affected inflationary expectations). Among the smaller Andean countries, growth in *Ecuador* is expected to strengthen, aided by the construction of the new oil pipeline, and inflation has continued to decline as dollarization takes hold. But further action is needed to address banking sector weaknesses, which remain an important source of vulnerability, and the recent Constitutional Court decision overturning the earlier increase in the VAT rate has added to fiscal uncertainties. In *Venezuela*, growth has also remained well sustained, but has been heavily dependent on rapid public expenditure growth, financed by buoyant oil revenues. With weak private investment and business confidence, and large capital outflows persisting, the economy remains vulnerable to lower oil prices. In contrast, growth is expected to weaken in *Colombia*, owing to lower coffee prices and weaker-than-expected investment. The stance of macroeconomic policies appears generally prudent, but much continues to depend on progress with the peace process, and maintaining the pace of structural reform in the run up to the coming elections. In *Peru*, growth has slowed sharply, mainly reflecting political uncertainties prior to the recent elections. The key challenge facing the new government is to restore confidence in a difficult external environment, through prudent macroeconomic policies and accelerated reforms, notably privatization.

Despite weakening tourism revenues, countries in the *Caribbean region* continued to experience solid growth and low inflation in 2000, underpinned by generally sound macroeconomic policies and buoyed by investment in natural gas and petrochemicals (*Trinidad and Tobago)*, and tourism and infrastructure (*Grenada* and *St. Kitts and Nevis)*. Prospects for the region in 2001 and the medium term may prove more difficult, due to the impact of the U.S. downturn on tourism; the erosion of preferential access for bananas and sugar into the European Union; and the decline in the offshore financial services industry in response to increased international scrutiny and a tightening of the regulatory framework. *Trinidad and Tobago* should continue to register strong growth, based on natural gas and services, and *Jamaica's* long period of economic stagnation could now be ending, based on a pickup in mining, tourism, and other services, as well as a steady decline in interest rates. Elsewhere, and particularly within the *Eastern Caribbean Currency Union*, countries should move quickly to strengthen their public finances, especially by containing the government wage bill, which is key to enhancing competitiveness, and pressing ahead with privatization and other structural reforms to offset the deteriorating external environment. Regulation and supervision of the offshore financial centers should also be strengthened.

Emerging Asia: Hard Hit by External Shocks

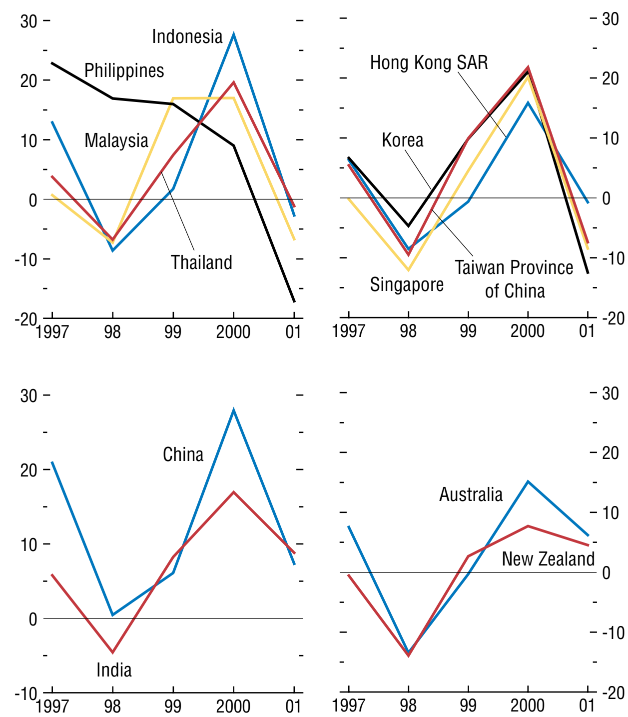
The outlook for the emerging markets of Asia has continued to deteriorate. From mid-2000, industrial production and exports slowed sharply, driven by the global slowdown, especially in the high technology sector, and more recently by weakening growth in Europe and Japan (Figure 1.10). Coming on top of a variety of earlier shocks, including higher oil prices, political uncertainties, and in some cases weakening confidence as a result of lagging structural reforms, growth prospects have declined further for most of the newly industrialized countries and members of the Association of South East Asian Nations (ASEAN) (Table 1.7). These shocks have been accompanied by a decline in stock markets, capital outflows, and periodic pressures on exchange rates. External trade accounts for a lower share of activity in the two largest economies of the region—China and India—but, while China's economic performance is expected to be relatively well-sustained, growth in India is projected to weaken in 2001 as a result of a range of domestic shocks together with falling exports.

Looking forward, growth in most Asian countries is expected to pick up in 2002, supported by an upturn in global activity and in the electronics cycle; and it is encouraging that foreign direct investment commitments continue to hold up quite well. However, there are important risks to the outlook, particularly given the increased global economic and financial market uncertainty following the September 11 terrorist attack on the United States. Specific concerns include the possibilities of a more prolonged downturn in the United States; a lagging recovery in the technology sector; and the weakening

Figure 1.10. Selected Asia-Pacific Countries: Weakening Export Growth[1]

(Percent change; U.S. dollars)

The newly industrialized economies and members of the Association of South East Asian Nations (ASEAN) are experiencing much weaker external demand, especially for technology.



Source: IMF staff estimates.
[1]Export of goods.

Table 1.7. Selected Asian Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	1999	2000	2001	2002	1999	2000	2001	2002	1999	2000	2001	2002
Emerging Asia[3]	**6.4**	**7.0**	**5.1**	**5.9**	**2.1**	**1.8**	**2.7**	**3.1**	**3.8**	**3.0**	**2.1**	**1.6**
Newly industrialized Asian economies	**7.9**	**8.2**	**1.0**	**4.3**	**—**	**1.2**	**2.1**	**2.1**	**7.1**	**4.9**	**5.0**	**4.8**
Hong Kong SAR	3.0	10.5	0.6	4.0	−4.0	−3.7	−1.4	0.6	7.3	5.4	6.6	7.5
Korea	10.9	8.8	2.5	4.5	0.8	2.3	4.4	3.4	6.0	2.4	2.6	2.1
Singapore	5.9	9.9	−0.2	4.0	0.1	1.4	1.5	1.7	25.9	23.7	21.0	19.8
Taiwan Province of China	5.4	6.0	−1.0	4.0	0.2	1.3	0.1	0.8	2.9	2.9	2.5	2.6
ASEAN–4	**2.8**	**5.0**	**2.4**	**4.1**	**10.2**	**3.0**	**6.6**	**5.0**	**9.2**	**8.0**	**4.8**	**3.9**
Indonesia	0.8	4.8	3.0	4.3	20.7	3.8	10.8	7.0	4.1	5.2	3.2	2.0
Malaysia	6.1	8.3	1.0	4.8	2.7	1.5	1.5	2.0	15.9	9.4	6.6	5.7
Philippines	3.4	4.0	2.5	3.5	6.6	4.3	6.5	5.7	10.0	12.5	6.4	7.2
Thailand	4.2	4.4	2.0	4.0	0.3	1.5	2.5	2.7	10.2	7.5	4.4	3.2
South Asia[4]	**6.4**	**5.8**	**4.5**	**5.6**	**4.8**	**4.0**	**3.8**	**5.5**	**−1.1**	**−1.1**	**−1.0**	**−1.1**
Bangladesh	5.4	6.0	5.5	5.0	6.4	2.3	3.1	5.5	−1.4	−1.2	−1.7	−1.8
India	6.8	6.0	4.5	5.7	4.7	4.0	3.6	5.5	−0.7	−0.9	−0.8	−0.9
Pakistan	4.1	3.9	3.9	4.6	4.1	4.4	5.1	5.1	−2.8	−2.1	−2.0	−2.0
Formerly centrally planned economies[5]	**7.0**	**7.9**	**7.4**	**7.1**	**−1.1**	**0.4**	**1.0**	**1.6**	**1.6**	**1.8**	**0.9**	**0.1**
China	7.1	8.0	7.5	7.1	−1.4	0.4	1.0	1.5	1.6	1.9	1.0	0.2
Vietnam	4.2	5.5	4.5	6.0	4.1	−1.7	0.6	4.3	4.5	2.1	1.3	−2.7

[1]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.
[2]Percent of GDP.
[3]Includes developing Asia, newly industrialized Asian economies, and Mongolia.
[4]Includes Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka.
[5]Includes Cambodia, China, Lao People's Dem. Rep., Mongolia, and Vietnam.

outlook for Japan (Box 1.4). Further deterioration in external financial conditions could also create difficulties for some regional economies. Given the improvement in economic fundamentals since the Asian crisis—including large current account surpluses, higher reserves, reductions in short-term external debt, and widespread adoption of flexible exchange rates—most countries are in a better position to manage such risks. However, a further slowdown in growth would exacerbate pressures on already weak financial and corporate sectors, aggravate the fiscal deficit in India, and complicate reform efforts in China. While the room for policy maneuver varies, macroeconomic policies should remain supportive of activity to the extent possible, accompanied by accelerated progress in financial and corporate reforms, especially in countries where this has lagged.

The economic slowdown has continued to be steepest among the four newly industrialized economies and *Malaysia*, which were furthest advanced in recovery from the 1997–98 crisis, are highly open, and—apart from *Hong Kong SAR*—are highly exposed to the technology sector (see Chapter III, Box 3.4). Export growth in all five has turned down sharply, accompanied by a rapid decline in industrial production, particularly in Malaysia, *Singapore,* and *Taiwan Province of China*. These developments have been exacerbated by slowing domestic demand growth, driven by declining consumer and business confidence—in some cases linked to banking and corporate sector weaknesses—and falling asset prices. In Taiwan Province of China, where GDP is now expected to decline in 2001, the sharp slowing in activity has increased concerns about the health of the financial system—including low banking sector profitability and the rising number of nonperforming loans. The external vulnerability of the economy is limited though by high foreign exchange reserves and low public debt. While business and household confidence have held up reasonably well in *Korea*, and unemployment remains low, downturns in industrial production and exports point to a further weakening in economic activity in 2001. The ASEAN countries (apart from Malaysia) are somewhat less open, and the main effect of global and domestic developments has been to further weaken an already faltering recovery. In the *Philippines* and *Thailand,* growth has been adversely affected by the electronics slowdown, banking system weaknesses, corporate vulnerabilities (Thailand), and a sizable budget deficit (Philippines). In Indonesia, market sentiment has improved following the recent peaceful resolution of the political crisis, reflected among other things in the strengthening of the rupiah by roughly 25 percent. The recent tightening of fiscal and monetary policy and the new government's intention to accelerate reforms are encouraging, but major challenges remain—particularly addressing concerns about fiscal sustainability and decentralization, containing inflation, and accelerating progress with bank and corporate restructuring.

Policy options for combating sustained weakness in domestic demand and output differ widely. Most countries have moved to reduce interest rates, and further scope for easing remains in many if necessary, consistent with maintaining low inflation rates. In Thailand, an increase in policy interest rates in early June created uncertainty over the course of monetary policy. However, since then the central bank has clarified its intention to maintain a supportive policy stance and has ruled out further rate increases in the near term. Inflation risks are more pressing in Indonesia, and the central bank has had to raise interest rates to address these concerns. In several cases, including Korea, Malaysia, Taiwan Province of China, and Thailand, sizable fiscal packages have been recently introduced to support growth; in others, notably Indonesia and the Philippines, room for maneuver is constrained by high levels of government deficits or debt.

China is expected to continue growing strongly in 2001, in part because total exports, and especially exports of high technology goods, comprise a much lower share of GDP than in most other emerging Asian economies. Indeed, although exports have slowed markedly in 2001—indicating that China is not immune to the global slowdown—overall activity remained strong in the first half of 2001, led by buoyant private consumption and strong public investment resulting from the September 2000 fiscal package. China's near-term vulnerability to external shocks is also limited both by its high level of foreign reserves and by strong inflows of foreign direct investment—running at around $40 billion a year since 1996 and showing a strong pickup in commitments over the past year. The key economic challenges, which have become more urgent with impending entry to the World Trade Organization, remain to strengthen the banking sector, which, despite recent loan transfers to asset management companies, remains burdened by high levels of nonperforming loans; move forward with enterprise restructuring; and, over the medium term, strengthen the fiscal position to cover the costs of bank and corporate reforms and meet outstanding pension liabilities. A gradual shift to more flexible exchange rate management would also be desirable at the appropriate time.

India is also relatively insulated from the global slowdown, given the nature of its IT sector (which is focused on services, where India remains highly cost competitive) and its relatively closed economy. Nonetheless, activity has slowed sharply, reflecting the effects of drought, energy price hikes, the waning effect of the substantial fiscal stimulus introduced during the late 1990s, and the devastating earthquake in Gujarat. As a result, growth in 2001 is projected to drop to around 4.5 percent (or 5 percent in FY 2001/02), well below levels considered necessary to make significant inroads into poverty (see Box 1.6). With signs of a favorable monsoon, the economy is expected to recover gradually in the latter half of 2001 and into 2002, and India's

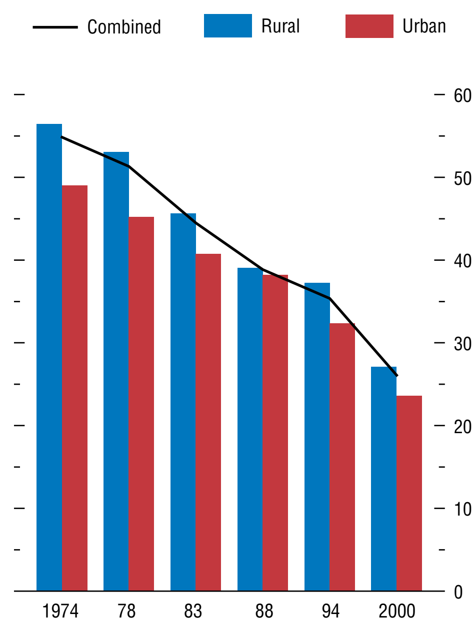
Box 1.6. The Growth-Poverty Connection in India

Over the last three decades, India's poverty rate has declined significantly. Social development indicators, such as life expectancy, literacy, and infant mortality rates, have also improved. Despite this progress, around 260 million people (26 percent of the population) still live below the poverty line, which continues to present a major policy challenge.[1]

Between 1974–2000, the percentage of the population living below the poverty line fell from 55 percent to 26 percent (see the Figure). The decline was fairly uniform across rural and urban areas. Rural poverty, which constitutes roughly three-quarters of the national poor, declined from 56 percent in 1974 to 27 percent in 2000, while during the same period, urban poverty dropped from 49 percent to 24 percent. Interstate differentials in poverty also narrowed, but they still remain large—while 6 percent of the state of Punjab's population lives below the poverty line, in Bihar the incidence of poverty is now around 43 percent. The rate of reduction in poverty during this period has been generally steady, with the largest reduction having taken place between 1994–2000.

Analysis of poverty trends in India, however, has been complicated by statistical problems. Although the data on poverty in India are believed to be among the best among developing countries, there are a number of areas of concern, in particular related to the coverage and frequency of the National Sample Surveys (NSS), from which poverty estimates are constructed.[2] In addition, concerns have been raised regarding the accuracy of the price deflators used in estimating real consumption expenditure, and the use of estimation procedures that do not reflect the increasing monetization and changing consumer preferences, particularly in the rural economy. More recently, questions have arisen regarding the poverty estimates from 2000. Some analysts have cautioned that confusion on the part of both respondents and enumerators due to changes in the survey questionnaires may have resulted in measurement errors and a possible downward bias to the poverty rate.

Trends in Poverty
(Percent of population below poverty line)



Source: Official Expert Group estimates.

[1]India's official poverty line, based on a nutritional norm, is determined at 49 rupees per capita monthly expenditure at 1973–74 prices for rural areas, and 57 rupees per month for urban areas. This official poverty line is lower than the World Bank's dollar-a-day (at purchasing power parity) poverty line, according to which 47 percent of India's population lived in poverty in 1994, compared with the official estimate of 35 percent for the same year.

[2]The NSS carries out two types of consumer surveys—an annual survey with limited sample size and coverage, and a more comprehensive survey with a larger sample conducted roughly every five years. Although estimates from the smaller samples are made public, they are not used to construct official poverty estimates. Nonetheless, most analyses on the time series properties of poverty have supplemented the estimates from the large-sample surveys with those from the small-sample surveys.

Despite these issues, several stylized facts have emerged from the extensive body of research on poverty in India. *First,* at the microeconomic level, poverty rates appear to be higher among women; those who are illiterate; landless laborers; and those who belong to the lower castes (see National Council of Applied Economic Research, 1996). *Second,* at the macroeconomic level, growth has been a major influence on poverty. Empirical studies show that both higher agricultural yields and increases in nonfarm output have significantly reduced poverty rates. In addition to growth, low inflation, education, public development spending, and land reforms—particularly tenancy reforms—have also played key roles in reducing poverty. *Lastly,* poverty alleviation programs (food subsidy, rural works, and self-employment schemes) have not been very cost effective, largely due to poor targeting, leakages, and abuse. However, some progress has recently been made in rationalizing and better targeting these programs (World Bank, 2000).

In the last few years, some analysts have raised concerns that the positive link between growth and poverty reduction, evidenced in the past, may have weakened in the 1990s. Critics contend that, although the reforms in the early 1990s raised economic growth markedly, the benefits in terms of poverty reduction were relatively muted. Supplementing poverty estimates from the five-yearly large sample surveys with the annual small-sample surveys for the period 1974–97, a recent analysis shows that although poverty increased in the initial years of the reforms (1991–92), the trend was sharply reversed in the later years as the benefits of the reforms began to filter through the economy.[3] However, other factors that were previously poverty reducing, such as low inflation and high public development spending, appear to have been less effective during this period.

The 2000 survey data—which showed a marked decline in the poverty rate after 1997 during a period of relatively robust growth—provides further evidence that growth has been pro-poor in India. In addition, the fact that per capita consumption—based on national account statistics—grew rapidly during the past decade, at a rate even faster than the growth implied by the NSS surveys, while income distribution worsened only marginally, appears to confirm this conclusion.

[3]See Aziz (forthcoming) who examines the experience with poverty at the state level during 1974–97, using estimates from both the five-yearly large sample and annual small-sample surveys.

external position is also projected to remain relatively comfortable. However, the recent slowdown—and associated fiscal revenue shortfalls—is expected to cause the public sector deficit to rise to more than 11 percent of GDP in FY 2001/02. It remains critical that steps are taken to assure fiscal sustainability and lay the foundations for strong and sustained growth—including by moving ahead with proposed fiscal responsibility legislation and by implementing the ambitious structural reform agenda recently laid out in the Prime Minister's Economic Advisory Council.

Agricultural conditions are contributing to a divergence in short-term economic prospects for *Pakistan* and *Bangladesh.* Severe drought in Pakistan has held down growth and weakened the trade balance, adding to the already-severe financial vulnerabilities—including low reserves, high public debt, and a large financing gap—while agricultural output and external trade in Bangladesh have picked up following a flood-affected slowdown in 2000. Partly reflecting these trends, tax revenues have been below expectations in Pakistan, but have grown strongly in Bangladesh. In both countries, further progress in needed to improve medium-term budgetary positions, including improvements in tax administration and spending discipline. Further privatization of public banks and enterprises, to-

Table 1.8. European Union Accession Candidates: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	1999	2000	2001	2002	1999	2000	2001	2002	1999	2000	2001	2002
E.U. accession candidates	**–0.1**	**4.9**	**1.1**	**4.7**	**25.3**	**24.3**	**20.5**	**14.7**	**–4.1**	**–5.1**	**–2.8**	**–3.6**
Turkey	–5.0	7.5	–4.3	5.9	64.9	54.9	51.9	32.7	–0.7	–4.9	3.0	–0.4
Excluding Turkey	2.1	3.8	3.4	4.2	11.2	12.9	8.8	7.5	–5.7	–5.3	–5.3	–5.0
Baltics	**–1.7**	**5.1**	**4.5**	**5.2**	**1.8**	**2.2**	**2.3**	**3.1**	**–9.3**	**–6.3**	**–6.7**	**–6.4**
Estonia	–0.7	6.9	4.5	5.0	3.3	4.0	5.7	3.8	–4.7	–6.4	–7.2	–6.8
Latvia	1.1	6.6	6.0	6.0	2.4	2.6	2.3	3.0	–9.7	–6.8	–6.3	–5.8
Lithuania	–3.9	3.3	3.6	4.7	0.8	1.0	0.6	2.8	–11.2	–6.0	–6.7	–6.6
Central Europe	**3.1**	**3.9**	**3.1**	**4.0**	**6.9**	**8.6**	**5.3**	**5.0**	**–5.7**	**–5.2**	**–5.1**	**–4.9**
Czech Republic	–0.4	2.9	3.3	3.9	2.1	4.0	3.9	3.8	–2.9	–4.6	–5.0	–4.9
Hungary	4.5	5.2	4.5	4.5	10.0	9.8	9.4	6.4	–4.3	–3.6	–4.8	–4.8
Poland	4.1	4.1	2.5	3.7	7.3	10.1	5.7	5.7	–7.5	–6.3	–5.2	–5.0
Slovak Republic	1.9	2.2	3.0	4.4	10.7	12.0	7.2	6.0	–5.7	–3.7	–7.3	–6.4
Slovenia	5.2	4.9	4.5	4.0	6.2	8.9	7.0	5.0	–3.9	–3.2	–2.7	–2.4
Southern and South Eastern Europe	**–0.7**	**2.8**	**4.2**	**4.6**	**30.9**	**32.9**	**24.1**	**18.2**	**–4.0**	**–5.1**	**–5.7**	**–5.2**
Bulgaria	2.4	5.8	4.5	5.0	2.6	10.4	6.8	3.2	–5.3	–5.8	–6.0	–5.7
Cyprus	4.5	5.1	4.2	4.0	1.8	4.1	2.2	2.5	–2.4	–5.0	–3.6	–3.0
Malta	4.0	4.7	4.1	4.3	2.1	2.4	1.8	2.0	–3.4	–14.5	–5.9	–5.1
Romania	–2.3	1.6	4.1	4.5	45.8	45.7	33.8	26.0	–4.1	–3.9	–6.0	–5.5

[1]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.
[2]Percent of GDP.

gether with liberalization of energy and other key sectors, would also support investment, diversification, and sustained growth.

Growth in *Australia* and *New Zealand* is expected to slow significantly in 2001—albeit by much less than other countries in the region—accompanied by declining inflation and smaller current account deficits. The export sectors of both countries have been performing well, supported by more depreciated real exchange rates, although the sustainability of recent export growth may be at risk if external markets continue to weaken. Domestic demand has been more patchy: investment—particularly residential construction—has been weak, but recent data point to a strong rebound in Australia, and consumer confidence and spending in both countries have held up relatively well. Interest rates in Australia have been cut substantially, supporting a bounce back in activity after the slowdown in the second half of 2000, which in part reflected an unwinding of the buildup of demand ahead of changes in the tax regime in mid-2000. Faced with tighter labor markets and high capacity utilization, interest rate reductions in New Zealand have been more moderate. Nevertheless, provided inflation remains subdued, both countries have scope for further rate reductions—particularly if external and domestic demand weaken under the impact of the global slowdown.

The economic performance of individual *Pacific island countries* has varied quite widely over the years, reflecting differences in the strength of economic policy implementation, the political environment, and the timing and severity of particular external shocks. Thus, real GDP contracted sharply in *Fiji* and the *Solomon Islands* in 2000, where confidence was badly shaken by political disturbances and civil unrest, but picked up strongly in *Samoa*, which benefited from continued sound policies and a diversion of tourism from Fiji. The global economic slowdown is likely to dampen growth in 2001, particularly in countries where the tourism sector is relatively large.

Emerging Europe: A Difficult Balance Between Short- and Medium-Term Objectives

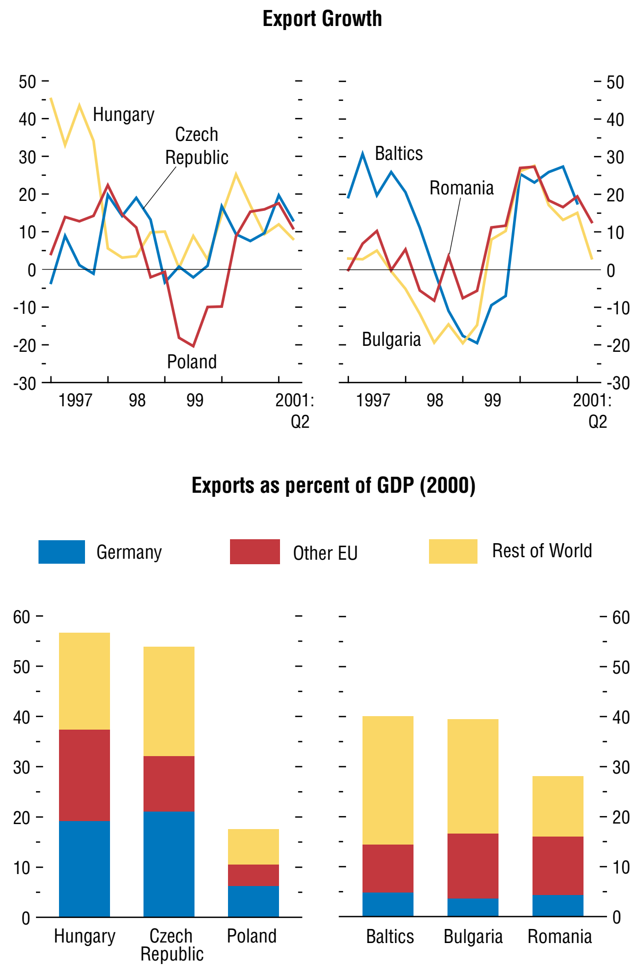
Following a strong pickup in 2000, regional GDP growth is expected to fall to 1.1 percent in 2001 (Table 1.8), due largely to a sharp decline in output in Turkey. GDP growth in most other countries in the region is expected to weaken moderately, as export growth—which has so far held up relatively well, buoyed by foreign direct investment and corporate restructuring—is increasingly affected by weakening demand in Europe, particularly Germany (Figure 1.11). Correspondingly, little progress is expected in reducing external current account deficits, which, although largely financed by foreign direct investment, remain a source of vulnerability. So far, contagion from the Turkish crisis has been limited, although some countries—including Poland and Hungary—experienced some pressures on exchange rates as conditions in Argentina deteriorated in early July. In most countries, unemployment—linked to labor market rigidities and high labor taxation—is also a serious concern.

For the regional aggregates, developments have been dominated by the crisis in *Turkey*, where a combination of weakening economic fundamentals, policy slippages, and increased political uncertainty culminated in a major speculative attack and the floating of the lira in late February. The extremely high interest rates experienced during the crisis period, combined with the large overnight borrowing of the state banks and official support for intervened private banks, resulted in a substantial increase in public debt and in a rapid shortening in its maturity. While interest rates eased in the immediate aftermath of the crisis, they have remained at high levels, putting fiscal sustainability and economic recovery at risk. Along with extreme uncertainty about exchange rates and inflation, high real interest rates hampered the real economy and increased pressures on the already fragile banking system. The key challenge facing the new economic team has been to restore confidence and to bring down interest rates rapidly and in a sus-

Figure 1.11. Emerging Europe: Export Growth[1]

(Percent change from four quarters earlier unless otherwise noted)

Exports in emerging Europe have been growing strongly over recent years, partly reflecting the impact of corporate restructuring and foreign direct investment. However, export growth has recently weakened under the impact of the global slowdown.



Sources: IMF, *Direction of Trade Statistics;* and various central bank websites.

[1] Export of goods only.

tainable fashion. To this end, the authorities' revised program focuses on addressing key structural weaknesses, particularly in the banks; reducing the public sector borrowing requirement and helping ensure debt sustainability, while centering monetary policy on inflation reduction; and strengthening the social dialogue to promote wage moderation and social protection. The program is supported by substantial additional external financing and resources from international financial institutions, including the IMF.

To date, performance has been mixed. As expected, output growth has declined rapidly, although there are signs that business confidence may be leveling off, and exports and tourism are expected to pick up sharply due to the depreciation of the lira. The authorities have made significant progress toward restructuring the banking system; the fiscal outturn has been stronger than expected; inflation has shown signs of moderating; and, following some earlier slippages, policy implementation has significantly improved. Even so, while domestic interest rates have declined somewhat, they remain well above programmed levels, reflecting continued market perceptions of high risk, as well as external factors (including contagion effects from the crisis in Argentina). Given the still very difficult economic situation and the need to further strengthen external confidence, flawless implementation of the program, together with full and undivided political support, remains essential.

In other countries in the region, macroeconomic and structural policies have continued to center on early accession to the European Union, including the adoption of the *acquis communautaire* (the detailed body of laws and regulations that underpins the European Union). With ongoing uncertainties over the timing of enlargement, and signs that popular support could be eroding in both accession and EU countries, the agreement by EU leaders at the Göteborg summit in June to seek to conclude negotiations with the most advanced countries by the end of 2002, with entry in 2004, is particularly welcome. But with discussions in the most difficult areas still under way, much remains to be done—by both the EU and the accession countries—if this objective is to be achieved.

In Central Europe, key challenges are how best to set the fiscal-monetary policy mix in light both of cyclical conditions, and the need to make progress toward the medium-term goals of reducing fiscal and external deficits. In *Poland*, where activity has weakened sharply and inflation is declining, interest rates have been reduced, most recently in August, accompanied by a broadly cyclically neutral relaxation of the budget deficit target. With interest rates still remaining very high in real terms, there appears scope for further easing. Next year's budget needs to avoid any new spending commitments and tax exemptions to avoid the emergence of imbalances and resume progress toward medium-term fiscal consolidation. In contrast, in *Hungary* the expansion remains reasonably robust and inflation has returned to double digit levels. The recent widening of the exchange rate band is facilitating the necessary tightening of monetary conditions but needs to be supported by a tighter fiscal stance. In the *Czech Republic*, demand and activity remained strong in the first quarter but have since shown signs of slowing. The Central Bank raised its policy interest rate for the first time since March 1998, against a backdrop of rising headline inflation, as well as a projected expansion of the underlying budget deficit (excluding privatization reserves and expenditures related to bank restructuring). Over the medium term, all countries face serious fiscal challenges related to aging, high tax burdens on labor, and expenditures required for EU accession, underscoring the need to rationalize other current expenditures including through restructuring the civil service and improving the targeting of social spending (see Christou and Daseking, forthcoming).

Activity in the Baltics is projected to remain relatively robust, with a moderate slowdown in *Estonia*—in part reflecting its exposure to the electronics sector—offset to some extent by *Lithuania*'s continuing recovery from the 1999 recession. Given the openness of these economies, however, they remain vulnerable to weaker external demand, particularly in Europe. Budget deficits in all three Baltic countries have been sharply reduced in the past two years, contributing to the decline in external current account deficits across the region. While external deficits nonetheless remain high—partly because of higher oil prices—vulnerabilities are reduced by the high level of foreign direct investment and generally low external debt. Over the medium term, the key challenge is to consolidate this progress while meeting higher expenditure needs for EU accession, as well as pension reform; and, in Lithuania and *Latvia*, to support eventual repegging of their currencies to the euro (in Lithuania, planned for 2002).

In southeastern Europe, the expansion in *Bulgaria* has been underpinned by sound macroeconomic policies, although the slowdown in Europe and the crisis in Turkey have begun to affect export revenues. The key challenge for the new government is to maintain the momentum of structural reform necessary to establish a fully functioning and competitive market economy. In *Romania*, which has adopted a "stop-go" approach to reform and macroeconomic stability in recent years, GDP growth has become increasingly driven by domestic demand, accompanied by a significant widening of the current account deficit. To reduce these pressures, and support a further reduction in inflation, fiscal policy will need to be tightened, including through measures to strengthen the financial performance of public enterprises. It is also essential to reinvigorate the reform process, including through more rapid progress in privatization and improved governance.

In the *Federal Republic of Yugoslavia*, which faces an enormous task of economic reconstruction and a crushing burden of external debt, the new government has moved with impressive speed and commitment to formulate and begin to implement an ambitious program of stabilization and reform. Macroeconomic policies are focused on reducing inflation, which peaked at over 100 percent at the end of 2000, through strict restraint on credit expansion—especially quasi-fiscal lending to state enterprises—while increasing reliance on noninflationary sources of finance such as foreign assistance and privatization revenues. This is being accompanied by wide-ranging structural reforms, including the almost complete liberalization of the trade and foreign exchange system, fiscal reforms, and the initiation of a bank resolution strategy. However, with much remaining to be done, it will be critical that the momentum of reform is sustained, supported by continued generous assistance from the international community including through debt restructuring.

Commonwealth of Independent States (CIS): Recovery Continues, But Reforms Lag

Following the recession induced by the Russian crisis in 1998, the CIS experienced a strong and widespread recovery in 1999–2000. In *Russia* and the energy exporting countries, the combination of higher oil prices and sharply depreciated exchange rates led to a surge in GDP growth to 8.6 percent in 2000 (Table 1.9), accompanied by the emergence of large fiscal and balance of payments surpluses. Despite the terms of trade shock from higher oil prices, GDP growth also appears to have picked up significantly in the energy importing countries, supported by strong import demand from Russia, exchange rate depreciation, and a variety of country-specific factors.

In 2001, regional GDP growth is projected at 4.4 percent, 3.5 percentage points lower than in 2000. The decline in 2001 largely reflects the partial reversal of the factors that had boosted growth earlier, including real exchange rate appreciation, particularly in countries where the strength of the balance of payments has contributed to rapid monetary growth and rising inflationary pressures; weaker-than-expected activity in Western Europe; and lower energy prices. Correspondingly, GDP growth in Russia and the energy exporting countries—which have been adversely affected by all these factors—is projected to halve to 4.3 percent, with a smaller decline in GDP growth in energy importing countries. To date, contagion from the crises in

Table 1.9. Commonwealth of Independent States: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	1999	2000	2001	2002	1999	2000	2001	2002	1999	2000	2001	2002
Commonwealth of Independent States	**4.6**	**7.9**	**4.4**	**4.0**	**70.6**	**25.0**	**21.6**	**13.0**	**1.5**	**3.5**	**2.5**	**1.7**
Russia	5.4	8.3	4.0	4.0	85.7	20.8	22.1	12.9	11.7	18.0	11.5	7.9
Excluding Russia	2.8	6.9	5.4	4.1	42.1	34.8	20.6	13.1	–0.1	0.2	0.1	—
More advanced reformers	**1.4**	**6.7**	**6.1**	**4.7**	**16.9**	**19.7**	**11.5**	**9.4**	**–0.7**	**3.2**	**1.4**	**0.3**
Armenia	3.3	6.0	6.5	6.0	0.7	–0.8	4.5	3.0	–16.6	–14.6	–14.1	–12.1
Azerbaijan	7.4	11.1	8.5	8.5	–8.5	1.8	2.5	2.5	–13.2	–2.7	–6.1	–17.3
Georgia	3.0	1.8	3.5	3.8	19.1	4.0	5.9	5.2	–7.9	–6.0	–5.6	–4.9
Kazakhstan	2.8	9.5	6.0	5.0	8.4	13.3	9.4	7.5	1.0	8.0	5.0	4.3
Kyrgyz Republic	3.7	5.0	5.0	4.5	35.9	18.7	9.1	7.8	–22.9	–15.6	–8.5	–6.0
Moldova	–3.4	1.9	5.0	5.0	39.3	31.3	12.8	10.0	–2.6	–8.4	–6.9	–5.3
Ukraine	–0.2	5.8	6.2	4.0	22.7	28.2	14.9	12.3	2.6	4.7	2.9	2.6
Less advanced reformers	**5.7**	**7.4**	**4.1**	**3.0**	**111.9**	**71.2**	**41.5**	**20.9**	**–0.1**	**—**	**—**	**—**
Belarus	3.4	5.9	2.5	2.2	293.7	169.0	69.0	23.7	–1.6	–1.3	–1.3	–1.8
Tajikistan	3.7	8.3	5.0	5.0	27.5	32.9	39.9	10.7	—	—	—	—
Turkmenistan	16.0	17.6	10.0	6.0	23.5	8.0	15.0	15.0	–16.0	2.7	2.0	2.0
Uzbekistan	4.3	4.0	3.0	2.0	29.1	25.0	26.1	22.2	–1.0	1.4	1.4	2.1
Memorandum												
Net energy exporters[3]	5.5	8.6	4.3	4.2	75.3	19.6	20.7	12.4	9.9	16.7	10.7	7.2
Net energy importers[4]	1.6	5.2	4.7	3.5	56.1	44.9	25.0	14.9	—	0.1	—	—

[1]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.
[2]Percent of GDP.
[3]Includes Azerbaijan, Kazakhstan, Russia, and Turkmenistan.
[4]Includes Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Tajikistan, Ukraine, and Uzbekistan.

Turkey and Argentina has been relatively modest: spreads on both Russian and Kazakh eurobonds have fallen for the year as a whole, aided by high energy prices and limited financing needs (although some pressures emerged temporary at the end of June as the situation in Argentina deteriorated and oil prices declined). However, those countries where Turkey accounts for a significant share of exports (including *Georgia*) are likely to be adversely affected during the year.

On the macroeconomic side, the policy challenges vary widely. In Russia, despite some weakening in oil prices from their late 2000 peaks and continued high capital outflows, the external current account and overall balance of payments are expected to remain in strong surplus. The authorities face the difficult task of creating appropriately tight domestic liquidity conditions to restrain inflation while avoiding an overly rapid real appreciation of the ruble that could threaten economic growth. Despite stronger-than-expected fiscal surpluses, inflation is running ahead of projections, suggesting that monetary policy may need to be tightened. Similar challenges are faced in *Kazakhstan*, which is experiencing rapid growth driven by buoyant oil exports, and has set up an oil stabilization fund to help manage the inflows. *Ukraine's* growth, inflation, and external position have performed significantly better than expected based on sound macroeconomic policies, substantial excess capacity, and competitive wage and exchange rates; the effects of earlier structural reforms, especially in agriculture, have been an important contributing factor in 2001.

Inflation has continued to decline across the region, but remains at high levels in a few countries, particularly *Belarus*, *Tajikistan* and *Uzbekistan*. In these cases, it will be essential to avoid further slippage in macroeconomic policy through maintaining strict fiscal discipline and reducing recourse to directed credit, which continues to undermine monetary policy in a number of cases. In *Armenia,* Georgia*, Kyrgyz Republic, Moldova* and Tajikistan, the dramatic increase in external debt over the past decade is a serious threat to external and fiscal sustainability (Figure 1.12) and is of particular concern given these countries' very low per capita income and high poverty levels. The rise appears to stem from sharp increases in energy prices and the loss of transfers from the central government of the former USSR early in the transition, resulting in large current account deficits. Regional and internal conflicts, policy failures and weak governance, and sharp currency devaluations following the 1998 Russia crisis also played an important role.[9] These factors were compounded by overestimation of implementation capacity and underestimation of the difficulties of transition by the governments, international financial institutions, and other creditors. Also, in some cases the financing received by these countries was not appropriately concessional, and related investments suffered from inadequate project planning. While policies to strengthen domestic adjustment and growth performance will help alleviate the situation, a number of these countries could face serious difficulties if the external environment deteriorates or if economic growth does not respond to reforms as expected. In this event, additional assistance from the international community will be needed to avoid an abrupt adjustment that could have a serious impact on the poor.

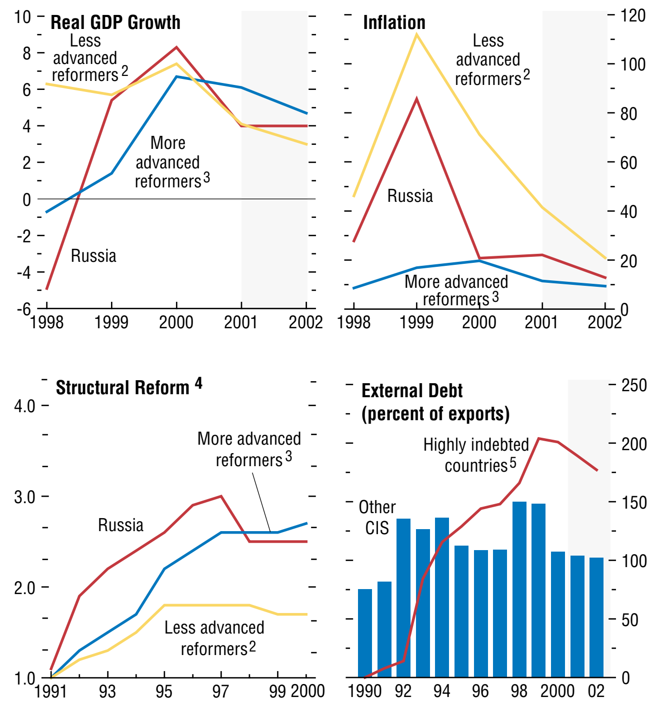
Looking to the longer term, the reinvigoration of the structural reform process—particularly in institution building and governance, enterprise restructuring, the financial sector, and transforming the role of the state—remains the key to sustainable growth in the CIS. Indicators of structural reform produced by the European Bank for Reconstruction and Development (EBRD) suggest that little progress was made between 1998

[9]For a detailed discussion, see "Armenia, Georgia, Kyrgyz Republic, Moldova, and Tajikistan: External Debt and Fiscal Sustainability," jointly prepared by the European II Department of the IMF and the Europe and Central Asia Region of the World Bank, available at http://www.imf.org/external/np/eu2/2001/edebt/eng/index.htm

Figure 1.12. Commonwealth of Independent States (CIS): Continuing Recovery But Disappointing Progress on Reform[1]

(Annual percent change unless otherwise noted)

GDP growth has picked up since the Russian crisis and inflation is declining, although it remains high in a number of countries. But progress in structural reform has been disappointing, while high external debt in some countries is a serious concern.



Source: European Bank for Reconstruction and Development, *Transition Report 2000.*
[1]Shaded areas indicate IMF staff projections
[2]Belarus, Tajikistan, Turkmenistan, and Uzbekistan.
[3]Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, and Ukraine.
[4]Simple average of EBRD indicators for eight structural reform indicators. A score of 1 represents conditions before reform in a centrally planned economy; a score of 4 1/3 shows structural characteristics comparable to those in advanced economies.
[5]Armenia, Georgia, Kyrgyz Republic, Moldova, and Tajikistan.

Table 1.10. Selected African Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	1999	2000	2001	2002	1999	2000	2001	2002	1999	2000	2001	2002
Africa	**2.5**	**2.8**	**3.8**	**4.4**	**11.5**	**13.6**	**12.6**	**8.0**	**–3.6**	**0.5**	**–0.9**	**–1.4**
Maghreb	**2.5**	**2.4**	**5.0**	**5.0**	**2.0**	**1.3**	**3.1**	**4.8**	**–0.6**	**7.2**	**4.9**	**2.8**
Algeria	3.2	2.4	3.8	4.9	2.6	0.3	3.0	6.8	—	16.8	12.0	8.0
Morocco	–0.7	0.8	6.0	4.5	0.7	1.9	3.4	3.0	–0.5	–1.7	–2.1	–1.9
Tunisia	6.2	5.0	6.2	6.1	2.7	3.0	2.9	2.7	–2.1	–3.7	–3.1	–3.1
Sub-Sahara[3]	2.8	2.9	3.8	4.5	19.1	23.5	20.2	11.0	–7.2	–2.4	–4.6	–5.3
Cameroon	4.4	4.2	5.3	5.5	2.9	0.8	2.0	2.0	–4.1	–1.7	–2.0	–1.3
Côte d'Ivoire	1.6	–2.3	–1.0	3.5	0.7	2.5	4.0	3.6	–4.2	–5.4	–5.5	–4.3
Ghana	4.4	3.7	4.0	5.0	12.4	25.0	33.0	19.0	–11.5	–9.2	–6.9	–4.9
Kenya	1.3	–0.2	1.3	2.0	6.1	7.1	5.0	5.0	–2.3	–2.1	–5.6	–6.2
Nigeria	1.1	3.8	3.1	2.2	6.6	6.9	21.1	17.1	–9.5	4.9	–0.8	–4.6
Tanzania	4.8	5.1	5.9	6.2	6.3	6.2	5.2	4.4	–3.9	–0.7	–2.8	–3.6
Uganda	7.9	4.4	4.9	6.3	–0.2	6.3	4.3	5.0	–7.6	–8.8	–7.6	–10.4
South Africa	**1.9**	**3.1**	**2.8**	**3.4**	**5.2**	**5.4**	**6.1**	**4.5**	**–0.4**	**–0.3**	**0.1**	**1.4**
Memorandum												
Oil importers	2.6	2.8	3.9	4.4	11.0	13.5	11.8	6.7	–2.9	–2.7	–3.0	–2.7
Oil exporters	2.2	2.9	3.7	4.2	13.3	13.8	15.4	12.5	–5.8	9.7	4.8	2.1

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages ather than as December/December changes during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Excludes South Africa.

and 2000 (Figure 1.12), despite relatively favorable macroeconomic conditions (and in some cases reform actually moved backwards). Against that background, the 10-year reform program announced by the Russian government is encouraging, and the recently implemented tax reform is a major step forward (although the revenue implications will need to be monitored carefully, especially if oil prices decline further). New legislation in a broad range of areas is progressing through the Duma, including proposals on simplification of business regulations, money laundering, land code, and pension reform. The government has also approved strategies for reform of two key utilities—electricity and railways. Elsewhere, the experience remains mixed. While the momentum of reforms has picked up in some countries (including Armenia and Azerbaijan), in others—including many of the countries least advanced in transition—the reform process remains stalled. In a number of these, where further liberalization is being blocked by vested interests that benefit from a situation of partial reform, a major domestic political initiative will be needed to achieve further progress.

Africa: Supporting Growth and Poverty Reduction

Growth in Africa is projected to reach close to 4 percent this year, driven by a substantial improvement in the Maghreb region—especially as *Morocco* recovers from drought—and a more modest increase in activity in sub-Saharan Africa (Table 1.10).[10] Inflation is expected to remain subdued in the Maghreb, as well as most countries of sub-Saharan Africa, although it remains a concern in some countries—notably in *Angola*, the *Democratic Republic of Congo*, and *Zimbabwe*, but also in *Ghana* and *Nigeria*. While the regional current account deficit remains small—reflecting large surpluses in oil and gas producers—many sub-Saharan African countries continue to experience large deficits, in part driven by weak non-

[10]However, IMF forecasts of African growth have in the past been too optimistic, reflecting a combination of adverse shocks, including conflicts, as well as shortfalls in policy implementation.

fuel commodity prices, high oil prices, and still high external debt servicing costs.

With exports accounting for more than one-third of African GDP, the global slowdown will weaken external trading conditions—particularly trade with the European Union, which absorbs around 40 percent of the region's exports. More significant though for external balances and economic activity in most African countries are market conditions for individual commodities—which are not well correlated in all cases with the global cycle (Figure 1.13; see also Appendix I). In the energy-producing countries, including *Algeria* and Nigeria, high oil and gas prices continue to support growth in domestic demand and improvements in fiscal and external balances. At the same time, these gains risk being cut short by looser macroeconomic policies—notably but not exclusively in Nigeria—particularly if the oil market were to weaken further.

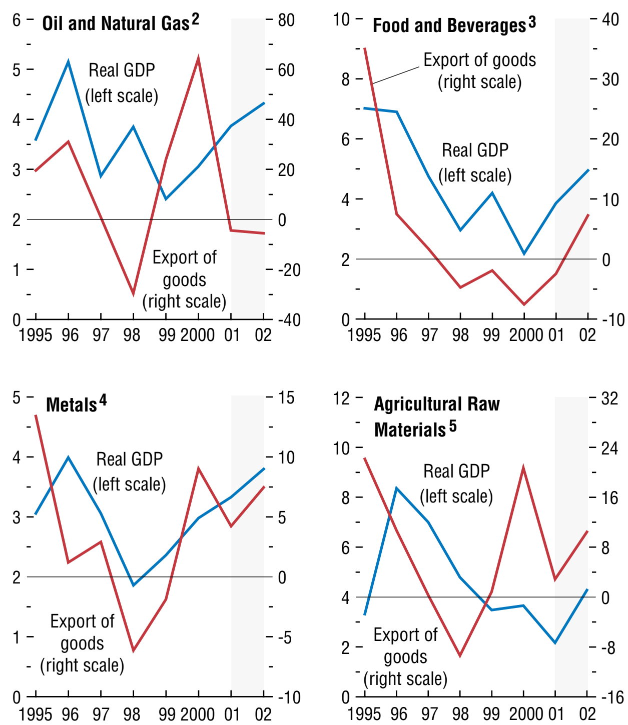
Most nonfuel commodity prices remain weak (as noted in Appendix I, the main exceptions are some timber and meat prices). Among food and beverages, the most significant development has been the severe drop in coffee prices—down more than 60 percent since 1997—which has contributed to weak export growth and high external trade deficits in *Kenya* and *Uganda*. Agricultural commodity prices have also come down substantially since 1997, including cotton (a key export of *Benin*, *Chad*, and *Mali*) and tobacco (important for *Malawi* and Zimbabwe). Prices of aluminum and copper—of particular significance for *Mozambique* and *Zambia*, respectively—have declined since the beginning of 2001 and could fall further as global demand weakens, although recent increases in these countries' export volumes are helping to offset the lower prices. The prolonged decline in gold prices continues to weigh on export earnings of *South Africa*.

Global and commodity market developments notwithstanding, local influences still play the dominant role in the economic prospects of most African countries. In particular, the outlook for private investment, economic diversification, and longer-term growth is generally brighter in countries that have pursued sound macroeconomic

Figure 1.13. Selected African Countries: Sensitive to Commodity Markets[1]

(Percent change; countries grouped according to key sources of export earnings)

Commodity market developments have a major impact on overall economic activity in many African countries.



[1]Shaded area indicates IMF staff projections.
[2]Algeria, Angola, Cameroon, Republic of Congo, Equatorial Guinea, Gabon, and Nigeria.
[3]Burundi, Comoros, Côte d'Ivoire, Ethiopia, Guinea-Bissau, Kenya, Mauritania, Mauritius, Rwanda, São Tomé and Príncipe, and Uganda.
[4]Central African Republic, Ghana, Guinea, Mozambique, Namibia, Niger, Sierra Leone, South Africa, and Zambia.
[5]Benin, Chad, Malawi, Mali, Sudan, and Zimbabwe. This category includes cotton and tobacco.

Box 1.7. Economic Growth, Civil Conflict, and Poverty Reduction in Sub-Saharan Africa

Efforts to reduce poverty in sub-Saharan Africa have been disappointing over the past two decades, and its poverty gap with the rest of the world has widened significantly. While the share of sub-Saharan Africa's population earning less than $1 per day fell by 1½ percentage points over the 1990–98 period (see the Table), the proportion fell by 4 percentage points in south Asia and by 12½ percentage points in east Asia (Chen and Ravallion, 2000). In low- and middle-income countries, the decline in poverty during the 1990s closely tracked trends in per capita economic growth.

This relationship is confirmed in a number of recent empirical studies. Ravallion and Chen (1997), for example, find that the share of the population living on less than $1 per day falls by 3 percent for every 1 percent increase in mean per capita income, while Dollar and Kraay (2000) find a 1 percent increase in economic growth is associated with a 1 percent increase in income of the poor. Such studies, however, to a large extent have not focused specifically on Africa, owing to the paucity of quality data on income of the poor. Nonetheless, trends in broader "nonincome" poverty (or human development) indicators, which are more readily available for sub-Saharan Africa, also closely track changes in economic growth.

Infant mortality rates fell by 20 percent in sub-Saharan Africa from 1980 to 1998, a relatively modest improvement compared to the declines of around 30 to 50 percent achieved in other regions of the world. Similarly, life expectancy increased by only 4 percent in sub-Saharan Africa during this period and remains well below average lifespans elsewhere. This poor progress in raising life expectancy in sub-Saharan Africa is partially explained by the high incidence of HIV/AIDS in a number of countries. Cross-country empirical analysis highlights the important role of growth in explaining broader "non-income" poverty reduction in sub-Saharan Africa.[1] It has been estimated that a 10 percent increase in per capita GDP is associated with a 1 percent increase in life expectancy, a 3 percent to 4 percent decline in infant mortality rates, and a 3½ percent to 4 percent increase in the rate of primary school enrollment.[2] The analysis also finds that civil conflict, income distribution, and social service delivery are also significant factors affecting poverty in Africa. Implementing structural adjustment programs does not significantly affect life expectancy or infant mortality rates, though adjusters tend to have higher primary school enrolment rates—it is the economic growth resulting from adjustment programs that reduces poverty.

Considering in more detail the impact of escalating civil conflict, a study of six African countries that experienced extensive economic losses during sustained civil conflicts in the 1980s and

[1]See Moser and Ichida (2001) for a more detailed discussion.

[2]Based on the estimation of a reduced-form poverty equation, employing a panel of 46 sub-Saharan African countries covering the period 1972–97.

Poverty Indicators and Growth

	Life Expectancy at Birth (in years)		Infant Mortality Rate (per 1000)		Share of Population Living Below $1 Per Day		Real GDP Growth Rate Per Capita (Avg.)	
	1980	1998	1980	1998	1990	1998	1980–90	1990–99
Low- and middle-income countries	**58**	**65**	**87**	**59**			**1.3**	**1.4**
East Asia and Pacific	. . .	69	55	35	28	15	5.7	5.9
Europe and Central Asia	68	69	41	22	2	5	1.9	–3.3
Latin America and Caribbean	65	70	61	31	17	16	–1.3	0.9
Middle East and North Africa	59	68	95	45	2	2	–1.1	–0.1
South Asia	54	62	119	75	44	40	3.9	3.2
Sub-Saharan Africa	48	50	115	92	48	46	–1.0	–0.2

Source: World Bank, World Development Indicators, 2000; Chen and Ravallion (2000).

1990s finds that real per capita GDP at the end of the conflict period averaged only 55 percent of its prewar level.[3] Moreover, while there was an initial postwar rebound in agricultural output, the destruction of the capital base—both human and physical—limited the extent of medium-term gains. Consequently, five years after the end of the conflict, real per capita GDP had increased on average to only about 75 percent of prewar levels.

More generally, a comparison of poverty and income trends for conflict and nonconflict countries in sub-Saharan Africa over the 1972 to 1997 period reveals the following:[4]

- The infant mortality rate for nonconflict countries fell by 36½ percent, compared with a decline of 25½ percent for conflict countries. Excluding conflict-affected countries, the infant mortality rate in sub-Saharan Africa compares much more favorably (at 82 per 1000 in 1997) with that in south Asia.
- Life expectancy increased by 17½ percent for nonconflict countries compared with 9½ percent for conflict-affected countries, even though improvements in life expectancy generally stalled in the 1990s owing to the spread of HIV/AIDS.
- Gross primary school enrollment increased from 61 to 89 percent over 1972 to 1992 in nonconflict countries, compared with an increase from 46 to 66 percent in conflict countries.
- Economic performance, which experienced an initial surge in the 1970s, also differed substantially between the two groups of countries: real GDP per capita (in purchasing power parity terms) grew at an average annual rate of 5½ percent in nonconflict countries over the 1972–97 period, compared with 3 percent in conflict countries. Real per capita GDP (in U.S. dollar terms, converted at 1990 exchange rates) increased at an average rate of 1 percent annually for nonconflict countries compared with a decline of 1½ percent annually for conflict countries.

[3]Moser, Staines, and Engstrom (forthcoming).

[4]Conflict countries over the 1972–97 period comprised Angola, Burundi, Chad, Democratic Republic of the Congo, Ethiopia, Guinea-Bissau, Liberia, Mozambique, Nigeria, Rwanda, Sierra Leone, Sudan, and Uganda. These countries represented 55 percent of the population in sub-Saharan Africa in 1990.

and structural policies. Reflecting this, relatively strong growth—around 5 percent and above—is expected to continue in *Botswana*, *Cameroon*, Mozambique, *Tanzania*, and Uganda. In contrast, poor policy performance, often combined with political uncertainty and/or conflict, has markedly adverse effects on prospects for sustained growth and for reductions in poverty (see Box 1.7). In Zimbabwe, for example, the turbulent land reform program and inappropriate macroeconomic policies are expected to lead to the economy contracting by around 8½ percent in 2001, with inflation reaching more than 90 percent by the end of the year; in *Côte d'Ivoire*, the recent political uncertainty has hurt public finances and contributed to a weak investment climate and a fall in output. Local weather conditions can also have a major impact on year-to-year changes in output and prices, especially given the importance of agriculture in many African economies. The pickups projected for Kenya, Morocco, and Mozambique, for example, reflect in part the return of more normal weather following adverse conditions in 2000.

The central challenge remains how best to improve the environment for growth and investment, particularly through improving public service delivery—including education and poverty relief; promoting conflict resolution and prevention; strengthening infrastructure; liberalizing trade, to reverse Africa's declining share in world trade; and improving governance. The main responsibility for such progress must, of course, lie with African governments themselves: recent developments are encouraging in this regard, including the *New African Initiative,* which emphasizes the principles of African ownership, leadership, and accountability in eliminating home-grown obstacles to sustained growth. These efforts are being supported by the enhanced initiative for Heavily Indebted Poor Countries (or HIPC Initiative); through June 2001, 23 countries, mainly in Africa, had qualified for and begun to receive debt relief totaling some $34 billion—implying that on average their debt-to-GDP ratios will be halved.[11] Annual savings in debt service will represent about $1 billion on average in the initial years, which is substantially exceeded by the increase in social spending of more than $1½ billion—mainly on health and education, including programs to combat HIV/AIDS. For many sub-Saharan countries, the HIV/AIDS pandemic represents the largest threat to medium-term growth. In addition to the HIPC initiative, encouraging progress has been made in lowering the costs of antiretroviral drug therapies and in providing support through the International Partnership against AIDS in Africa, drawing together African governments, the United Nations, and public, private, and community sectors internationally. But, given the scale of the problem, an enormous effort lies ahead—including developing the health sector infrastructure to support advanced treatments, providing further financial support to countries affected, and stepping up HIV/AIDS awareness and prevention efforts.

Looking at the three largest economies of the region, South Africa's vulnerability to external shocks has been substantially reduced as a result of sound macroeconomic policies, with public spending effectively restrained, the budget deficit limited to around 2½ percent of GDP, and inflation expected to come back within the target range of 3 to 6 percent. These policies have helped sustain recent gains in external competitiveness and have enabled the Reserve Bank to lower its benchmark interest rates by 100 basis points in June. Furthermore, higher private capital inflows—including receipts from the sale of De Beers—have allowed the Reserve Bank to lower its net open forward position to $5 billion as of mid-2001, down from $22.5 billion in 1998. Short-term prospects have been weakened by the global slowdown, however, given South Africa's relatively strong trade and financial linkages with the advanced economies. In addition, regional uncertainty has increased as a result of the ongoing economic and political difficulties in Zimbabwe. Major challenges lie ahead. As in many other African economies, extremely high unemployment (over 35 percent in South Africa) and minimal progress in raising per capita incomes underscore the need for wide-ranging structural reforms to improve the investment climate, boost employment, and raise growth to a rate that can make sizable inroads on poverty. In particular, further progress is needed with measures directed at improving education and training, increasing labor market efficiency, restructuring and privatizing state-owned enterprises, and liberalizing external trade.

In Nigeria, the spending of windfall gains from higher oil prices has led to a substantial boost to activity. But serious macroeconomic imbalances threaten these gains: sharply higher government spending, especially at state and local levels, has been accompanied by rapid monetary expansion, a surge in inflation, and disorder in the foreign exchange markets. Efforts to restore macroeconomic stability, particularly by restraining public spending at all levels and saving a larger portion of oil proceeds, remain an urgent priority. These measures need to be supported by wide-ranging institutional and structural reforms directed at improving the climate for private investment and economic diversification. Key steps include moving ahead with plans to privatize state-owned enterprises; building the public sector's capacity to formulate and implement reforms; and maintaining the drive to identify and weed out corruption.

Algeria's fiscal and external balances have also improved significantly as a result of strong growth in oil revenues. But, with a substantial share of oil revenues being set aside in a stabiliza-

[11]See Box 1.5, "The Enhanced HIPC Initiative in Africa," of the May 2001 *World Economic Outlook*.

Table 1.11. Selected Middle Eastern Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	1999	2000	2001	2002	1999	2000	2001	2002	1999	2000	2001	2002
Middle East[3]	**3.0**	**5.5**	**4.5**	**4.4**	**12.0**	**9.4**	**9.6**	**8.9**	**3.1**	**11.6**	**8.9**	**6.1**
Oil exporters[4]	**2.6**	**5.9**	**5.0**	**4.5**	**15.8**	**12.1**	**12.3**	**11.0**	**5.2**	**15.9**	**12.4**	**8.6**
Saudi Arabia	–0.8	4.5	2.2	2.7	–1.3	–0.6	–0.6	0.9	0.3	9.0	8.1	3.6
Iran, Islamic Rep. of	3.1	5.8	5.0	5.0	20.4	12.6	16.0	13.0	6.4	13.0	7.3	5.8
Kuwait	–0.6	3.6	0.8	3.0	3.0	1.7	2.5	2.5	17.0	39.3	35.3	30.8
Mashreq[5]	**4.1**	**4.1**	**3.2**	**4.2**	**2.0**	**2.2**	**2.3**	**3.2**	**–3.5**	**–2.9**	**–3.1**	**–2.3**
Egypt	6.0	5.1	3.3	4.8	3.8	2.8	2.4	3.0	–1.9	–1.2	–0.2	–0.7
Jordan	3.1	3.9	3.5	4.5	0.6	0.7	1.4	2.1	5.0	0.7	–2.7	–2.5

[1]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.
[2]Percent of GDP.
[3]Includes Bahrain, Egypt, Islamic Rep. of Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, United Arab Emirates, and Republic of Yemen.
[4]Includes Bahrain, Islamic Rep. of Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and United Arab Emirates.
[5]Includes Egypt, Jordan, Lebanon, and Syrian Arab Republic.

tion fund—expected to total close to 20 percent of GDP by the end of 2001—and sustained monetary discipline and low inflation, Algeria should be able to avoid the same extent of boom-bust cycle that Nigeria may face. Some developments are of concern, however, including a surge of public wage and capital expenditure and a pickup in monetary growth that may add to inflation pressures. Maintaining prudent macroeconomic policies, together with increasing the pace of privatization, trade liberalization, and other structural reforms, would help promote private-sector led investment and growth—particularly needed in non-energy sectors of the economy.

The Middle East: Managing Oil Price Volatility

The economies of the Middle East face a range of external and domestic pressures. Most notable among these are oil market developments, including the increased uncertainties in the market following the September 11 terrorist attack in the United States; the stance of domestic policies—particularly fiscal policy; the regional security situation; and the global economic slowdown, especially—in the case of *Israel*—in the high-technology sector. While the region as a whole is expected to register relatively robust growth of 4.5 percent in 2001 and 4.4 percent in 2002, the short- to medium-term outlook varies quite widely from country to country (Table 1.11).

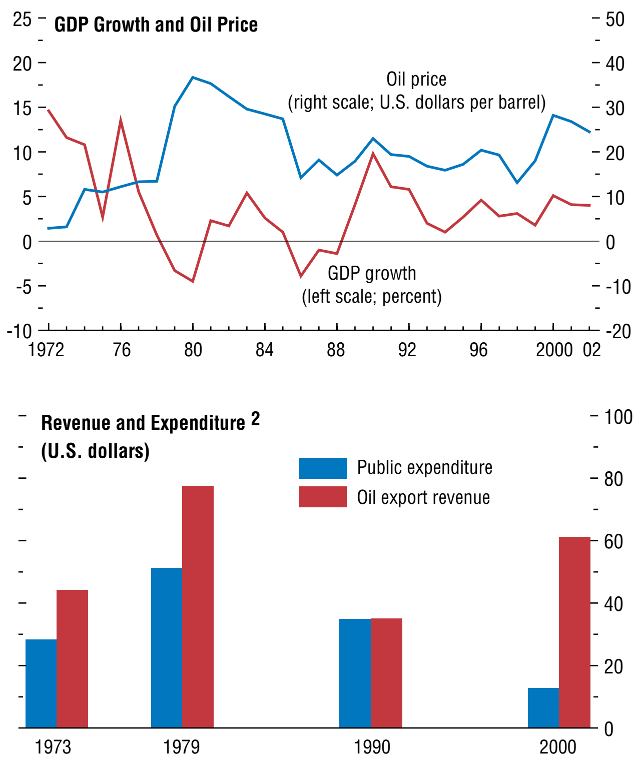
Although non-oil growth is likely to accelerate in 2001 owing in part to ongoing structural reforms, total growth in most regional oil producers is expected to moderate, mainly reflecting limits on oil production under quotas agreed to by the Organization of the Petroleum Exporting Countries (OPEC) as well as somewhat lower oil prices. In *Iran*, this impact is largely offset by strong growth in non-oil activities—driven in part by a recovery in agriculture from last year's drought and by a pickup in domestic demand. Given the need to sustain relatively high growth to generate employment for a rapidly growing labor force, policy emphasis needs to be placed on macroeconomic stabilization, as well as on pushing ahead with reform efforts directed at liberalizing and opening the economy. Expenditure restraint is being applied in most oil-producing countries, as they attempt to mute the boom-bust cycles experienced under earlier oil price fluctuations and, in *Saudi Arabia*, to reduce high domestic debt (Figure 1.14). In addition, official net foreign assets have continued to increase. With all the oil exporting countries recognizing the need for economic diversification, the maintenance of firm macroeconomic policies would help to strengthen the climate for private investment, as would restructuring and privatization in the dominant state-owned enterprise sector.

For the countries of the Mashreq (see Table 1.11), economic growth is projected to be somewhat lower than in the Middle East as a whole, in part the result of the difficult security situation. Economic vulnerabilities are acute in *Lebanon*, where the government deficit and debt have reached very high levels; a comprehensive strategy to address these concerns needs to be implemented rapidly. In *Egypt*, real GDP growth is projected to ease to 3.3 percent in 2001, largely reflecting the recent slowing of credit expansion from earlier unsustainable rates. The fluctuation band for the pound was devalued by 6½ percent in early August, and widened to +/–3 percent (from +/–1½ percent). The 25 percent currency depreciation against the dollar since mid-2000 will, over time, help stimulate the traded goods sector, but continuing flexibility will be needed to avoid balance of payments constraints as economic growth recovers. Prospects for recovery over the year ahead will depend, in part, on the speed with which investor confidence strengthens and on developments within the region. In the Mashreq as a whole, reforms directed at further trade liberalization and developing a supportive business environment would improve the longer-term outlook for growth.

Economic activity in Israel weakened sharply in the final quarter of 2000, led by a falloff in investment and exports, and GDP growth is expected to decline from 6.2 percent in 2000 to 0.7 percent this year. This slowdown is mainly a result of the global high-technology slump and of the deterioration in regional security—the latter leading to lower numbers of foreign tourists, a poorer investment climate, and, through labor shortages, weakness in the construction and agricultural sectors. But, having pursued generally sound macroeconomic policies over the past decade and achieved substantial declines in inflation and public debt, Israel has some room for maneuver on the macroeconomic front. In addition, sound banking policies over the same

Figure 1.14. Selected Middle Eastern Oil Producing Countries: Fiscal Restraint Apparent[1]

Faced with higher export earnings, most oil producing countries are now showing greater fiscal restraint as they seek to avoid boom-bust cycles of the past.



[1] Data for 2001 and 2002 are IMF staff projections. Oil producers include Bahrain, Islamic Rep. of Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and United Arab Emirates.
[2] Increase (in U.S. dollars) in the three years following each oil price shock compared with the three years before.

period have helped to make this sector resilient to shocks. Inflation outturns and expectations have fallen, providing scope for a more aggressive easing of monetary policy without jeopardizing inflation targets. The automatic fiscal stabilizers should be allowed to work, but additional discretionary easing of the fiscal stance should be resisted as public expenditures and debt remain high (in relation to GDP) in comparison to most other advanced economies.

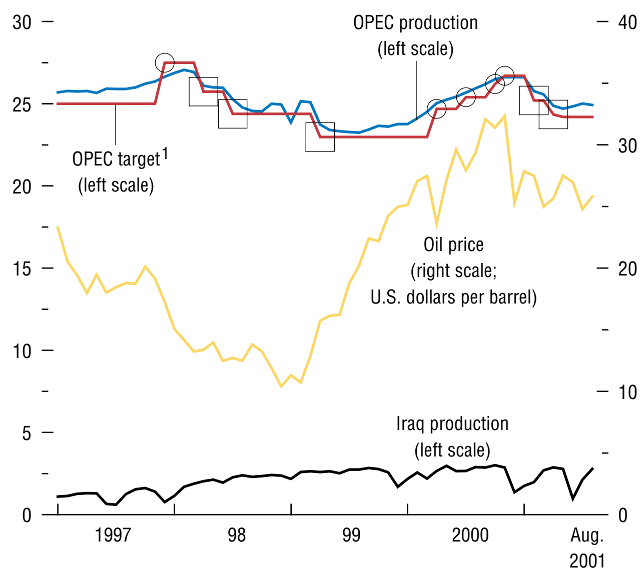
Appendix I: Primary Commodities and Semiconductor Markets

The slowdown in global growth is reducing demand for semiconductors and for a number of primary commodities, weakening already depressed prices: for example, metals prices have generally declined since the beginning of the year and, in mid-2001, prices of oil and oil products also turned down. While weaker global demand is likely to hold down commodity price pressures more generally, developments in many specific commodities—including most food and beverage items—are driven more by supply side shocks, including changes in production patterns (leading, for example, to a marked reduction in coffee prices) and animal diseases (driving up meat prices). Uncertainties about the global economic outlook, including prospects for oil and other commodity markets, have been heightened by the September 11 terrorist attack and its possible aftermath.

Oil

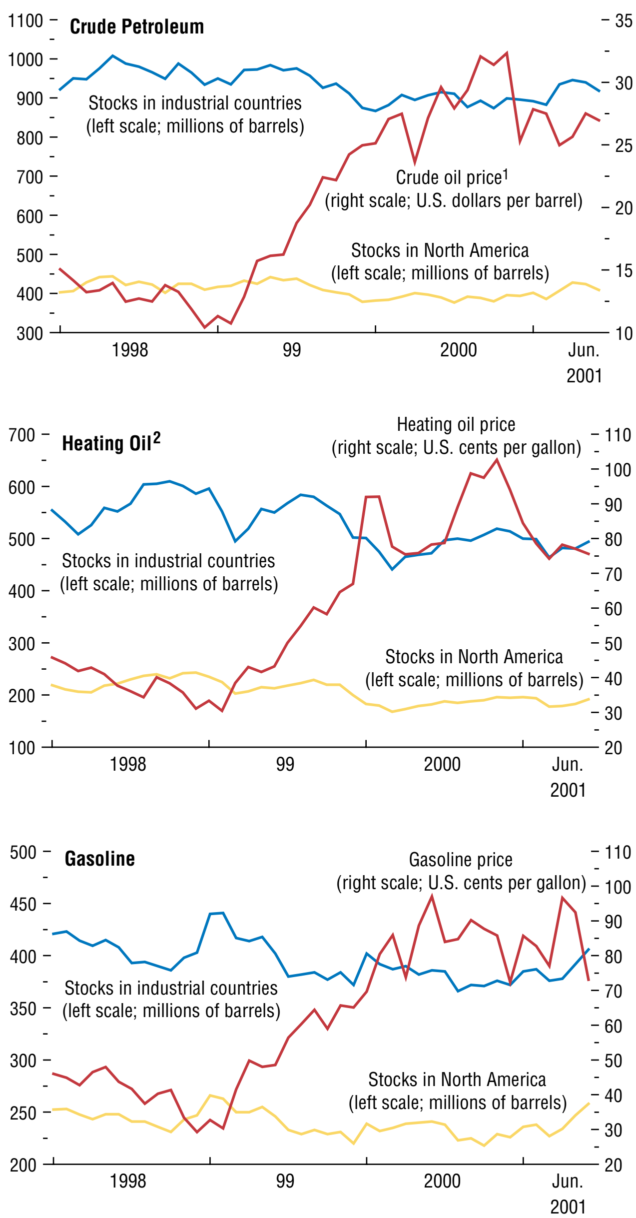
In 1998, in the wake of the Asian financial crisis, slowing demand growth for energy, and important production increases (above their target) by OPEC countries, oil prices fell to about $11 dollars per barrel, a price not experienced even in nominal terms since the mid-1980s. The rapid and steep decline in prices led to a revival of OPEC's efforts to control supplies entering the oil market. Initial efforts were not particularly effective as members found it difficult to reintroduce controls that they had

Figure 1.15. OPEC Target and Actual Production of Oil
(Millions barrels per day unless otherwise indicated)



Source: Bloomberg Financial Markets, LP.
[1]Circles denote increases in OPEC target production and squares denote decreases in OPEC target production.

Figure 1.16. Commercial Stocks and Prices



Sources: International Energy Agency, *Oil Market Report*.

[1] Crude oil price is the IMF's indicator price, an average of West Texas Intermediate, U.K. Brent, and Dubai.

[2] Products for which a large part is used as heating fuel, including diesel, other gas oil, and LPG.

largely abandoned in the previous decade. However, the further prices fell, the more efforts to reach a workable agreement were intensified. During the first half of 1999, rising demand for oil, reflecting the strength of world economic growth as well as the need to build up stocks, and firmer compliance to production targets by OPEC members, contributed to a significant rebound in oil prices: these reached $25 per barrel by December 1999 and, with demand increasing and compliance remaining high, averaged over $28 per barrel in 2000 (Figure 1.15).

From January to August 2001, prices remained within OPEC's target band of $22 to $28 per barrel, although fluctuating quite widely. Prices moved close to the upper end of this range early in 2001 and again in late May. But the increasingly sluggish pace of global economic activity, together with rising stocks of oil and oil products, led to a substantial weakening of prices in June and July (Figure 1.16). In the United States in particular, gasoline prices for current and near-term delivery fell sharply over this period as stocks built up to levels last seen in mid-1999—supported also by rising gasoline imports, higher crude stocks (6 percent above mid-2000 levels), and high capacity utilization in refineries. Immediately following the September 11 terrorist attack, crude spot prices initially increased, but then receded back to levels prevailing in the week before the attack—dampened by reassurances by OPEC members of production increases if they became necessary, and falling demand for crude and products, particularly for jet fuel, associated with air transport restrictions.

On the supply side, in an attempt to maintain oil prices within their targeted price band, OPEC has reduced oil production—lowering output by about 1½ million barrels a day on February 1 and a further 1 million barrels a day on April 1—and in late July announced another 1 million barrel reduction to take effect in September. Non-OPEC production, particularly in Russia, has increased modestly in 2001, and Iraq has resumed oil exports after suspending shipments briefly to protest United Nations economic sanctions.[12]

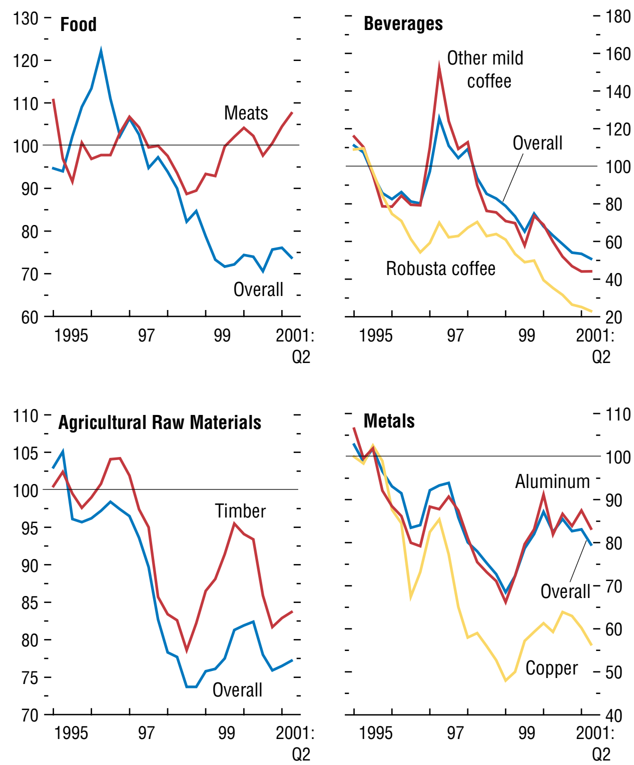
The outlook for oil prices also depends on global economic growth, especially in the major industrial countries, and on prospects for continuing cohesion within OPEC—where futures prices indicate that market participants generally expect OPEC's target price band to be maintained. Following the September 11 terrorist attack, futures prices increased slightly for the near term and decreased for long-term contracts. As of mid-September, crude prices were around $27 at the end of 2001, weakening to around $22 by the end of 2002. In addition to economic and political uncertainties surrounding the oil market, the vulnerability of markets for oil products to disruptions in production and distribution also needs to be emphasized. For example, with capacity utilization in U.S. refineries currently running at around 93 percent and little recent investment to enhance capacity, product markets have little room for maneuver in the event of unexpected breakdowns or other supply disruptions.

Agricultural Commodities

Production of most agricultural commodities failed to adjust to slower demand growth in 1997–98 and, with a succession of good harvests, it has been difficult to absorb inventories accumulated in those two years. As a result, prices generally remain well below their levels of the mid- to late 1990s (Figure 1.17). While the current slowing in global demand may exacerbate price weakness, low prices for most of these commodities tend to stem from supply rather than demand conditions. In particular, price declines over recent years have led to some strategic shifting among annual crops but have generally not led to a decrease in overall production. The situation has been most serious for tree and other

[12]Iraq's agreement with the United Nations to export oil in return for food and medicine expires on November 30, 2001, which adds to the uncertainty regarding supply in the near term.

Figure 1.17. Indices of Commodity Prices
(1995 average = 100)



Sources: *Yellow sheets,* Urnerbarry Publications*; The National Business Review;* Bloomberg Financial Markets, LP; *Tropical Timbers Journal;* U.S. Forest Service, USDA; London Metals Exchange; World Bank and IMF staff calculations.

perennial crops—notably coffee, but also cocoa, sugar, palm oil, coconut oil, cotton, and natural rubber. Noteworthy exceptions to the overall weakness in agricultural commodity markets are timber and meat prices. Timber prices have been supported by strong construction demand, particularly in the United States, and by institutional factors, including quotas and trade controls. Meat prices have been affected by livestock disease problems in Europe and South America and by measures taken to control these problems.

The most extreme case of low agricultural commodity prices is coffee. In the first seven months of 2001, prices of robusta and arabica coffee were about 30 percent and 50 percent, respectively, of their inflation-adjusted averages for the previous 30 years. During the past three years the price of coffee has progressively deteriorated: demand growth has been insufficient to absorb increasing supplies, particularly from Brazil and Vietnam, leading to accumulation of inventories. In the past, such situations have usually been alleviated by frosts in Brazil. This "solution," however, has now become less likely, as the coffee growing area in Brazil has been shifting and is now concentrated in areas less exposed to frost. Brazil has become the largest producer of robusta coffee—grown in frost free areas—in addition to maintaining its traditional position as the largest producer of arabica coffee. Vietnam has aggressively entered the market during the past two decades and now ranks as the world's second robusta producer. On the demand side, consumption growth has been sluggish. Attempts to promote coffee consumption in markets where per capita consumption is low have met with little success, and attempts by the Association of Coffee Producing Countries to set up an export retention scheme have not come to fruition.

Metals

Inventories and prices of metals have reacted quite promptly over recent years to signals of weakening or strengthening in global activity.

Table 1.12. Volatility Measures

	Standard deviation of monthly growth rates
Industrial production[1]	
G-7 countries	0.5
Newly industrialized economies of Asia[2]	7.0
ASEAN-4[3]	3.7
Non-oil commodity price index[4]	1.7
World sales of semiconductors[4]	14.7

[1]Calculated for de-meaned series, 1993M2-2001M3.
[2]Comprising Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.
[3]Comprising Indonesia, Malaysia, Philippines, and Thailand.
[4]Calculated for de-meaned series, 1991M1-2001M4.

The large inventories of metals accumulated in the aftermath of the 1997–98 financial and economic crises were run down in 2000, but there is renewed accumulation in 2001 as industrial production weakens. For example, aluminum prices declined by 15 percent and copper prices by 18 percent between January and the end of August, 2001 (Figure 1.17). For these and most other metals, prices are expected to pick up in 2002 as recovery takes hold. Short-term risks are probably on the downside, however, and, even with some pickup in 2002, prices generally appear likely to remain well below their levels of the mid-1990s. Gold prices initially moved up sharply in response to the September 11 terrorist attack and then came down again—remaining though above their level of the first half of 2001.

Semiconductors

Microchips are an increasingly important item in international trade and, while not a primary commodity, exhibit many of the characteristics of primary commodities. The electronics industry has been hit hard by the global slowdown. Semiconductor prices have fallen sharply, with sales to all major markets weakening significantly since mid-2000, following rapid growth over the previous year (Figure 1.18). While orders for new equipment have been reduced or canceled, adjustment of supply has been slow—in part because of the difficulties in operating plants at less than optimal capacity—and inventories have become overinflated.

As discussed earlier, ASEAN members and the newly industrialized economies of Asia (NIEs), apart from Indonesia and Hong Kong SAR, have been heavily exposed to recent fluctuations in the electronics industry. With exports of electronic goods ranging from about one-third of total exports in Thailand up to around two-thirds in Malaysia and the Philippines, rising global demand for electronics contributed to the strong recovery of growth among the emerging Asian economies after the 1997–98 crises, and the collapse in demand since mid-2000 has led to a sharp weakening in regional activity. Indeed, industrial production among the NIEs and ASEAN economies has been substantially more volatile than in the large industrial economies over the past decade, reflecting both the fluctuations of world semiconductor sales and the increasing concentration of Asian production in electronics (Table 1.12).

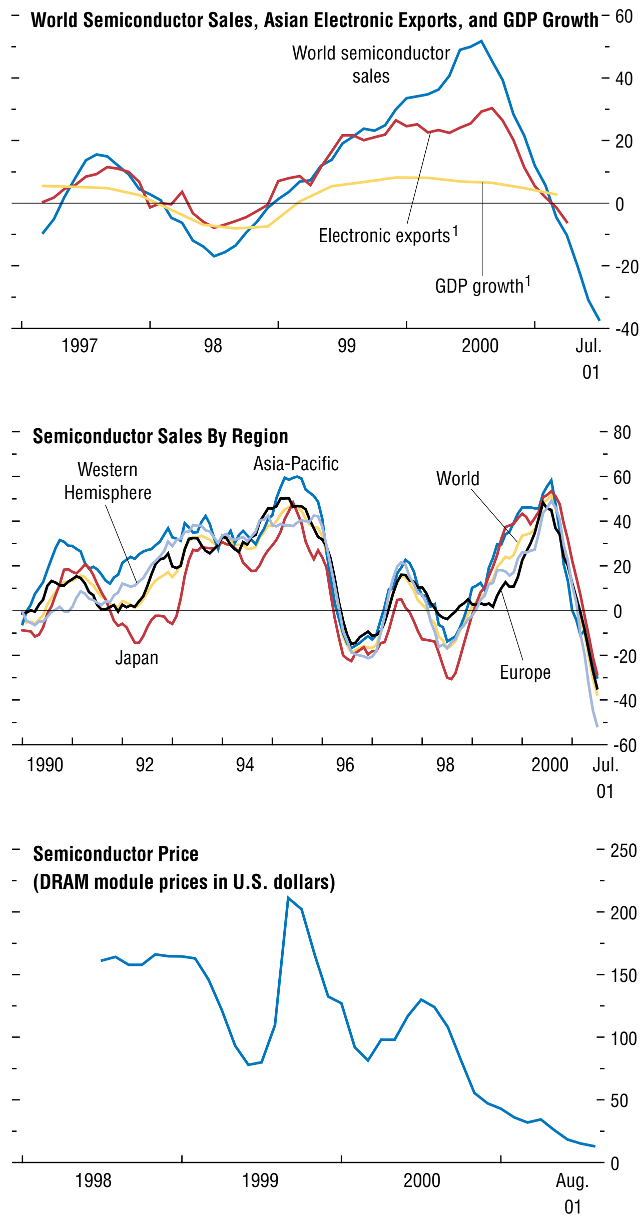
Appendix II: Alternative Scenarios—How Might Medium-Term Productivity Growth Affect the Short-Term Outlook?

As sound macroeconomic policies have stabilized inflation expectations, private sector views on future growth are an increasingly important factor behind the business cycle. Accordingly, the underlying growth rate of productivity is a major concern for the global economy. In the United States, the uncertainty is centered on the size of the increase in productivity growth associated with information technology revolution (discussed in detail in Chapter III) and on the linked issue of whether the boom in the late 1990s generated significant overinvestment. Elsewhere, uncertainties about the rate of growth of potential output are associated with the speed of technology catch-up and, most notably in the euro area and Japan, the impact of future structural reforms.

Some of these issues have been explored in previous *World Economic Outlooks.* Chapter II of the October 2000 edition reported simulations

Figure 1.18. Semiconductor Sales and Prices

(Year on year percent changes in three-month averages unless otherwise indicated)



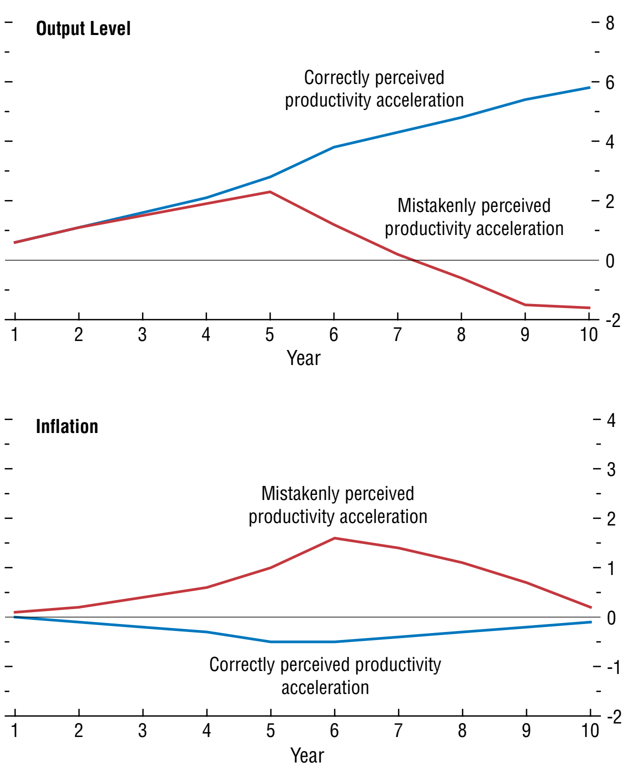
Sources: CEIC Data Company Limited; and Primark Datastream.
[1]Includes Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, and Thailand.

Table 1.13. Potential Output Growth Rates in the Baseline

	1996–2001	2002–2006	Increase
United States	3.2	3.2	—
Euro area	2.4	2.6	0.2
Japan	1.6	1.6	—
Other industrial countries	2.8	2.8	—

Figure 1.19. Illustrative Country Scenario: Productivity Uncertainty

(Percent, deviations from baseline)



Source: October 2000 *World Economic Outlook*, page 54.

illustrating the impact of failing to realize that five years ago the growth of total factor productivity had accelerated or decelerated. These simulations, which combine a change in future productivity growth with a reassessment of the current cyclical position, illustrate how faulty assessments of past and future growth trends can create significant cyclical disturbances. Figure 1.19 illustrates the path of real output and inflation in a situation where people assume that productivity growth has risen by ½ percent either correctly or incorrectly (in the incorrect case it is assumed that they realize their mistake after five years). This simulation is intended to reflect the practical consequences of the difficulty in identifying long-term productivity trends, particularly in the presence of cycles, data revisions, and other effects. As can be seen, it is hard to distinguish the two paths over the initial five-year period, but in the scenario where the perception is incorrect there is a significant fall in activity once the error is realized as the excesses associated with earlier exuberance need to be corrected. The alternative scenarios reported below extend this type of analysis by looking at how alternative assumptions about past and future potential output growth could impact the global economy over the next few years.

Before describing these scenarios, however, it is useful to characterize the assumptions embodied in the current forecast discussed in the main body of this chapter. Table 1.13 reports the average rate of potential output growth assumed for the three major currency areas and for the other advanced economies. In the *United States*, the growth of potential output is assumed to stay steady at 3¼ percent over the next five years, toward the lower end of the generally accepted range of 3 percent to 4 percent.[13] In *Japan*, where potential output growth has been falling over the late 1990s, it is assumed to rise from its current value of 1¼ percent to 1¾ percent by 2006 as structural reforms are implemented. In the *euro area*, progress on structural reforms and uptake of IT also is assumed to fuel an increase in the growth of potential, which rises by about ¼ percent between 1996–2001 and 2002–06. A similar level and increase is assumed for the United Kingdom, the largest member of the other advanced countries group, although for the aggregate of the *other industrial countries* growth of potential output stays at around 2¾ percent.

How might changes in these rates of growth in potential affect the economic outlook in the next few years? This appendix explores two possibilities, both of which are assumed to occur at the beginning of 2002:

- *Future U.S. total factor productivity growth is ½ percent higher than in the baseline.* This moves potential output from the lower to the upper part of the current range of estimates, particularly once the additional capital accumulation associated with higher productivity is factored into the equation. As evidence of higher growth in the United States gradually accumulates over the next five years and is incorporated into expectations, the dollar and U.S. equity markets are assumed to gradually strengthen.
- *Potential output disappoints in the industrial countries.* In the "lower industrial countries productivity" scenario, it is assumed that underlying U.S. total factor productivity has been growing at ¼ percent lower than in the baseline since 1996. As a result, in addition to a slowing of future productivity, there is a significant current overhang of investment due to the reduction in underlying potential output, and thus a lower desired level of the capital stock. At the same time, productivity growth from 2002 onwards is assumed to be ½ percent lower than in the baseline in the rest of the advanced economies as the gains from structural reforms and IT catch-up disappoint. As a result, by 2006, total factor productivity is 2½ percent lower than in the baseline in all advanced economies. Two separate assumptions are made about financial market expectations. In the "immediate realization" scenario, markets realize the new realities immediately—including the need for an investment correction in the United States—leading to an abrupt fall in the U.S. dollar against the euro and the currencies of most other advanced economies as capital flows reverse (U.S. equity markets also fall abruptly). This does not occur against the yen, however, because of the lack of monetary policy options in the face of continuing difficulties in the Japanese economy. In the "gradual adjustment" scenario, the realization of the new environment occurs more slowly, leading to a more sluggish adjustment of exchange rates and equity markets.

In all scenarios, monetary policies are assumed to follow a forward looking Taylor rule, responding to changes in future core inflation and the current output gap, while the fiscal authorities allow automatic stabilizers to operate but do not initiate any discretionary policies.

The results of higher U.S. potential output growth are reported in Table 1.14 and Figure 1.20. As the evidence for strong productivity growth and continuing high real returns in the United States accumulates, this provides a steady upward boost to the U.S. dollar and stock market. Buoyant future expectations about profits and wages raises investment and, to a somewhat lesser extent, consumption, raising domestic demand and output by more than the rise in potential, only partly offset by tighter monetary policy as inflationary pressures emerge. The resulting surge in U.S. imports supports activity in the rest of the world, even

[13]These data incorporate recent revisions to the GDP accounts for 1998–2000, which significantly lowered output and productivity growth in 2000.

Table 1.14. Alternative Scenario: Faster U.S. Productivity Growth
(Percent deviation from baseline unless otherwise specified)

	2002	2003	2004	2005	2006
World real GDP	0.3	0.5	0.7	0.9	1.3
United States					
Real GDP	0.8	1.1	1.8	2.4	3.2
Potential output	0.6	1.2	1.8	2.5	3.3
Real domestic demand	0.9	1.3	2.0	2.8	3.8
Real investment	2.3	2.6	4.0	5.5	7.9
Real effective exchange rate	0.4	0.4	0.7	1.0	1.4
Current account ($billion)	–11.5	–22.5	–37.8	–59.1	–89.7
Net private Sector Saving (percentage points of GDP)	–0.2	–0.1	–0.2	–0.4	–0.6
CPI Inflation (percentage points)	—	0.1	0.1	0.1	0.2
Short-term interest rate (percentage points)	0.3	0.2	0.3	0.4	0.6
Euro area					
Real GDP	0.2	0.2	0.2	0.3	0.5
Potential output	—	—	—	—	–0.1
Real domestic demand	0.1	—	–0.1	–0.1	–0.2
Real investment	0.2	–0.2	–0.6	–1.1	–1.8
Real effective exchange rate	–0.2	–0.3	–0.5	–0.8	–1.3
Real U.S. dollar exchange rate	–0.5	–0.5	–1.0	–1.5	–2.4
Current account ($billion)	4.6	7.9	13.6	21.2	30.7
Net private sector saving (percentage points of GDP)	—	0.1	0.2	0.3	0.3
CPI inflation (percentage points)	—	0.1	0.2	0.3	0.4
Short-term interest rate (percentage points)	0.2	0.4	0.6	0.9	0.9
Japan					
Real GDP	0.2	0.2	0.2	0.3	0.4
Potential output	—	—	—	—	–0.1
Real domestic demand	0.1	0.1	—	—	–0.1
Real investment	0.3	–0.0	–0.4	–0.7	–1.3
Real effective exchange rate	–0.4	–0.5	–0.9	–1.4	–1.9
Real U.S. dollar exchange rate	–0.5	–0.7	–1.3	–2.0	–2.7
Current account ($billion)	2.2	5.8	8.9	13.7	20.3
Net private sector saving (percentage points of GDP)	—	0.1	0.2	0.2	0.3
CPI inflation (percentage points)	—	0.1	0.1	0.2	0.3
Short-term interest rate (percentage points)	0.1	0.3	0.4	0.7	1.1
Other industrial economies					
Real GDP	0.2	0.2	0.3	0.4	0.5
Real domestic demand	0.1	0.1	—	–0.1	–0.2
Current account ($billion)	4.8	8.5	14.8	23.3	36.4
Industrial countries					
Real GDP	0.4	0.6	0.8	1.1	1.5
Real domestic demand	0.4	0.5	0.8	1.0	1.4
Current account ($billion)	0.2	–0.2	–0.6	–0.9	–2.3
Developing countries					
Real GDP	0.1	0.2	0.3	0.4	0.6
Real domestic demand	0.2	0.3	0.4	0.7	0.9
Current account ($billion)	–0.2	0.2	0.6	0.9	2.3

though investment elsewhere falls in the medium-term as capital is diverted to the United States. With the United States acting as the locomotive of the world economy, existing imbalances expand. The U.S. current account deficit grows by $90 billion and net private saving steadily slips by more than ½ percentage point of GDP. In short, this scenario is a continuation of the U.S.-led expansion that characterized the later part of the 1990s, and the imbalances and consequent financial uncertainties that were created.

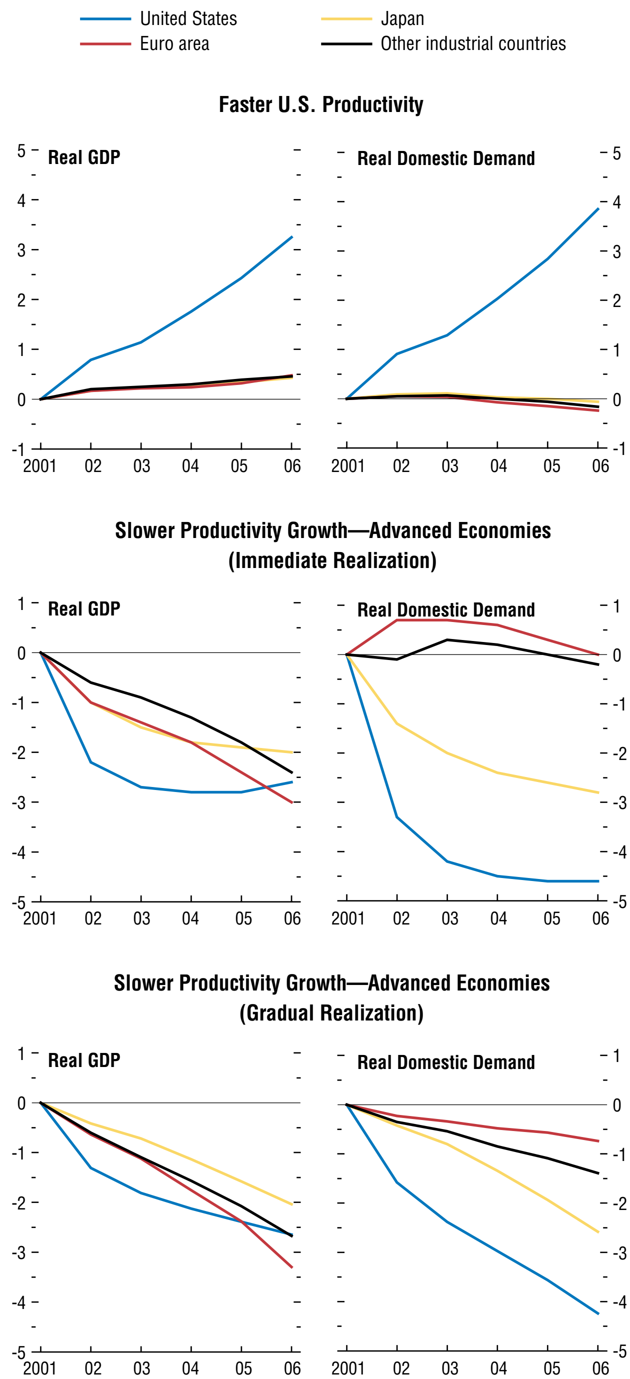
Could such a situation be sustained over a prolonged period of time? Significant deficits of an order of magnitude not dissimilar to that currently being experienced by the United

States, as well as low saving rates, were sustained over the period 1880–1913 by several areas of new European settlement, including Australia and Canada (but not the United States). In this case, however, the areas of new European settlement were exploiting a resource (new land) that was not available in the European countries supplying the capital, and was complemented by large inflows of labor. By contrast, the United States is currently exploiting a technology whose components are highly traded (see Chapter III). Even if, as assumed in this scenario, the United States was able to further expand its existing productivity advantage over the other main industrial countries, this situation would be unlikely to last for an extended period of time, especially if structural reforms are introduced. As the gap between the output potential of the United States and the rest of the world widened, the opportunities for catch-up through copying U.S. organizational techniques would likewise increase. At some point, the greater expected real return to the United States, and associated capital flows and exchange rate strength, would reverse, ideally in a gradual fashion.

The second set of scenarios looks at the consequences of a slowing of productivity growth around the world, together with a realization that overly optimistic assumptions about recent rates of growth of potential output growth have led to significant investment and consumption overhangs within the United States.

When it is realized that current U.S. potential output is 1½ percent lower than initially assumed, investment falls in order to restore the desired capital output ratio. More generally, lower productivity growth in the United States and elsewhere also depresses wealth, and hence investment and consumption. The most dramatic version of this scenario, reported in Table 1.15, is when financial markets correctly reassess the situation immediately, which leads to a significant reduction in existing international imbalances at considerable short-term costs to global output and demand. In this case, the U.S. equity market falls by 20 percent as the

Figure 1.20. Impact of Changes in Productivity Growth
(Deviation in percent from baseline real GDP)



Source: IMF MULTIMOD simulations.

Table 1.15. Alternative Scenario: Immediate Realization of Slower Productivity Growth
(Percent deviation from baseline unless otherwise specified)

	2002	2003	2004	2005	2006
World real growth	–1.2	–1.6	–1.8	–2.1	–2.3
United States					
Real GDP	–2.2	–2.7	–2.8	–2.8	–2.6
Potential output	–1.6	–2.1	–2.6	–3.1	–3.5
Real domestic demand	–3.3	–4.2	–4.5	–4.6	–4.6
Real investment	–2.7	–7.0	–7.7	–8.2	–8.4
Real effective exchange rate	–7.1	–7.3	–7.4	–7.9	–8.7
Current account ($billion)	40.1	86.4	119.3	144.2	160.5
Private lending (percentage points of GDP)	0.4	0.7	0.8	0.8	0.8
CPI inflation (percentage points)	0.5	0.1	–0.1	–0.1	0.1
Short-term interest rate (percentage points)	–0.4	–0.7	–0.5	–0.1	0.1
Euro area					
Real GDP	–1.0	–1.4	–1.8	–2.4	–3.0
Potential output	–0.5	–0.9	–1.4	–1.8	–2.3
Real domestic demand	0.7	0.7	0.6	0.3	—
Real investment	1.2	2.6	2.6	2.7	2.8
Real effective exchange rate	10.4	10.1	9.9	9.8	9.6
Real U.S. dollar exchange rate	17.8	17.7	17.5	17.6	17.9
Current account ($billion)	–9.5	–35.3	–55.2	–72.6	–88.2
Private lending (percentage points of GDP)	–0.2	–0.9	–1.2	–1.4	–1.2
CPI inflation (percentage points)	–1.6	–0.8	–0.5	–0.4	–0.3
Short-term interest rate (percentage points)	–1.6	–1.9	–2.2	–2.3	–2.3
Japan					
Real GDP	–1.0	–1.5	–1.8	–1.9	–2.0
Potential output	–0.5	–1.0	–1.6	–2.1	–2.7
Real domestic demand	–1.4	–2.0	–2.4	–2.6	–2.8
Real investment	–0.9	–2.3	–2.7	–3.0	–3.1
Real effective exchange rate	–6.2	–6.2	–6.4	–6.6	–6.8
Real U.S. dollar exchange rate	0.2	0.2	–0.1	–0.2	–0.2
Current account ($billion)	–2.3	–2.3	–1.5	1.8	10.1
Private lending (percentage points of GDP)	–0.1	–0.2	–0.3	–0.7	–0.2
CPI inflation (percentage points)	0.4	0.0	–0.1	–0.1	–0.1
Short-term Interest Rates (percentage points)	–0.2	–0.2	–0.2	—	0.1
Other industrial economies					
Real GDP	–0.6	–0.9	–1.3	–1.8	–2.4
Real domestic demand	–0.2	0.3	0.2	—	–0.2
Current account ($billion)	–21.8	–49.3	–62.2	–73.5	–84.4
Industrial countries					
Real GDP	–1.4	–1.8	–2.1	–2.4	–2.5
Real domestic demand	–1.3	–1.7	–1.9	–2.2	–2.3
Current account ($billion)	6.4	–0.5	0.3	–0.1	–2.0
Developing countries					
Real GDP	–0.5	–0.7	–1.0	–1.2	–1.3
Real domestic demand	–0.5	–1.0	–1.3	–1.5	–1.8
Current account ($billion)	–6.4	0.5	–0.3	0.1	2.0

consequences of the investment overhang are realized, and the dollar falls by a similar amount against the euro and around 15 percent against other industrial country currencies, except the yen, as the consequences for capital flows are realized, boosting real exports and reducing real imports. Consistent with the depreciation of the real exchange rate, U.S. domestic demand falls by 4¼ percent compared to baseline by 2003 and stays broadly level thereafter. This reflects the resolution of the excesses of the previous boom based in overly optimistic potential output assumptions, which leads to a rapid reduction in investment (which in turn further reduces the rate of growth of potential output) and, to a lesser extent, private consumption.

Table 1.16. Alternative Scenario: Gradual Realization of Slower Productivity Growth
(Percent deviation from baseline unless otherwise specified)

	2002	2003	2004	2005	2006
United States					
Real GDP	–1.3	–1.8	–2.1	–2.4	–2.6
Potential output	–1.5	–1.9	–2.3	–2.8	–3.2
Real domestic demand	–1.6	–2.4	–3.0	–3.6	–4.2
Real investment	–1.4	–3.8	–4.8	–5.8	–6.9
Real effective exchange rate	–1.9	–3.6	–5.1	–6.7	–8.6
Current account ($billion)	13.0	28.8	45.5	66.1	87.8
Net private sector savings	0.1	0.2	0.3	0.4	0.6
CPI inflation (percentage points)	0.2	0.3	0.4	0.5	0.7
Short-term interest rate (percentage points)	0.0	0.1	0.2	0.5	0.9
Euro area					
Real GDP	–0.6	–1.1	–1.7	–2.4	–3.3
Potential output	–0.5	–1.0	–1.4	–1.8	–2.3
Real domestic demand	–0.2	–0.3	–0.5	–0.6	–0.7
Real investment	0.6	1.6	2.3	3.0	3.8
Real effective exchange rate	2.1	3.7	6.0	8.1	10.9
Real U.S. dollar exchange rate	3.5	6.8	10.2	13.8	18.4
Current account ($billion)	–4.1	–9.1	–15.7	–27.0	–39.5
Net private sector savings	—	–0.2	–0.3	–0.5	–0.6
CPI inflation (percentage points)	–0.3	–0.5	–0.6	–0.8	–1.0
Short-term interest rate (percentage points)	–0.3	–0.6	–1.0	–1.6	–1.9
Japan					
Real GDP	–0.4	–0.7	–1.1	–1.6	–2.0
Potential output	–0.5	–1.0	–1.5	–2.0	2.5
Real domestic demand	–0.4	–0.8	–1.3	–1.9	–2.6
Real investment	0.3	0.5	–0.1	–0.7	–1.5
Real effective exchange rate	–1.4	–2.7	–3.9	–5.1	–6.6
Real U.S. dollar exchange rate	—	—	—	—	—
Current account ($billion)	–3.5	–5.2	–4.8	–2.2	4.2
Net private sector savings	–0.1	–0.3	–0.3	–0.3	–0.2
CPI inflation (percentage points)	0.1	0.1	0.1	0.1	0.2
Short-term Interest Rates (percentage points)	–0.1	—	—	0.1	0.2
Other industrial economies					
Real GDP	–0.6	–1.1	–1.6	–2.1	–2.6
Real domestic demand	–0.3	–0.5	–0.8	–1.1	–1.3
Current account ($billion)	–7.2	–15.2	–23.1	–32.8	–45.3
Industrial countries					
Real GDP	–0.8	–1.3	–1.7	–2.2	–2.6
Real domestic demand	–0.8	1.2	–1.6	–2.0	–2.4
Current account ($billion)	–1.7	–0.7	1.5	3.2	5.5
Developing countries					
Real GDP	–0.3	–0.5	–0.7	–1.0	–1.2
Real domestic demand	–0.4	–0.6	–0.9	–1.2	–1.6
Current account ($billion)	1.7	0.7	–1.5	–3.2	–5.5

Monetary conditions are eased significantly, although the reduction in short-term interest rates is constrained by the inflationary impulse from the depreciation of the dollar. Real GDP shows a similar, if less dramatic, fall, being reduced by 2½ percent by 2003. With the retrenchment in real domestic demand over one-and-a-half times the fall in real output, the current account balance steadily improves, by about $160 billion in 2006, when private sector borrowing has fallen by three-quarters of a percentage point of GDP. These effects would be even larger if future productivity growth was assumed to be more robust in the rest of the world. An alternative scenario reported in the October 2000 *World Economic Outlook* suggests that if future growth in the euro area and Japan is ½ percent a year higher than in the baseline, the U.S. current account would increase by around $50 billion after five years.

Turning to the rest of the world, despite the significant reduction in future productivity growth, real domestic demand rises *above* baseline in the euro area and remains close to baseline in the other industrial country group. In response to the exchange rate appreciation and resulting lower inflation, the authorities in these regions lower short-term interest rates, leading to somewhat looser monetary conditions. This boosts investment and consumption, which are also supported by the diminution in capital flows to the United States. The impact on real net exports of exchange rate appreciation and weak demand in the United States, however, is such that output remains mildly below the (weaker) path for potential output. In Japan, by contrast, the lack of room for monetary easing means that domestic demand cannot substitute for the loss of external demand. Domestic demand falls by 2 percent compared to baseline and real GDP by 1½ percent after two years, associated with a rapid reduction in real imports, and continues to deteriorate at a slower rate thereafter. In developing countries, domestic demand is trimmed by slightly more than real GDP, as lower demand from the advanced economies pushes output below baseline—an outcome that could be exacerbated by significant financial turbulence in emerging markets. The counterpart to the decrease in the U.S. current account deficit is deteriorating balances in the euro area and the other industrial country group.

In the case when financial markets realize the fall in productivity more slowly, the responses of domestic demand, real GDP, and the current account are correspondingly more gradual over time (Table 1.16). In the case when the dollar depreciates, by 2006 the longer-term real GDP outcomes are similar to the "immediate realization" case, although the divergences in real domestic demand and the current account are less dramatic. As a result, the U.S. current account balance improves by $90 billion by 2006, about two-thirds of the value in the "immediate realization" case, although some of the relative price effects may still not have occurred. Finally, when this scenario is repeated with the U.S. dollar being kept at its approximate baseline values, changes in net exports are more subdued, keeping the path of real GDP and domestic demand more closely correlated in the United States and elsewhere. By 2006, real GDP and real domestic demand are significantly lower in the United States than elsewhere despite the fact that the fall in total factor productivity is identical across countries, largely reflecting the impact of weaker U.S. investment over the intervening five years. As a result, even in this case, the U.S. current account improves by around $75 billion by 2006.

References

Aziz, Jahangir, forthcoming, "India's Interstate Poverty Dynamics," IMF Working Paper (Washington: International Monetary Fund).

Callen, Tim, and Warwick McKibbin, forthcoming, "Japan and Asia: Policy and Prospects," in *Japan: Selected Issues* (Washington: International Monetary Fund).

Chen, Shaohua and Martin Ravallion, 2000, "How Did the World's Poorest Fare un the 1990s?" World Bank Policy Research Working Paper No. 2409 (Washington: World Bank).

Christou, Costas, and Christina Daseking, forthcoming, "Balancing Fiscal Priorities: Challenges for the Central European Countries on the Road to EU Accession," in *The Road to EU Accession, a Collection of Papers Covering the Czech Republic, Hungary, Poland, the Slovak Republic, and Slovenia,* by an IMF staff team led by Robert A. Feldman and C. Maxwell Watson (Washington: International Monetary Fund).

Dollar, David, and Aart Kraay, 2000, "Growth is Good for the Poor," World Development Research Group (Washington: World Bank).

Moser, Gary, and Toshihiro Ichida, 2001, "Economic Growth and Poverty Reduction in Sub-Saharan Africa," IMF Working Paper 01/112 (Washington: International Monetary Fund).

Moser, Gary, Nicholas Staines, and Lars Engstrom, forthcoming, " Economic Development in Post-Conflict

Countries in Sub-Saharan Africa," IMF Working Paper (Washington: International Monetary Fund).

National Council of Applied Economic Research, 1996, "Human Development Profile of India: Interstate and Inter Group Differentials" (New Delhi).

Ravallion, Martin, and Shaohua Chen, 1997, "What Can New Survey Data Tell Us About Recent Changes in Distribution and Poverty?" *World Bank Economic Review*, Vol. 11, No. 2, pp. 357–82.

World Bank, 2000, *India: Reducing Poverty, Accelerating Development* (Washington: World Bank).