

Over recent months, there have been increasing signs that the global slowdown has bottomed out, most clearly in the United States and to a lesser extent in Europe and some countries in Asia. While serious concerns remain in a number of countries, notably Japan and—for different reasons—Argentina, most indicators suggest recovery is now under way, broadly along the lines described in the Interim World Economic Outlook issued last December (Figure 1.1). With confidence stabilizing, uncertainties easing, and emerging market financing conditions improving more quickly than was then anticipated, the risks to the outlook have become more balanced, although the recent volatility in the oil market is a significant concern. While the stance of policies should remain relatively supportive for the time being, there is now—except in Japan—little case for additional easing, and in countries where the recovery is most advanced, attention will need to turn toward reversing earlier monetary policy easing. It will be important to take full advantage of the recovery to reduce remaining economic vulnerabilities, and to pursue a collaborative approach designed to promote an orderly resolution of global imbalances—which remain a serious risk to economic stability—over the medium term.

There are now increasing signs that the global slowdown, which began in the middle of 2000, has bottomed out. As had been suggested in the October 2001 *World Economic Outlook*, the events of September 11 had a short-run impact on activity, but—in contrast to the fears that some expressed—have not prevented a recovery in the first half of 2002.¹ Leading indicators have turned up (Figure 1.2); consumer and business confidence have strengthened; and industrial production—including the information technology (IT) sector—is leveling off. This has been most apparent in the United States and, increasingly, the euro area; in Japan, while activity may now be bottoming out, the outlook remains very difficult with few signs of a sustained recovery in domestic demand. In emerging markets, there are signs of recovery in a number of Asian emerging markets—particularly Korea—aided by the nascent improvement in the IT sector, although not as yet in most Latin American countries.

Growing expectations of recovery have been particularly apparent in financial markets, which recovered strongly after the events of September 11 (Figure 1.3). Equity markets have picked up sharply across the globe, although flattening off in the first quarter of 2002; yield curves have steepened; and risk aversion and spreads—in both mature and emerging markets—have declined. Partly reflecting market expectations of the relative pace of recovery, the U.S. dollar has strengthened further, accompanied by a moderate weakening of the euro, while the yen has fallen to three-year lows. In emerging markets, contagion from the crisis in Argentina has to date been limited, reflecting the fact that the crisis was well anticipated, and that gross international capital flows were already at low levels (Figure 1.4), as well as a number of technical factors, including the relatively low leverage in the system.² Spreads for most emerging market debt have declined sharply since early November, and financing conditions for emerging market borrowers have improved more rapidly than

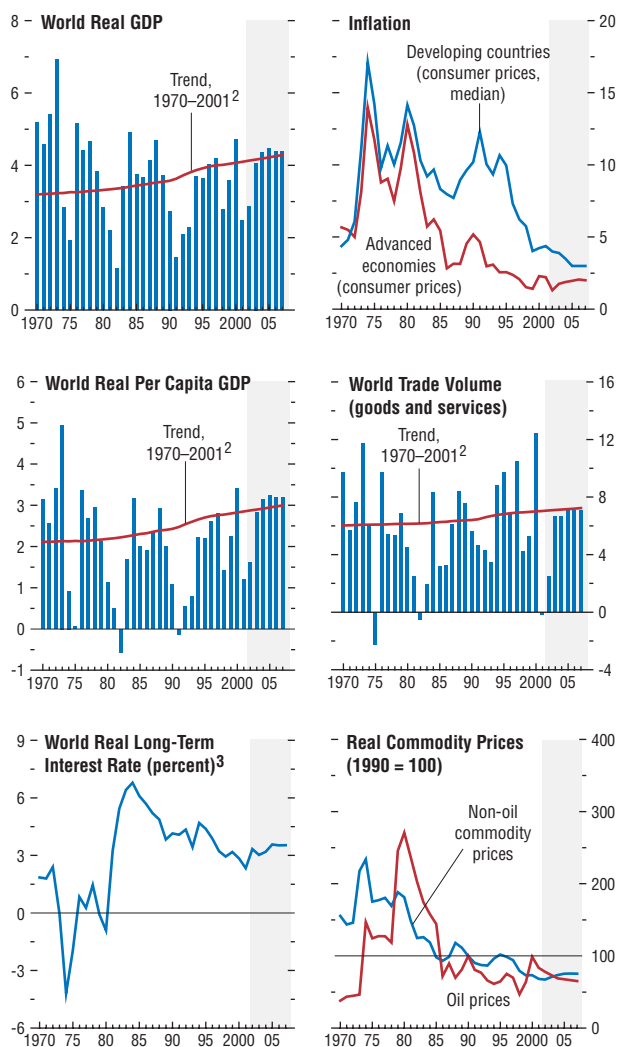
¹See Box 1.1, *World Economic Outlook*, October 2001.

²See “Contagion and Its Causes,” Chapter I, Appendix I, *World Economic Outlook*, December 2001.

Figure 1.1. Global Indicators¹

(Annual percent change unless otherwise noted)

While global growth is expected to increase moderately in 2002, this disguises a sharper pickup in activity during the year (see text). Inflation remains subdued.



¹Shaded areas indicate IMF staff projections. Aggregates are computed on the basis of purchasing-power-parity weights unless otherwise indicated.

²Average 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.

³GDP-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.

earlier anticipated, with high-quality borrowers reaccessing markets toward the end of 2001, followed increasingly thereafter by non-investment-grade issuers.

The recovery is being underpinned by a number of factors. First, and most important, macroeconomic policies in advanced countries have been substantially eased over the past year, notably in the United States, and—particularly since interest rate cuts were anticipated by markets, and therefore built into asset prices in advance—should now be providing increasing support to demand. Policies in a number of emerging market countries, especially in Asia, have also been eased, although in most others the scope has been relatively limited. Second, the completion of ongoing inventory cycles, which appears most advanced in the United States but is also under way in Europe, will support economic activity. Finally, activity has also been supported by the decline in oil prices since late 2000. Since late February, however, oil prices have risen significantly, reflecting concerns about possible military intervention in the Middle East, the deteriorating security situation in Israel and the West Bank and Gaza, as well as the strengthening global recovery. At the time the *World Economic Outlook* went to press, oil prices had returned to broadly their mid-2001 level, still well below their fall 2000 peak, and prices in futures markets were only moderately higher than the oil price assumption on which the forecasts in this *World Economic Outlook* are based (Table 1.1). Nonetheless, the past fall in oil prices will provide less support to recovery than earlier expected, while the potential for further volatility has become a significant risk to the outlook.

Inflationary pressures have continued to ease, reflecting weaker global activity. In advanced countries, inflation is projected to fall to 1.3 percent in 2002, the lowest level on record, and—while important wage negotiations in the euro area are still in train—wage increases have in general been moderate. Indeed, if sustained, inflation this low could be a concern, since it could limit the ability of central banks to engineer negative real interest rates when neces-

sary.³ Deflation remains a central issue in Japan, where prices appear set to fall for the fourth successive year. Elsewhere, however, the forces restraining prices are likely to ease as recovery gets under way, as excess capacity declines and commodity prices—especially oil—pickup (see Appendix 1.1). In emerging and developing countries, inflation is also projected to fall, although it remains of concern in the Commonwealth of Independent States—especially the less advanced reformers—some European Union (EU) accession countries, and a few countries in Latin America and Africa.

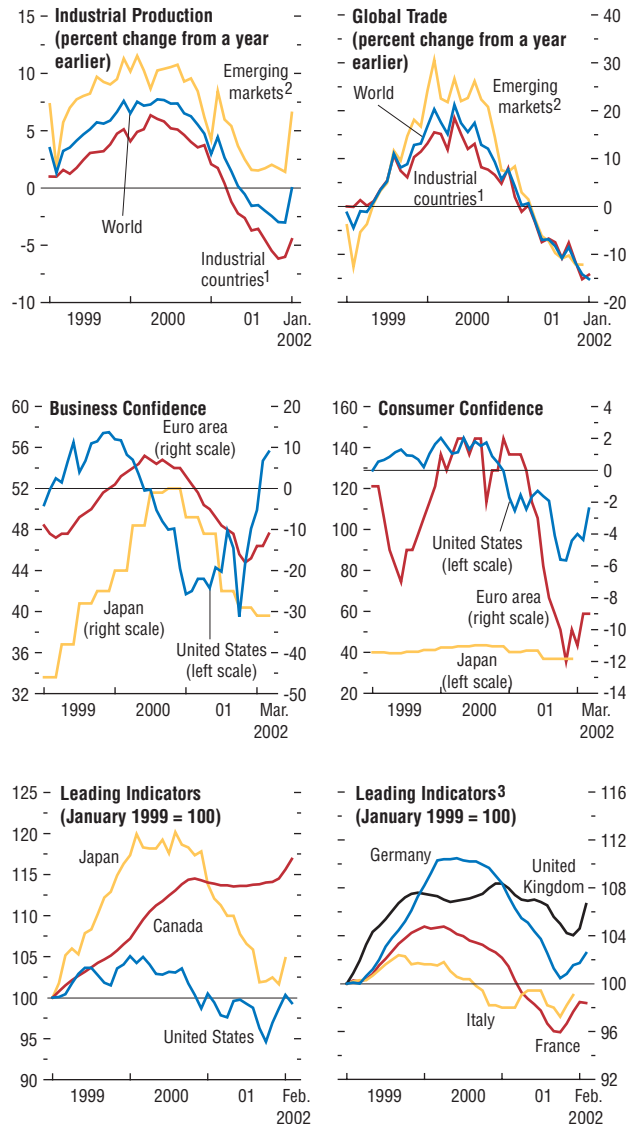
Assuming that the recovery is sustained, this global slowdown—while seriously affecting many countries and regions—will have proved to be more moderate than most previous downturns, and would probably not qualify as a full-fledged global recession (Box 1.1). Global GDP growth and global per capita GDP growth (the best measure of the impact on global welfare) would remain above the troughs experienced in the three major global recessions of the past 30 years (although below the level experienced during the Asian crisis in 1997–98). This partly reflects long-run structural trends, including the tendency toward milder recessions in industrial countries (see Chapter III), and the growing role of China and India, which—being relatively closed—are less affected by global downturns (although these factors are at least partly offset by countervailing forces, including increasing financial and corporate sector linkages). However, it clearly also reflects the generally prompt and aggressive response of policymakers to the slowdown, and—linked to that—the progress that has been made in reducing vulnerabilities and strengthening economic fundamentals in advanced and developing countries.⁴ As experience during the past year has shown, managing the downturn has been considerably easier in countries with the scope for policy flexibility,

³See Box 2.2, “Can Inflation Be Too Low?”

⁴See “Statement of the Managing Director on the Situation of the World Economy and the Fund Response,” IMF News Brief No. 01/98, October 5, 2001.

Figure 1.2. Emerging Signs of Recovery

Signs of recovery are suggested by recent improvements in confidence and other leading indicators, particularly in the United States and Europe.



Sources: Haver Analytic. Business confidence for the United States, the National Association of Purchasing Managers; for the euro area, the European Commission; and for Japan, Bank of Japan. Consumer confidence for the United States, the Conference Board; for the euro area, the European Commission; and for Japan, the Economic Planning Agency. Leading indicator for the United States, the Economic Cycle Research Institute; for Japan, the Cabinet Office; for Canada, Statistics Canada; and for Germany, France, Italy, and United Kingdom, OECD Main Economic Indicators.

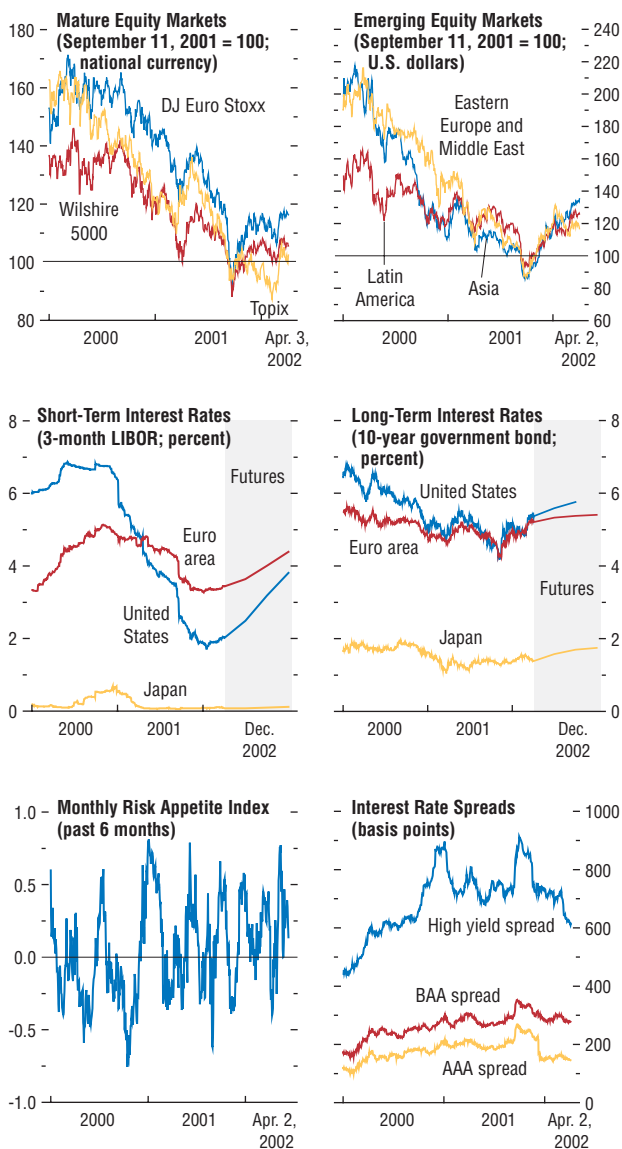
¹ Australia, Canada, Denmark, Euro area, Japan, New Zealand, Norway, Sweden, Switzerland, United Kingdom, and United States.

² Argentina, Brazil, Chile, China, Colombia, Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russia, Singapore, South Africa, Taiwan Province of China, Thailand, Turkey, and Venezuela.

³ Seasonally adjusted.

Figure 1.3. Financial Market Optimism

As expectations of a recovery have increased, financial markets have strengthened in almost all countries, accompanied by steepening yield curves and declining risk premiums and spreads.



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

while others have been forced to follow more procyclical policies, deepening the downturn and likely also slowing the ensuing recovery.

The main elements of the IMF's global forecast published in the Interim *World Economic Outlook* last December—which projected an upturn in the first half of 2002—have remained broadly unchanged. Global growth in 2002 is projected at 2.8 percent, somewhat higher than expected in December (Table 1.1). Growth in the United States—and countries with close economic links—has been revised significantly upward, as the pace of recovery has exceeded expectations. Elsewhere, adjustments to the forecast are more modest—with the exception of the Western Hemisphere, mainly due to the crisis in Argentina; the Middle East, due to lower than expected growth in oil exporters; and the Commonwealth of Independent States, reflecting the improved outlook for Russia. It is important to recognize that, while global GDP growth for 2002 is projected to be only slightly higher than in 2001, this disguises a substantial pickup during the year. As can be seen from Figure 1.5, global growth is projected to rise from 1½ percent in the last quarter of 2001 to nearly 4 percent by the end of 2002. As the full impact of this is felt, global growth is expected to rise to 4.0 percent in 2003, significantly above the long-run trend.

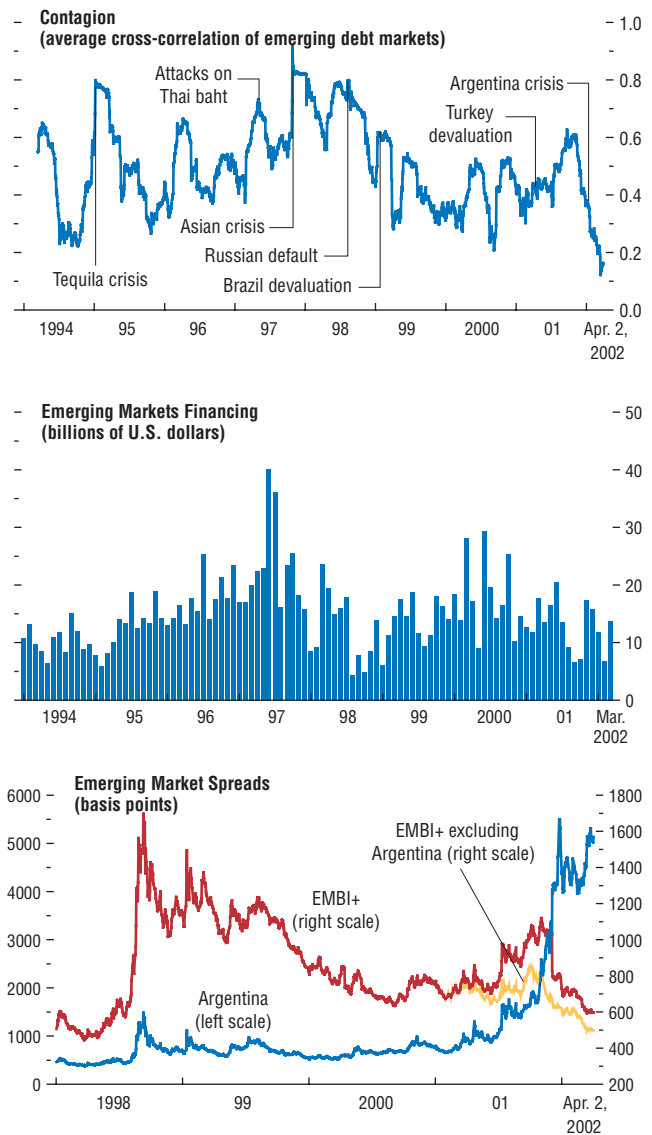
The global downturn has been more synchronized than the one in the early 1990s (although, as discussed in Chapter III, the degree of synchronicity has been broadly typical from a longer-term historical perspective). This has primarily been due to the commonality of shocks—notably, the bursting of the IT bubble, the run-up in oil prices in 2000, and the tightening of monetary policy from mid-1999 to end-2000—but has also reflected the increasing linkages across countries, particularly in the corporate and financial sphere. This naturally gives rise to the question whether the upturn in activity will be as synchronized. The IMF staff's projections suggest that the recovery in most regions will begin in the first half of 2002, with the United States in the lead, but the nature and pace will vary depending on the depth of the preceding

downturn, the openness of the economy, and the extent of policy stimulus in the pipeline, as well as country-specific factors and constraints.

- Among the *industrialized countries*, the upturn is expected to be strongest in the United States, driven initially by the completion of the inventory cycle, and a moderate pickup in final domestic demand (typical of the experience in past mild recessions), underpinned by the substantial macroeconomic stimulus in the pipeline as well as the effect of the previous fall in oil prices (Table 1.2). The pattern and drivers of the recovery in the *euro area* are likely to be broadly similar, but the pace slightly slower, reflecting the more moderate nature of the preceding slowdown, and the more limited policy easing in place. In contrast to the United States, there is less risk from domestic imbalances and corporate profitability remains strong, but weaker than expected external demand or rigidities in labor markets could dampen the pace of the rebound in the short and medium term. In contrast, the outlook for domestic demand in Japan remains very weak, and, while GDP growth (compared with the same period in the previous year) is expected to return to positive levels by the fourth quarter of 2002, this will primarily depend on an improvement in the external environment.
- Among the *major emerging markets*, the outlook varies widely. In Latin America, the recovery is likely to be strongest in Mexico and Central America, which are closely linked to the United States, as well as some Andean countries. In other countries, while they will benefit from improved conditions in financial markets, the pace of recovery will be more subdued; in *Argentina*, the situation remains extremely difficult and a substantial decline in output appears unavoidable. In emerging Asia, growth in China and to a lesser extent India is expected to remain relatively resilient. The highly open economies in the rest of the region will benefit from the pickup in external demand—supported in a number of cases by domestic policy stimulus—although much will depend on the pace of recovery in the IT sector, which ac-

Figure 1.4. Emerging Market Financing Conditions

Emerging market financing conditions have improved markedly, while contagion from the crisis in Argentina has been limited.



Sources: Bloomberg Financial Markets, LP; and IMF, *Emerging Market Financing*.

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

	2000	2001	Current Projections		Difference from December 2001 Projections ¹	
			2002	2003	2001	2002
World output	4.7	2.5	2.8	4.0	0.1	0.4
Advanced economies	3.9	1.2	1.7	3.0	0.1	0.8
Major advanced economies	3.5	1.1	1.5	2.8	0.1	0.9
United States	4.1	1.2	2.3	3.4	0.2	1.6
Japan	2.2	-0.4	-1.0	0.8	—	—
Germany	3.0	0.6	0.9	2.7	0.1	0.2
France	3.6	2.0	1.4	3.0	-0.1	0.1
Italy	2.9	1.8	1.4	2.9	—	0.2
United Kingdom	3.0	2.2	2.0	2.8	-0.1	0.2
Canada	4.4	1.5	2.5	3.6	0.1	1.7
Other advanced economies	5.3	1.6	2.5	3.7	0.1	0.6
<i>Memorandum</i>						
European Union	3.4	1.7	1.5	2.9	—	0.2
Euro area	3.4	1.5	1.4	2.9	—	0.2
Newly industrialized Asian economies	8.5	0.8	3.6	5.1	0.4	1.6
Developing countries	5.7	4.0	4.3	5.5	-0.1	-0.2
Africa	3.0	3.7	3.4	4.2	0.1	-0.2
Developing Asia	6.7	5.6	5.9	6.4	—	0.2
China	8.0	7.3	7.0	7.4	—	0.2
India	5.4	4.3	5.5	5.8	-0.1	0.3
ASEAN-4 ²	5.1	2.6	3.3	4.1	0.2	0.4
Middle East and Turkey ³	5.8	2.1	3.3	4.5	-0.1	-0.7
Western Hemisphere	4.0	0.7	0.7	3.7	-0.3	-1.0
Brazil	4.4	1.5	2.5	3.5	-0.3	0.5
Countries in transition	6.6	5.0	3.9	4.4	—	0.2
Central and eastern Europe	3.8	3.1	3.0	4.0	0.1	-0.2
Commonwealth of Independent States and Mongolia	8.3	6.2	4.5	4.6	0.1	0.6
Russia	9.0	5.0	4.4	4.9	-0.8	0.8
Excluding Russia	7.0	8.8	4.7	4.1	1.9	—
<i>Memorandum</i>						
World growth based on market exchange rates	4.0	1.4	1.8	3.2	—	0.6
World trade volume (goods and services)	12.4	-0.2	2.5	6.6	-1.2	0.3
Imports						
Advanced economies	11.6	-1.5	2.1	6.6	-1.2	0.7
Developing countries	16.0	2.9	6.4	7.7	-2.0	-0.1
Countries in transition	13.2	10.8	8.0	7.7	-0.5	0.2
Exports						
Advanced economies	11.7	-1.3	0.9	6.3	-1.0	0.3
Developing countries	15.0	3.0	4.8	7.0	-0.5	0.2
Countries in transition	14.6	6.3	5.2	6.1	-1.5	-1.4
Commodity prices (U.S. dollars)						
Oil ⁴	57.0	-14.0	-5.3	-4.4	—	18.4
Nonfuel (average based on world commodity export weights)	1.8	-5.5	-0.1	7.2	—	-1.8
Consumer prices						
Advanced economies	2.3	2.2	1.3	1.8	-0.1	—
Developing countries	6.1	5.7	5.8	5.1	-0.3	0.5
Countries in transition	20.2	15.9	10.8	8.7	-0.3	-0.3
Six-month London interbank offered rate (LIBOR, percent)						
On U.S. dollar deposits	6.6	3.7	2.8	4.5	-0.1	0.1
On Japanese yen deposits	0.3	0.2	0.1	0.1	—	—
On euro deposits	4.6	4.1	3.7	4.5	—	0.8

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during February 11–March 11, 2002.

¹Using updated purchasing-power-parity (PPP) weights, summarized in the Statistical Appendix, Table A.

²Includes Indonesia, Malaysia, the Philippines, and Thailand.

³Includes Malta.

⁴Simple 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 \$24.28 in 2001; the assumed price is \$23.00 in 2002, and \$22.00 in 2003.

counts for a substantial share of output and exports. In the Middle East, growth has been adversely affected by lower oil prices—although the recent rebound will help—as well as the deterioration in the security situation. Turkey is gradually recovering from the severe recession of 2001, but the economy remains vulnerable to adverse shocks. In contrast, growth in the Commonwealth of Independent States has been relatively unaffected by the slowdown, buoyed by solid growth in Russia and Ukraine. Activity in central and eastern European economies—except Poland—has also held up well, aided by robust domestic demand and foreign direct investment.

- While the *poorest* countries have clearly been adversely affected by the slowdown, primarily through lower commodity prices and falling external demand, growth has in general been surprisingly well sustained, especially in those countries with the strongest domestic policies. This has been aided by the ending of a number of conflicts in Africa, as well as the resources released under the Heavily Indebted Poor Countries Initiative (HIPC). Growth in the HIPC countries is projected to pick up further in 2003 and beyond, although it is important to recognize that in the past the IMF’s forecasts for African countries have proved consistently optimistic.⁵

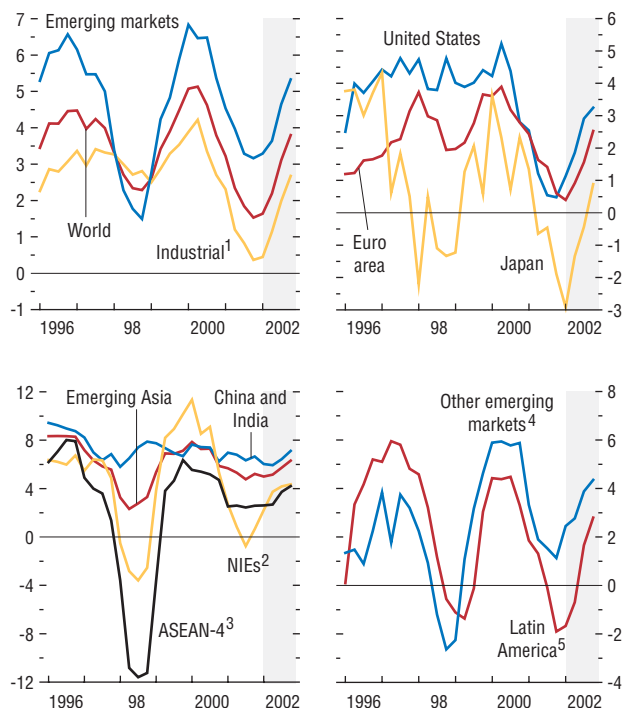
As noted above, the risks to the forecast have become more balanced over the past months. There are good reasons to expect a pickup in activity in the period ahead; indeed it is possible that the pace of recovery could exceed expectations, as has generally been the case in the past (Box 1.2). Nonetheless, there are also significant risks to the sustainability and durability of the upturn, in the United States and elsewhere, which will pose important challenges for policy-makers in the period ahead.

- *First, the late 1990s saw the cumulative development of a number of imbalances in the U.S. and the*

⁵In part reflecting the impact of natural disasters and conflicts. See Box 3.1, *Interim World Economic Outlook*, December 2001.

Figure 1.5. Global Recovery
(Percent change from four quarters earlier)

Real GDP in most regions is expected to have bottomed out in late 2001, with a recovery beginning in the first half of 2002.



Sources: Haver Analytics; and IMF staff estimates.
¹Australia, Canada, Denmark, euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom, and the United States.
²Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.
³Indonesia, Malaysia, Philippines, and Thailand.
⁴Czech Republic, Hungary, Israel, Poland, Russia, South Africa, and Turkey.
⁵Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

Table 1.2. Advanced Economies: Real GDP, Consumer Prices, and Unemployment
(Annual percent change and percent of labor force)

	Real GDP				Consumer Prices				Unemployment			
	2000	2001	2002	2003	2000	2001	2002	2003	2000	2001	2002	2003
Advanced economies	3.9	1.2	1.7	3.0	2.3	2.2	1.3	1.8	5.9	6.0	6.4	6.2
Major advanced economies	3.5	1.1	1.5	2.8	2.3	2.1	1.1	1.7	5.8	6.0	6.5	6.3
United States	4.1	1.2	2.3	3.4	3.4	2.8	1.4	2.4	4.0	4.8	5.5	5.3
Japan	2.2	-0.4	-1.0	0.8	-0.8	-0.7	-1.1	-0.5	4.7	5.0	5.8	5.7
Germany	3.0	0.6	0.9	2.7	2.1	2.4	1.5	1.2	7.9	7.9	8.2	8.1
France	3.6	2.0	1.4	3.0	1.8	1.8	1.5	1.4	9.5	9.0	9.2	8.7
Italy	2.9	1.8	1.4	2.9	2.6	2.7	2.2	1.6	10.6	9.5	9.3	8.9
United Kingdom ¹	3.0	2.2	2.0	2.8	2.1	2.1	2.4	2.5	5.6	5.1	5.4	5.4
Canada	4.4	1.5	2.5	3.6	2.7	2.5	0.9	1.8	6.8	7.2	7.1	6.7
Other advanced economies	5.3	1.6	2.5	3.7	2.4	2.9	2.0	2.1	6.2	6.1	6.3	5.8
Spain	4.1	2.8	2.3	3.2	3.5	3.2	2.3	2.3	14.1	13.0	13.0	12.4
Netherlands	3.5	1.1	1.4	2.7	2.3	5.1	3.4	2.3	2.6	2.0	2.5	2.7
Belgium	4.0	1.1	0.9	3.2	2.7	2.4	1.1	1.2	6.9	6.6	7.3	7.0
Sweden	3.6	1.2	1.6	2.7	1.0	2.6	2.3	2.2	4.7	4.0	4.4	4.3
Austria	3.0	1.0	1.3	2.9	2.0	2.3	1.8	1.6	3.7	3.8	4.1	3.8
Denmark	3.0	0.9	1.3	2.4	2.9	2.1	2.3	2.2	5.2	5.0	5.2	5.2
Finland	5.7	0.7	1.4	3.1	3.0	2.6	1.5	1.6	9.8	9.2	9.8	9.7
Greece	4.3	4.1	3.4	2.9	2.9	3.7	3.3	2.7	11.4	10.9	10.9	10.7
Portugal	3.2	1.6	0.8	2.0	2.8	4.4	2.9	2.2	4.0	4.1	4.2	4.3
Ireland	11.5	6.0	3.2	6.2	5.3	4.0	4.4	3.0	4.3	4.0	4.7	4.7
Luxembourg	7.5	5.1	3.0	6.0	3.2	2.7	1.9	1.8	2.6	2.5	2.9	2.7
Switzerland	3.0	1.3	0.8	2.6	1.6	1.0	1.0	1.0	2.0	1.9	2.6	2.3
Norway	2.3	1.4	2.3	2.2	3.1	3.0	1.5	2.5	3.4	3.6	3.8	3.7
Israel	6.4	-0.6	1.3	3.8	1.1	1.1	3.1	2.1	8.8	9.3	10.5	9.4
Iceland	5.0	2.1	-0.9	1.9	5.0	6.7	6.4	3.5	1.3	1.7	2.3	2.6
Cyprus	5.1	4.0	3.0	4.2	4.1	2.0	1.8	2.2	3.4	3.6	3.8	4.0
Korea	9.3	3.0	5.0	5.5	2.3	4.1	2.7	2.6	4.1	3.7	3.5	3.5
Australia ²	3.2	2.4	3.9	4.0	4.5	4.4	2.3	2.3	6.3	6.7	6.7	6.5
Taiwan Province of China	5.9	-1.9	2.3	4.8	1.3	—	0.4	1.6	3.0	5.1	5.0	4.9
Hong Kong SAR	10.5	0.1	1.5	3.6	-3.7	-1.6	-2.5	—	4.9	5.0	5.6	5.4
Singapore	10.3	-2.1	3.2	5.1	1.1	1.0	1.1	1.6	3.1	4.7	4.4	3.7
New Zealand ²	3.9	2.4	2.6	3.0	2.7	2.7	1.8	1.5	6.0	5.3	5.5	5.6
<i>Memorandum</i>												
European Union	3.4	1.7	1.5	2.9	2.3	2.6	2.0	1.8	8.2	7.7	7.9	7.7
Euro area	3.4	1.5	1.4	2.9	2.4	2.6	1.9	1.6	8.8	8.3	8.5	8.2

¹Consumer prices are based on the retail price index excluding mortgage interest.

²Consumer prices excluding interest rate components; for Australia, also excluding other volatile items.

global economy—notably, the large U.S. current account deficit and surpluses elsewhere (Table 1.3), the low U.S. personal savings rate, the apparent overvaluation of the U.S. dollar and undervaluation of the euro, and relatively high levels of corporate and household indebtedness in a number of countries. As has been discussed extensively in previous issues of the *World Economic Outlook*, these imbalances have been driven in large part by the relatively rapid growth in the United States relative to other countries. This, in turn, partly reflected cyclical factors, but also resulted from the improvement in U.S. productivity

growth relative to other countries. Partly because the downturn has been so synchronized and the recession in the United States has been mild, there has been only a moderate correction in these imbalances during the downturn, and the process by which this correction eventually occurs will importantly affect the outlook. For example, given the substantial stimulus in the pipeline, it is possible U.S. growth could rebound more quickly than expected, which would lead to a further widening of these imbalances. While this would likely be manageable in the short term, especially if underlying U.S. productivity growth remained

**Table 1.3. Selected Economies:
Current Account Positions**
(Percent of GDP)

	2000	2001	2002	2003
Advanced economies	-1.0	-0.8	-0.8	-0.7
Major advanced economies	-1.6	-1.4	-1.4	-1.4
United States	-4.5	-4.1	-4.1	-4.0
Japan	2.5	2.1	2.9	3.4
Germany	-1.0	0.5	0.5	0.6
France	1.8	2.5	2.5	2.2
Italy	-0.5	0.4	0.7	1.0
United Kingdom	-1.8	-1.8	-2.1	-2.3
Canada	2.5	2.7	1.8	1.6
Other advanced economies	1.8	2.5	2.4	2.3
Spain	-3.1	-2.0	-1.7	-1.6
Netherlands	3.0	3.1	3.7	3.3
Belgium-Luxembourg	4.8	4.9	4.9	4.7
Sweden	2.6	3.3	3.0	3.0
Austria	-2.8	-2.4	-1.6	-1.4
Denmark	1.6	2.9	2.5	3.2
Finland	7.4	5.4	4.8	4.9
Greece	-6.8	-6.2	-6.1	-6.0
Portugal	-10.4	-9.7	-9.3	-8.9
Ireland	-0.6	-0.6	-1.4	-1.6
Switzerland	12.9	10.2	10.8	11.3
Norway	14.3	14.8	13.9	13.1
Israel	-1.2	-1.5	-1.7	-2.1
Iceland	-10.3	-6.9	-5.2	-3.9
Cyprus	-5.2	-4.3	-3.9	-3.7
Korea	2.7	2.0	1.5	0.6
Australia	-4.0	-2.6	-3.2	-2.7
Taiwan Province of China	2.9	6.7	6.6	6.6
Hong Kong SAR	5.5	7.4	7.7	7.7
Singapore	17.0	23.3	21.4	21.4
New Zealand	-5.6	-3.2	-4.5	-4.2
<i>Memorandum</i>				
European Union	-0.4	0.4	0.4	0.4
Euro area ¹	-0.2	0.7	0.8	0.8

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

strong, it could adversely affect the sustainability of recovery later on, particularly if growth in other countries did not pick up, and increase the possibility of an eventual disorderly adjustment.⁶ It is also possible, however, that the recovery in the United States could be weaker than expected, partly because of the imbalances—for instance, if private investment is held back by weak profitability or excess capacity proves more widespread than presently believed, or if U.S. households and businesses

seek to strengthen savings and balance sheets earlier. In that case, the imbalances would likely correct sooner, but at the cost of a more subdued recovery in both the United States and the rest of the world.

- *Second, as also stressed in the IMF's Global Financial Stability Report, financial markets may still embody relatively optimistic expectations for corporate profitability and the pace of recovery. Were these expectations to be disappointed, there would likely be a downward adjustment in asset prices, which could adversely affect both consumer and business confidence and demand more generally. These risks may be heightened by the weaknesses in the accounting and auditing framework highlighted following the recent collapse of Enron, which has raised concerns that the financial positions of other firms could also prove weaker than expected. Beyond this, while the international financial infrastructure has generally held up well in the face of the shocks experienced in 2001, a decline in asset prices or delayed recovery could put pressure on financial institutions in countries where the pace of consolidation and restructuring has lagged, as well as the performance of certain financial markets, notably for credit derivatives.*
- *Third, the situation in Japan, which is presently undergoing its worst recession in the postwar period, remains a source of serious concern. Given the limited macroeconomic policy options, weak activity in Japan is proving increasingly difficult to offset through policy actions—with negative consequences, particularly for the rest of the region. The financial position of the banking system has become increasingly strained as loan-loss announcements have increased, and this is undermining confidence. Further, growing concerns about debt sustainability and additional downgrades by rating agencies make the government bond market vulnerable to a sharp swing in investor sentiment and a spike in yields.*

⁶See also "Alternative Scenarios: How Might Medium-Term Productivity Growth Affect the Short-Term Outlook?" Chapter I, Appendix II, *World Economic Outlook*, October 2001, for a detailed discussion.

Box 1.1. Was It a Global Recession?

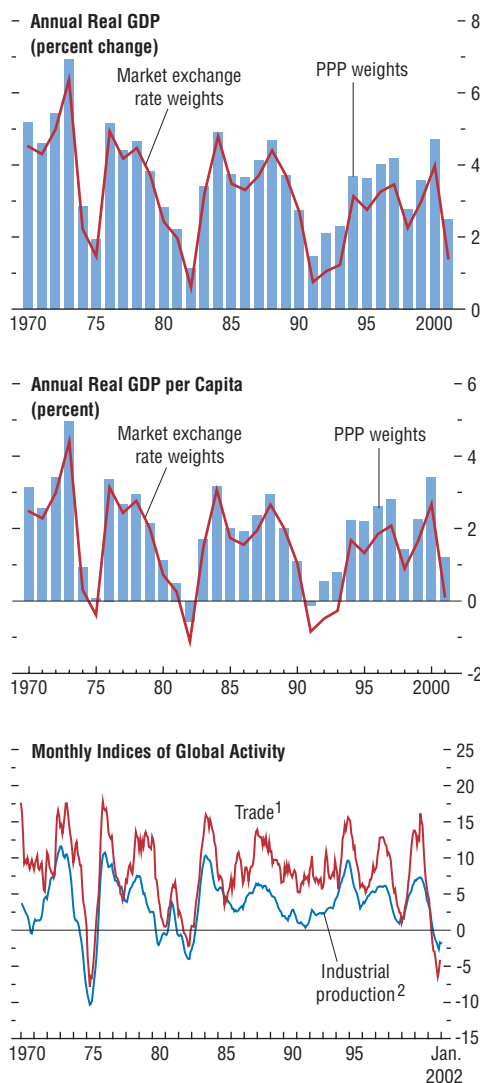
Perhaps the most conventional rule of thumb for defining a national recession is two straight quarters of negative GDP growth (see Chapter III on recessions). Unfortunately, this simple rule does not translate well to the global context. First, quarterly real GDP data are weak; for a number of major emerging market countries, quarterly output data do not exist before the mid-1990s, and there are still many countries that do not report GDP on a quarterly basis. Even among those that do, national methods for seasonally adjusting output data differ to such an extent that meaningful aggregation is difficult. Second, while we cannot measure it exactly, it is likely that quarterly global growth does not turn negative nearly as often as does GDP within the typical country. Indeed, annual global growth has never been negative for any year in recent history (see the first figure, which shows global GDP growth using the IMF's purchasing-power-parity (PPP) weights to aggregate country income.)

The principal reason that global growth is rarely negative is that world output is more diversified than national output. For example, the United States, Europe, and Japan do not always experience downturns at the same time. Data on annual real GDP indicate that this slowdown has a similar level of synchronization as earlier episodes in the mid-1970s and early 1980s, even though growth in China (in particular) has remained relatively robust over this slowdown. The lower level of synchronization in the early 1990s was an exception—largely reflecting specific regional events, including the asset price bubble in Japan and the consequences of German unification activity in continental Europe. It is also the case that trend growth for the world is higher than for most advanced economies because developing countries grow faster on average, so it takes a steeper dip to hit negative territory.

The main authors are Kenneth Rogoff, David Robinson, and Tamim Bayoumi, in consultation with other members of a committee that included Carmen Reinhart, Manmohan Kumar, and Aasim Husain.

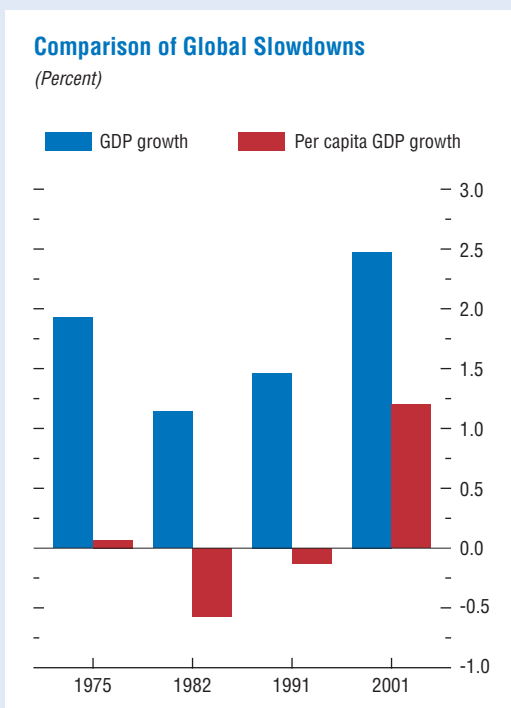
Measures of Global Activity

(Percent change from a year earlier; three-month centered moving average unless otherwise indicated)



Sources: IMF, *International Financial Statistics*; OECD, *Main Economic Indicators*; and WEFA-DRI.
¹Weighted average of imports and exports trade volumes, using 1993 trade weights.
²PPP-weighted average.

While global output may rarely decline, it is useful to have a simple benchmark for identify-



ing slowdowns that could be labeled as global recessions. One reasonable solution to this conundrum is to adjust world output growth for growth in world population, and declare that a sufficient (although not necessary) condition for a global recession is any year in which world per capita growth (on a PPP basis) is negative. In the second figure, the first bars show unadjusted world GDP growth during the major recent slowdowns, 1975, 1982, 1991, and 2001. In no case did world growth dip below 1 percent, much less turn negative. In 1975, GDP growth of 1.9 percent was almost exactly offset by world population growth, so that per capita GDP growth was about zero. However, per capita GDP growth actually turned negative in 1982 and, to a lesser extent, in 1991. By contrast, per capita GDP growth in 2001 was over 1 percent, well above zero. Compared with the earlier episodes, unadjusted growth was stronger at 2.5 percent, instead of dipping below 2 percent as in the previous episodes. Also, world population growth is lower today (1.3 percent) than it was a

decade earlier. Thus, the current slowdown has not come close to meeting the hurdle of negative per capita annual GDP growth, which would automatically qualify it as a recession. This partly reflects the relatively high weight of China, which has continued to grow strongly, in the IMF PPP weights. Nonetheless, even going to the extreme of using market exchange rate-based weights (which substantially reduce China's weight), per capita GDP growth would still remain slightly positive in 2001.

Can we declare that the world is not in recession simply because annual global per capita growth is positive? No, not necessarily. While negative per capita GDP growth (using IMF PPP weights) is a sufficient condition to identify a global recession, by itself it would probably be unduly conservative. As in the case of individual recessions, one can not rely absolutely on any mechanical rule, but instead some element of judgment is required. That is how recessions are identified in the United States by the National Bureau of Economic Research (NBER), for example. The NBER defines a recession as a significant decline in activity spread across the economy and lasting more than a few months, and focuses on economy-wide monthly series (especially nonfarm employment and real personal income less transfers). It also looks at data from manufacturing (real manufacturing and trade sales and industrial production), although—as the NBER notes—this is a relatively small part of the U.S. economy whose movements often differ from those of other sectors. The rule of thumb of two quarters of negative growth often referred to by commentators is simply a useful way of approximating this system. Indeed, in the recent downturn, the NBER committee chose to identify the U.S. slowdown as a recession even though, based on current information, GDP growth was only negative in the third quarter.

How might one apply these principles to identifying global recessions even when per capita GDP growth is positive? Given the data inadequacies, there is no simple extension of the NBER's methodology to the global economy. We have al-

Box 1.1 (concluded)

ready noted the difficulties in getting satisfactory quarterly global GDP, and certainly global versions of the main monthly indicators used by the NBER for the United States will not be available for the foreseeable future. However, there are monthly data on global industrial production and merchandise trade volumes, although—as in the United States—these focus on the manufacturing sector, which comprises less than one quarter of global GDP.¹ The first figure shows the change in industrial production and trade volumes at a global level since 1970. Both series clearly identify the global slowdowns after the two oil crises that are also clear in the real GDP data. Subsequently, however, the correspondence is less close. For example, growth in both monthly series remained positive in the recession of the early 1990s. Moreover, for the Asian crisis, both series suggest a more severe slowdown than does real GDP (partly reflecting the large manufacturing sectors in many Asian economies). The most recent data show a sharp fall in production and trade—corresponding to the synchronized and disruptive decline in manufacturing production, partly related to the information technology (IT) sector—but again the picture from these series appears more severe than that from

¹Manufacturing currently makes up slightly under 20 percent of GDP in industrial countries (down from almost 30 percent in 1970), and a relatively stable 23 percent in developing countries.

data on real GDP. Cyclical movements in manufacturing and trade tend to be larger than in overall activity. In addition, the manufacturing and trade series have been disproportionately impacted by the rapid fall in global IT.

Aside from the global aggregates, it is important to also look at the extent to which the slowdown is spread across the globe and the speed of the decline. If, for example, the United States experienced a sufficiently severe recession, global average numbers could be quite poor even if there were positive GDP growth elsewhere. This scenario would not, in our definition, qualify as a global recession. On the other hand, a particularly rapid and generalized fall from a high level to a much lower level should be an element of one's assessment. To ascertain the global nature of the slowdown, we considered, among other factors, quarterly GDP where available. These data indicate negative growth for the third quarter in some regions of the world, including the United States, Germany, Japan, and several emerging markets. While weakness remained in Germany and Japan in the fourth quarter, the United States rebounded. Growth in China and India has remained robust throughout.

Overall, therefore, our reading of the data indicates that the recent slowdown falls somewhat short of a global recession, certainly in comparison with earlier episodes that we would have labeled as global recessions. That said, it was a close call.

- *Finally, there are a number of specific risks to the outlook.* Most recently, the volatility in the oil market has become a significant potential risk to the recovery, especially if the security situation in the Middle East were to deteriorate further.⁷ Were oil prices to rise substantially further, there could be a significant impact on the global recovery (see Table 1.12 in Appendix 1.1, which shows the impact of higher oil prices on global growth). While oil

exporting countries would clearly benefit, there would be adverse effects on most industrial and many emerging market economies, notably in Asia, and many of the heavily indebted poor countries and several CIS countries could be quite seriously affected. Beyond this, the war against terrorism has so far gone better than expected but setbacks could adversely affect confidence; and, although contagion from developments in Argentina has so

⁷See IMF (2000) for a detailed discussion of the impact of oil price changes on the global economy.

Box 1.2. On the Accuracy of Forecasts of Recovery

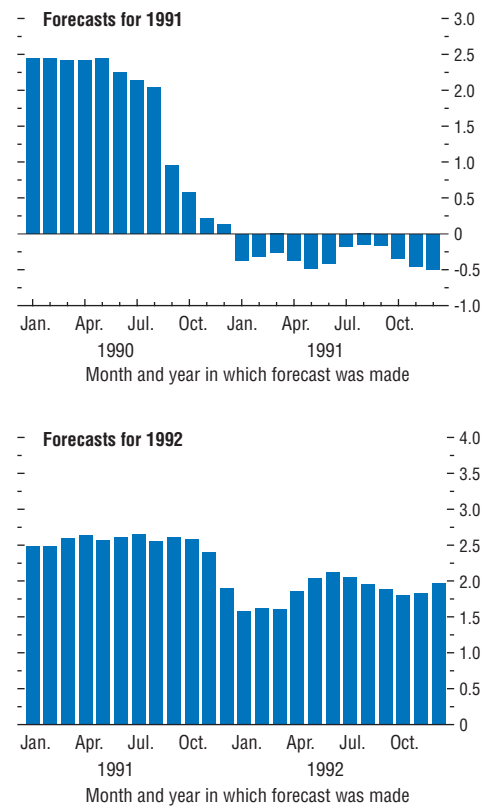
The consensus among economic forecasters is that the U.S. recession that started in March 2001 will be over during the course of this year. For example, the mean forecast for U.S. growth in 2002 reported by the March survey of *Consensus Forecasts* is 2.1 percent, which would imply a robust recovery in the second half of the year. Given economic forecasters' poor performance in predicting recessions,¹ it is natural to ask whether they are any better at predicting recoveries. It is difficult to answer this question using data for a single country as the number of recoveries for which consistent growth forecasts are readily available would be too small to make reliable inferences. Therefore, this box reviews the experience from a large sample of industrial countries to assess how well forecasters have done.

Cross-Country Evidence on Predicting Recoveries

The publication *Consensus Forecasts* has provided macroeconomic forecasts for 26 industrialized countries on a monthly basis since October 1989. Each issue of the publication surveys a number of prominent financial and economic analysts, and reports their individual forecasts as well as the mean forecast (the consensus). Every month, *Consensus Forecasts* contains a new forecast of average annual GDP growth in the current and forthcoming year. Thus, for example, between January 1990 and December 1991 there are 24 separate forecasts of real GDP growth in 1991.²

The behavior of forecasts during the U.S. recession and recovery of 1991–92 provides a good example of the behavior of forecasts around turning points (see the figure). In January 1990, the forecast for U.S. growth during 1991 was about 2.5 percent. Following Iraq's

**Consensus Forecasts of U.S. Growth for 1991–92
Recession and Recovery**
(Percent)



Source: Consensus Economics, Inc.

invasion of Kuwait in August 1990, forecasts for U.S. growth started to be marked down substantially. By the start of 1991, the forecast was for a modest recession that year (figure, top panel).

How did the recognition of the recession in 1991 affect the forecasts for 1992? Initially, not very much. The year-ahead forecasts for 1992 (the ones made during 1991) remained virtually unchanged at about 2.5 percent. The current-year forecasts for 1992 showed somewhat greater variation but clearly never came close to forecasting a continuation of the recession of the previous year (figure, bottom panel). The econ-

The main author is Prakash Loungani.

¹See Box 1.1, *World Economic Outlook*, May 2001, and Loungani (2001).

²The first 12 forecasts—the ones made during 1990—are referred to as *year-ahead* forecasts; the 12 forecasts made during 1991 are called *current-year* forecasts.

Box 1.2 (concluded)

omy did indeed recover and the forecast error was small.

The pattern displayed in the figure is quite typical of forecasts around turning points for the 25 other episodes of recessions and potential recoveries (in the subsequent year) since October 1989.³ Recessions typically arrive before they are forecast. The recognition that the country is in a recession does not generally lead to drastic markdowns of the forecast for the post-recession year. That is, forecasters act as though the recession is not going to lead to a second year of negative growth.

How well does this strategy work in delivering accurate forecasts? The simple answer is: “Reasonably well.” In three-fourths of cases over the 1990s, the recession did not result in a second year of negative growth.⁴ Hence, even though large forecast errors are made in the case of multiyear recessions, forecasting a recovery in the year following a recession turns out to be a reasonably good bet on average. Using the April survey of *Consensus Forecasts*, the mean absolute error of current-year forecasts for the 26 episodes of potential recoveries is 1.29 percentage points. This is only about half as large as the mean absolute error from a naive forecasting strategy of predicting a continuation of the recession. While the accuracy of the forecasts is quite good, there is a tendency for forecasts made at the start of the year of the recovery to underpredict it. This property was noted in the

³See Loungani (2002) for evidence from other industrialized countries.

⁴Over a longer period, as noted in Chapter III, 60 percent of recessions in industrial countries since 1973 lasted just one year.

case of forecasts of U.S. recoveries over the period 1972 to 1984 by Zarnowitz (1986). The U.S. recovery of 1992 and recoveries in the cross-country sample studied in this box also tended to be underpredicted—by about $\frac{1}{2}$ to $\frac{3}{4}$ of a percentage point—in forecasts made near the start of the year.

Comparison with WEO

On average, there is a high degree of similarity between forecasts made by the April *Consensus* survey and those reported in the IMF’s May *World Economic Outlook* during the years of potential recoveries: the mean absolute error of the May WEO forecasts is 1.24 percentage points, virtually identical to that of *Consensus Forecasts*. The forecast errors are also highly correlated at other forecasting horizons as well, such as comparing the October *Consensus* with the fall WEO current-year forecasts or comparing year-ahead forecasts; hence, the mean absolute errors for the two sources of forecasts are virtually the same at every forecasting horizon.

Conclusion

Conventional wisdom among forecasters is that the U.S. economy will start to grow again this year. What these forecasts have going for them is the fact that multiyear recessions are somewhat rarer than those that end in about a year. Over the 1990s, for the set of industrialized countries studied here, forecasting a recovery in the year following a recession has therefore turned out to be a reasonably good bet. So even though forecasters are caught flat-footed when recessions turn out to be multiyear, the message, broadly speaking, is, most recessions catch forecasters by surprise; most recoveries do not.

far been contained, risks remain, particularly for the other countries in the region.

In setting the stance of policies, policymakers will need to consider not just the baseline projections, but also the balance of these various risks and the costs associated with each. In making this assessment, a number of considerations are rele-

vant. First, given the past fall in commodity prices and substantial excess capacity in most industrial countries, and increasing evidence that the improvement in central bank credibility in recent years is helping to anchor inflationary expectations (Chapter II), long-term inflationary risks remain limited at this stage. Second, if growth in

some industrial countries were to disappoint, there could be a significant impact on the rest of the world, particularly in emerging market and developing countries. Third, while wider global imbalances would clearly be of concern, these should be addressed primarily through appropriate medium-term policies in the United States and better growth policies elsewhere. Overall, there appear to be three main policy priorities.

- *Macroeconomic policies in most industrial countries should remain broadly supportive of activity, although in countries where the recovery is most advanced, attention will need to turn toward reversing earlier monetary policy easing; in Japan, aggressive action to address deflation is required.* The Federal Reserve appropriately left U.S. interest rates on hold in March, while noting that the risks to price stability and growth had become broadly balanced. As the recovery progresses, some withdrawal of stimulus is likely to be required, while the focus of fiscal policy should shift to medium-term consolidation. In the *euro area*, with growing signs of recovery, the present stance of monetary policy is broadly appropriate, while the automatic stabilizers should be allowed to operate to support activity within the constraints of the Stability and Growth Pact. In Japan, macroeconomic policies should be as supportive as possible, including through more aggressive monetary easing to address deflation, even if this results in some further depreciation of the yen, and through an additional supplementary budget to maintain a broadly neutral fiscal stance in 2002 and 2003 (Table 1.4).
- *The medium-term policy framework needs to be geared toward supporting sustainable growth and an orderly reduction in the global imbalances.* As has been argued in many previous issues of the *World Economic Outlook*, the global imbalances reflect not just not the past strong growth in the United States—and the excesses that were associated with it—but also relatively weak growth in other parts of the world. Consequently, decisive action to reinvigorate activity in Japan, continued structural reforms to encourage growth in the euro area, building on the progress

made at the Barcelona summit, and continued corporate and financial sector reform in some Asian emerging markets with large current account surpluses, are a priority from both national and international perspectives. In the United States, in turn, it will be important to avoid exacerbating external imbalances by ensuring that fiscal balance (excluding social security) is restored over the medium term (see Appendix 1.2 for a detailed discussion).

- *As experience during the downturn has shown, it remains essential to press ahead with efforts to reduce vulnerabilities and maximize the scope for policy flexibility in response to external shocks.* In industrial countries, this requires accelerated efforts to address the looming problems resulting from aging populations, where progress in many countries falls short of what is required; a sustained effort to use the recovery to achieve broadly balanced budgets in the euro area within a reasonable time frame, as called for under the Stability and Growth Pact; and the design and publication of a credible medium-term fiscal consolidation plan in Japan. In emerging markets, corporate and financial reforms remain a central priority, particularly in Asia; in Latin America—and in some Asian countries, including India and China—medium-term efforts to strengthen fiscal positions are also critical (Chapter II).

For many developing countries, an overarching priority over the longer run remains an enduring reduction in poverty, which in turn will require a sustained improvement in growth. From this perspective, it is encouraging that GDP growth in China, India, and sub-Saharan Africa, where the bulk of the poorest live, has been relatively well sustained during the downturn, and is expected to pick up in 2002–03. In both China and India, poverty has been on a steady downward trend, although in India GDP growth may still fall short of the level consistent with further sustained progress, underscoring the need for fiscal and structural reforms (see below). The most entrenched problems remain in sub-Saharan Africa, where GDP growth is well below the level needed to make substantial inroads in poverty.

Table 1.4. Major Advanced Economies: General Government Fiscal Balances and Debt¹
(Percent of GDP)

	1986–95	1996	1997	1998	1999	2000	2001	2002	2003	2007
Major advanced economies										
Actual balance	-3.9	-3.6	-2.0	-1.6	-1.2	-0.3	-1.7	-2.6	-2.1	-0.6
Output gap ²	-0.6	-1.9	-1.3	-1.1	-0.7	0.3	-1.0	-1.7	-1.4	—
Structural balance	-3.5	-2.7	-1.4	-1.0	-0.9	-1.0	-1.5	-2.0	-1.7	-0.6
United States										
Actual balance	-4.5	-2.4	-1.3	-0.1	0.6	1.5	0.1	-1.4	-1.2	-0.5
Output gap ²	-1.4	-2.8	-1.6	-0.5	0.4	1.4	-0.4	-0.8	-0.5	—
Structural balance	-4.0	-1.5	-0.7	0.1	0.5	1.0	0.1	-1.2	-1.0	-0.5
Net debt	53.2	59.2	57.0	53.4	48.9	43.7	42.2	42.0	40.9	34.6
Gross debt	67.3	72.8	70.3	66.6	63.4	57.4	55.4	54.7	53.0	44.3
Japan										
Actual balance	-0.4	-4.9	-3.7	-5.6	-7.6	-8.5	-8.5	-8.7	-7.6	-2.3
Excluding social security	-3.2	-7.0	-5.8	-7.2	-9.0	-9.2	-8.8	-8.7	-7.4	-2.9
Output gap ²	0.7	0.8	1.0	-1.6	-2.2	-1.3	-2.7	-4.6	-4.8	—
Structural balance	-0.6	-5.2	-4.1	-5.0	-6.9	-8.3	-7.8	-7.3	-6.1	-2.1
Excluding social security	-3.5	-7.2	-6.0	-6.8	-8.6	-9.2	-8.6	-8.1	-6.8	-2.8
Net debt	13.8	21.6	27.9	38.0	44.4	52.7	62.2	72.4	80.2	85.3
Gross debt	71.8	91.7	97.4	108.4	120.6	130.8	143.4	157.0	166.4	166.5
Euro area										
Actual balance	-4.5	-4.2	-2.5	-2.2	-1.3	0.2	-1.4	-1.6	-1.1	0.2
Output gap ²	-0.2	-2.1	-2.0	-1.4	-1.1	-0.1	-0.9	-1.9	-1.4	-0.2
Structural balance	...	-3.0	-1.4	-1.4	-0.8	-1.1	-1.1	-0.8	-0.5	0.2
Net debt	46.2	62.6	62.9	61.4	60.5	58.3	57.6	57.4	56.4	51.4
Gross debt	61.0	76.1	75.4	73.7	72.6	70.2	69.1	68.9	67.5	58.4
Germany³										
Actual balance ⁴	-2.2	-3.4	-2.7	-2.2	-1.6	1.2	-2.7	-2.7	-2.0	0.2
Output gap ²	0.1	-0.7	-1.2	-1.1	-1.1	—	-1.2	-2.1	-1.4	—
Structural balance	-1.8	-2.7	-1.6	-1.3	-0.8	-1.3	-2.0	-1.4	-1.1	0.2
Net debt	27.6	51.1	52.3	52.2	52.6	51.6	51.1	52.5	52.7	47.9
Gross debt	45.1	59.8	61.0	60.9	61.3	60.3	59.8	61.2	61.4	56.6
France										
Actual balance ⁴	-3.5	-4.1	-3.0	-2.7	-1.8	-1.4	-1.4	-2.1	-1.9	—
Output gap ²	-0.5	-3.3	-3.1	-1.8	-1.2	-0.2	-0.5	-1.5	-0.9	—
Structural balance	-3.0	-1.9	-1.0	-1.6	-1.0	-1.2	-1.3	-1.4	-1.3	—
Net debt	30.6	48.1	49.6	49.8	48.9	47.8	48.8	48.3	48.0	51.6
Gross debt	39.3	57.1	59.3	59.5	58.5	57.5	57.1	58.0	57.7	51.6
Italy										
Actual balance ^{4,5}	-10.4	-7.1	-2.7	-2.8	-1.8	-0.5	-1.4	-1.2	-0.2	-0.3
Output gap ²	-0.1	-2.0	-2.3	-2.4	-2.7	-1.9	-2.0	-2.5	-1.6	—
Structural balance	-10.4	-6.2	-1.7	-1.7	-0.6	-2.1	-1.2	-0.7	-0.1	-0.3
Net debt	97.8	116.1	113.8	110.1	108.4	104.6	103.5	101.9	99.2	86.2
Gross debt	103.7	122.7	120.2	116.4	114.5	110.6	109.4	107.7	104.8	91.1
United Kingdom										
Actual balance ⁴	-3.4	-4.1	-1.5	0.3	1.5	4.4	0.4	-0.9	-1.2	-1.0
Output gap ²	0.5	-1.3	-0.5	0.2	-0.5	0.1	-0.1	-0.8	-0.7	—
Structural balance	-3.0	-3.3	-0.9	0.5	1.6	2.1	0.3	-0.7	-0.8	-1.0
Net debt	25.7	46.2	44.6	41.9	39.0	34.5	30.9	28.9	28.6	28.6
Gross debt	43.4	51.8	49.6	46.5	43.9	40.9	37.9	35.7	34.6	33.9
Canada										
Actual balance	-6.5	-2.8	0.2	0.5	1.6	3.2	2.4	1.7	1.7	1.5
Output gap ²	-2.5	-6.5	-5.1	-3.7	-1.4	0.3	-0.9	-1.0	-0.2	—
Structural balance	-5.1	—	2.1	2.4	2.4	3.1	2.9	2.3	1.9	1.5
Net debt	69.9	87.8	84.1	81.2	74.9	66.3	61.8	58.7	53.9	38.8
Gross debt	101.6	120.3	117.6	115.7	112.3	102.6	97.8	93.9	87.3	66.6

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

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

²Percent of potential.

³Data 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.

⁴Includes one-off receipts from the sale of mobile telephone licenses equivalent to 2.5 percent of GDP in 2000 for Germany, 0.1 percent of GDP in 2001 and 2002 for France, 1.2 percent of GDP in 2000 for Italy, and 2.4 percent of GDP in 2000 for the United Kingdom.

⁵Includes asset sales equivalent to 0.6 percent of GDP in 2001 and 2002, 0.5 percent in 2003, and 0.1 percent in 2004.

The main responsibility, of course, continues to lie with national governments, which must create conditions favorable to domestic savings mobilization and private sector investment and ensure the effective use of both domestic and external public resources—for which good governance is clearly key. The New Partnership for Africa’s Development embodies a concerted and welcome approach to these issues. However, as the Managing Director has stressed,⁸ these efforts must be matched by “stronger, faster, and more comprehensive” support from the international community. Substantial assistance has now been provided under the Heavily Indebted Poor Countries Initiative (HIPC), and the progress made at the Monterrey Conference—including the pledges of higher aid by the European Union and the United States—is encouraging, but much more needs to be done to increase aid flows, which are less than one-third of the U.N. target of 0.7 percent of GNP.

The most important issue, however, remains to further open up industrial country markets and phase out trade-distorting subsidies—particularly in agriculture—which seriously limit the ability of poorer countries to compete in areas where they would otherwise have a comparative advantage. This would directly support growth and reform efforts in the poorest countries, and would ultimately also be to the benefit of the richer countries themselves. More generally, the recent decision by the United States to raise tariffs on steel products is regrettable, and has already led to the prospect of retaliation from other countries. It will be essential for all countries to make renewed efforts to resist protectionist pressures, and to ensure that substantive progress is made with multilateral trade negotiations under the Doha round.

North America: A Strengthening Recovery

In the *United States*, activity remained weak during the second half of 2001, but there are in-

creasingly strong indications that recovery is under way, as the negative effects of the September 11 events have proved more moderate than earlier feared. Manufacturing output has begun to turn up, including in the high-tech sector; the housing market has remained strong; retail sales have remained surprisingly robust, although aided by auto incentives; and initial jobless claims have fallen back, while the unemployment rate, which would generally still be increasing at this stage of the cycle, remains below its December 2001 peak. Forward-looking indicators, including business and consumer confidence, have picked up significantly, equity markets have rebounded after September 11, and the yield curve has steepened. At the same time, aided by the earlier decline in oil prices and substantial excess capacity, inflationary pressures remain moderate.

With activity expected to accelerate significantly in the first half of 2002, the recent recession is likely to be the mildest on record. While the decline in fixed investment and inventories has been similar to previous downturns (Figure 1.6), private consumption has remained surprisingly strong. This has been supported by the substantial reductions in interest rates, and tax cuts over the past year; strong wage growth; widespread auto incentives, which—after netting off the inventory draw down—boosted GDP growth by an estimated $\frac{3}{4}$ percentage point (annualized) in the fourth quarter; the strength of house prices (which appears to have offset a significant portion of the impact on consumption from lower equity prices—see Chapter II); and lower oil prices.

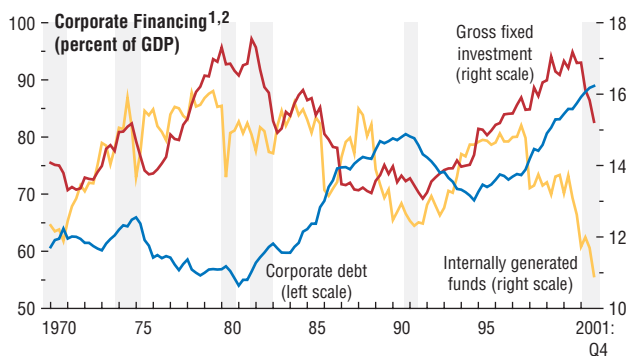
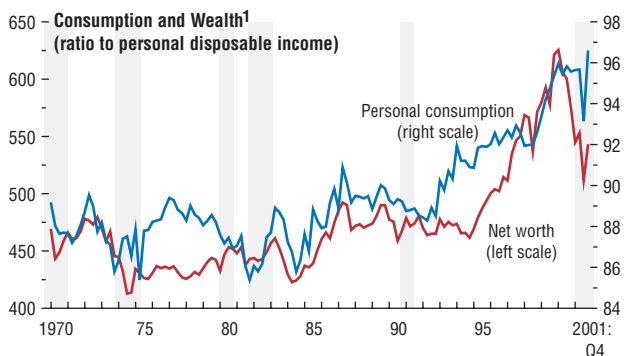
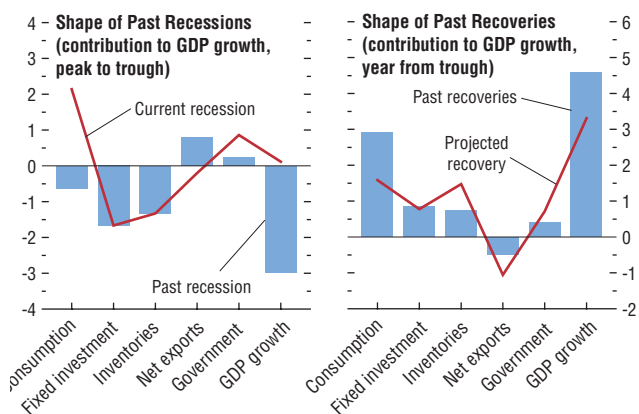
Given signs of a sharp turnaround in inventory adjustment in early 2002, as well as the substantial stimulus that is already in the pipeline, the staff’s projections envisage a strong recovery in activity in the first half of the year, falling back somewhat thereafter as the effects of these two factors begin to dissipate. The risks to the projection appear broadly balanced, and are importantly linked to the process by which the various

⁸See “Working for a Better Globalization,” address by the Managing Director to the Conference on Humanizing the Global Economy, January 28, 2002 (www.imf.org/external/np/speeches/2002/012802.htm).

Figure 1.6. United States: Recessions and Recoveries

(Percent unless otherwise indicated)

The U.S. recession has been remarkably mild compared with previous experience, and the pace of recovery is correspondingly projected to be somewhat more moderate. The low level of private saving and the high corporate financing requirement remain potential brakes on activity.



Sources: Haver Analytics; and IMF staff estimates.
¹ Shading indicates business cycle from peak to trough.
² All data for nonfinancial corporate business sector.

imbalances in the economy—notably the high current account deficit, low personal savings rate, and relatively large financing requirement in the corporate sector (Figure 1.6)—are resolved. On the one hand, it is certainly possible—given the size of the stimulus in the pipeline—that activity will recover more strongly than projected. While this would be welcome in a number of respects, it could—as discussed above—exacerbate these imbalances, especially if growth in other countries disappoints. On the other hand, there remain questions about the sustainability of a pickup in final domestic demand. In particular, private sector investment could be constrained by excess capacity and weak profitability (although the improvement in the fourth quarter of 2001 is welcome); and private consumption growth could be dampened if consumers seek to increase savings and rebuild balance sheets. Both of these could be exacerbated by a correction in equity markets, which still appear richly valued. This would likely result in an earlier correction in imbalances, but at the cost of a more subdued U.S. and global recovery. Finally, much continues to depend on external developments, including the speed of recovery in the rest of the world, oil prices, and geopolitical developments.

In assessing the appropriate stance of policies, policymakers need to take account of the risks and costs related to the uncertainties on both sides of the forecast, within a longer-term policy framework that is consistent with a gradual reduction in the imbalances in the economy over time. With clear evidence that recovery is under way, the Federal Reserve noted in March that the risks to economic growth and price stability had become more evenly balanced. Provided signs of economic strength continue, attention will soon need to shift to withdrawing the substantial stimulus provided last year. On the fiscal side, the combination of the June 2001 tax cuts and the emergency spending measures passed in the aftermath of the terrorist attacks, along with the operation of the automatic stabilizers, has provided substantial support to the economy. This has come, however, at the cost of a significant deterioration in the fiscal position; the adminis-

tration's recent budget—adjusted to take account of the latest stimulus package as well as the faster than expected recovery—provides additional stimulus in 2002 and would result in budget deficits (excluding the social security surplus) persisting into the medium term.

Moreover, with the budget based on relatively optimistic assumptions with regard to the containment of non-defense expenditures, even this may prove difficult to achieve. With economic activity improving, efforts will now need to focus on returning the budget to broad balance (excluding social security) over the medium term, and to address the longer-term financial problems in the social security system. This would help manage the pressures associated with the aging population, as well as being supportive of adjustment in the current account deficit.

Given the strong trade and financial linkages, *Canada* was strongly affected by the faster than expected slowdown in the United States, and experienced a mild downturn in the second half of 2001. As activity slowed, and with core inflation at the lower end of the 1–3 percent target band, the authorities eased monetary policy substantially during 2001; at the same time, the exchange rate depreciated to near historically low levels in real effective terms, which is helping to cushion the impact of the external slowdown and weak commodity prices. Fiscal policy has also provided support through the operation of the automatic stabilizers, previous expenditure and tax measures, and a moderate discretionary stimulus in the 2001/02 budget. Aided by the pickup in the United States, growth rebounded in the fourth quarter of 2001, and economic indicators suggest that a strong recovery is now under way. With the economy expected to reach its potential output sometime during the next year, the process of withdrawing monetary stimulus also will likely need to begin in the near term.

Japan: Significant Challenges Remain

Japan is experiencing its third—and most severe—recession of the past decade. While the proximate causes of the current downturn in ac-

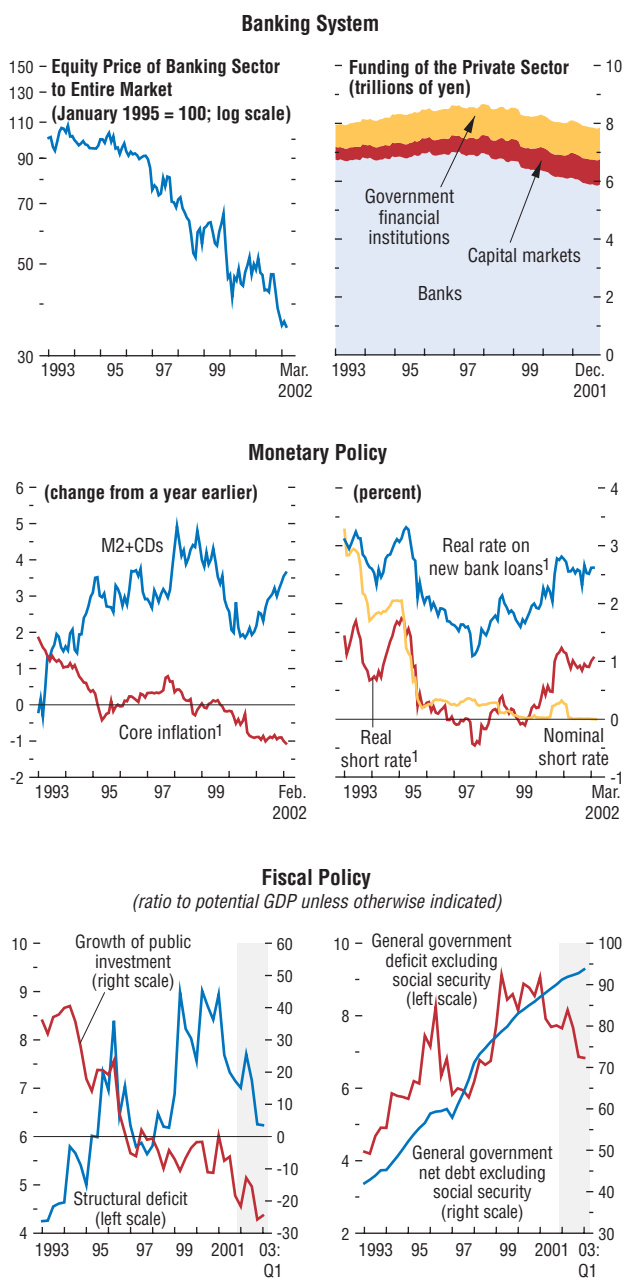
tivity include a variety of domestic and external factors, including falling consumer confidence and the global slowdown, the inability to achieve sustained growth over the past decade reflects the failure to deal decisively with deep structural impediments (a pattern also seen in other countries, as discussed in Chapter III). This is most urgent in the case of the banking system, whose difficulties go back to the bursting of the asset price bubble in the early 1990s.

Short-term prospects are a source of considerable concern. Output is expected to fall by 1 percent in 2002 after a decline of ½ percent in 2001, as the pronounced weakness in private demand seen in 2001 continues through the first half of 2002 even as external demand revives, a path consistent with the results of the March *Tankan* survey and the depressed levels of equity prices even after a recent rebound. To date, the fall in activity has been driven by both external and domestic developments. Exports declined in the face of the global slowdown and rapid fall in demand for IT goods. Consumption slumped since early 2001 as the unemployment rate has set new records, overtime hours have fallen, and real earnings have stagnated. Business investment showed some resilience over much of 2001, but weakened dramatically late in the year. The government announced a package to combat deflation late in February, including a re-statement of its intention to proceed with the disposal of nonperforming loans (NPLs) and an explicit commitment to take any necessary measures to ensure the stability of the financial system. The package also sets out new measures such as strengthened regulation of short selling of equities. While growth in 2002 could be more rapid than projected—most notably if recovery comes more speedily in the rest of the world and the IT cycle rebounds more rapidly than currently anticipated—downside risks predominate given the difficult domestic environment.

Weak growth over the 1990s reflects a failure to deal decisively with structural weaknesses, especially in the banking system. Since the mid-1990s, bank equity prices have been falling relative to the rest of the market (which has also

Figure 1.7. Japanese Policy Dilemmas

Japan's financial problems are reflected in the falling relative equity price of the banking sector and in the decline in bank lending. Meanwhile, deflation is intensifying and real interest rates are rising. Current fiscal plans involve a significant withdrawal of stimulus later this year, while debt ratios continue to climb.



Sources: CEIC Data Company Limited; Nikkei Telecom; Nomura Security; and IMF staff estimates.

¹Adjusted for changes in indirect taxes in 1997.

been on a downward trend, eroding bank capital held in the form of equities), and loans to the private sector have been declining (Figure 1.7, top panels). Despite past deregulation of the financial system—most notably the “big bang” completed in 2000—and its accomplishments so far, the level of direct financing from capital markets remains limited (Bank of Japan, 2001). These bleak trends have in many respects worsened since mid-2001, with NPLs remaining at high levels despite large write-offs, the relative equity prices of banks falling further (partly as a result of recent regulatory actions imposing greater market discipline on banks), increasing real interest rates on bank loans, and, more recently, a significant increase in bank borrowing costs for debentures and certificates of deposit, especially for weaker banks.

The banking sector will be a significant impediment to sustained recovery unless decisive action is taken. Progress has been made in tackling banking sector reform and the allied issue of corporate restructuring. In particular, the Financial Services Agency (FSA) has tightened NPL classifications for banks and strengthened the role of market forces through initiatives such as mark-to-market accounting. However, the FSA should further its efforts to encourage banking sector restructuring through more accurate classification of problem loans (where the FSA’s special audits will be critical), rapid disposal of a wide range of such loans (which will also help with corporate restructuring), encouraging banks to raise further private capital, and, if appropriate, targeted injections of public money. The basis for effective corporate restructuring has been laid through a number of welcome initiatives, including the introduction of consolidated corporate taxation and reform of the commercial code, but rapid disposal of problem loans and a more aggressive industrial deregulation policy are needed to push this process forward.

On the macroeconomic front, policymakers currently face the difficult task of supporting the implementation of structural reforms in the face of very limited room for monetary and fiscal maneuver. Monetary policy should be used aggres-

sively to address deflation, thereby lowering real interest rates and supporting activity, while the fiscal stance should remain broadly unchanged and be flexible to changing economic conditions. This policy advice partly reflects the following assessment of two key policy questions.

- *How effectively can monetary policy support activity?*

Despite zero nominal short-term interest rates, deflation means that short-term real rates are positive and, if anything, rising (Figure 1.7, middle panel). Monetary policy should be clearly focused on reviving activity by ending deflation; evidence from the U.S. Great Depression indicates that aggressive quantitative easing can be effective in this regard, especially if financial sector issues are also tackled. To this end, the Bank of Japan has recently raised its target for excess bank reserves from over ¥6 trillion to ¥10–15 trillion, as well as raising its purchases of government bonds somewhat. Reserves will need to be kept at or above the ¥15 trillion upper range to engineer a continued rapid expansion of the monetary base. Quantitative easing and official pronouncements have recently been associated with a weakening of the yen, which will help revive external demand. However, further easing will be required if deflationary forces do not abate soon, including a commitment to end deflation within a relatively short time period.

- *Is high and rising government debt reducing the effectiveness of fiscal policy?* The initial budget for FY2002/03 implies a ½ percentage point of GDP withdrawal of stimulus, concentrated in the second half of 2002 when spending increases earlier in the year associated with the second supplementary budget of 2001/02 are expected to be rapidly reversed (Figure 1.7, lower panels). A timely supplementary budget should be considered to mitigate fiscal contraction in the latter part of 2002 to avoid the outcome in 1997, when aggressive consolidation plans helped to propel the economy into a recession. At the same time, it should be recognized that experience in a number of European countries suggests that policies to curb high and rising debt levels can have confi-

dence effects that reduce the impact of fiscal contraction on activity. The evidence to date on Japan is more ambiguous, although potential further downgrades of Japanese government debt by credit rating agencies appear to reflect concerns over debt sustainability. This underlines the need to set any further provision of stimulus within a concrete medium-term plan for fiscal consolidation to boost confidence and make current policy commitments more credible, including ending the earmarking of tax revenues, and reform of public enterprises and of the health care system.

The Japanese recession, and the possibility that an easing of monetary policy would result in a further weakening of the yen, has raised concerns about the consequences for the rest of the region. The Japanese economy and exchange rate have significant regional impacts (see Box 1.4 of the October 2001 *World Economic Outlook*). Even so, given the increased exchange rate flexibility and strengthened macroeconomic cushions in the region since the Asian crisis, a depreciation of the yen would appear generally manageable (although the impact could be greater in those countries with fixed exchange rate systems). This could be particularly the case if yen weakness was a byproduct of a comprehensive package of structural and macroeconomic measures to restore sustained growth in Japan, which would clearly provide significant medium-term benefits to the region and the rest of the world.

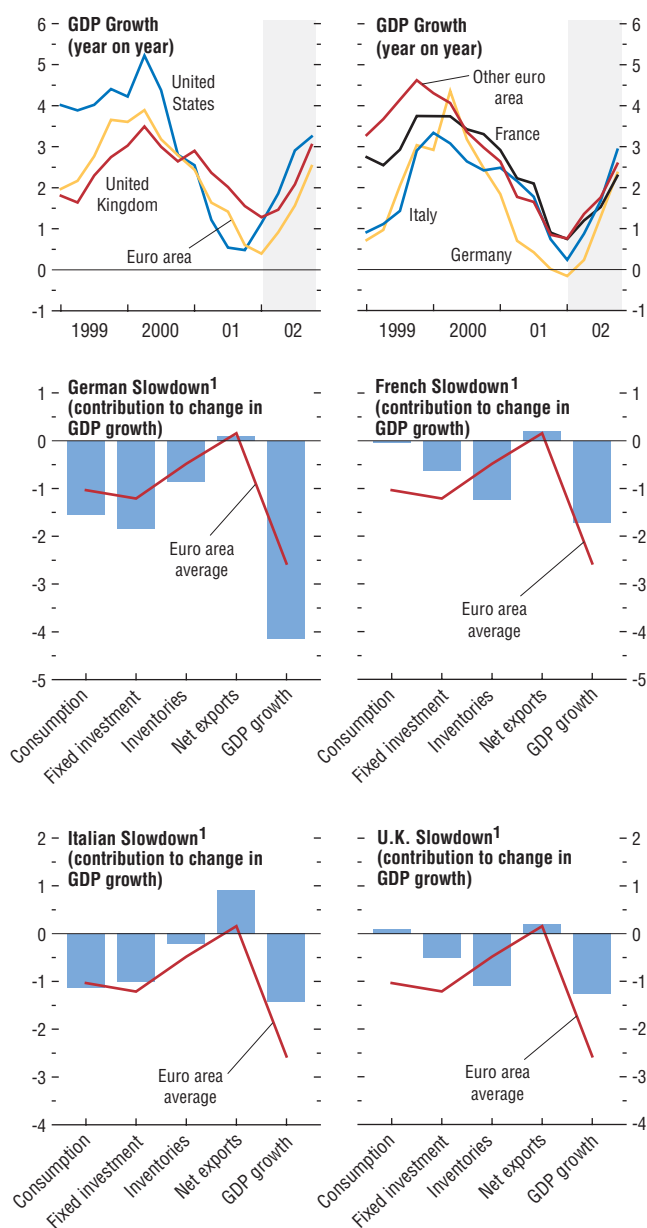
How Will the Recovery in Europe Compare with That in the United States?

In Europe, GDP growth began to slow from mid-2000, and—after a temporary rebound in late 2000 and early 2001—continued to weaken in the remainder of the year. The speed and extent of the slowdown, as well as the degree of synchronization with the United States, has taken most forecasters and policymakers by surprise. To a considerable extent, it has been due to the commonality of shocks, including the rise in oil prices during 2000, the bursting of the technology bubble, and the repricing of global

Figure 1.8. European Slowdown

(Percent)

The slowdown in Europe has been more moderate than that in the United States. However, there are substantial differences across countries, which mainly reflect consumer behavior.



Sources: Haver Analytics; and IMF staff estimates.

¹Defined as the difference between average annualized GDP growth rate during 2000:Q2 to 2001:Q4, and the year to 2000:Q2. The remaining variables show the contributions of consumption, fixed investment, inventories, and net exports to the change in GDP growth.

equity markets, but also increased corporate and financial linkages with the rest of the world. Europe-specific factors—notably animal diseases—have also played a role, as has the strength of cross-country linkages, particularly among the euro area countries.

Partly as a result, the nature of the slowdown has become increasingly similar to—although less steep than—that in the United States. Since mid-2000, the major countries have all experienced a weakening in fixed investment and inventories (Figure 1.8), and falling export growth (although this has been offset by lower import growth, resulting in some strengthening in net exports). The extent of the slowdown has differed considerably across countries, being particularly marked in *Germany*—which has experienced a technical recession (i.e., two quarters of negative growth)—*Belgium*, *the Netherlands*, and, particularly since the second quarter of 2001, *Italy*. In contrast, growth in *France* and the *United Kingdom* has in general been better sustained; and growth in *Spain*, while slowing, has also remained above the euro area average. The differences in the depth of the slowdown appear to reflect domestic, rather than external, factors. In particular, consumption behavior has differed markedly across countries, weakening significantly in Germany and Italy, but remaining surprisingly strong in the United Kingdom and France, buoyed by relatively strong real wage growth, stronger labor market conditions, and, in the United Kingdom, rising house prices.

In the euro area, although activity and demand remain weak, signs of recovery have begun to emerge. Business confidence—and to a lesser degree consumer confidence—have improved: the German IFO business climate index has risen for five successive months; indices of purchasing managers' sentiment have strengthened; and industrial production has begun to rise. Overall, GDP growth is expected to turn up in the first half of 2002, slightly behind the pickup in the United States, spurred by a turnaround in the inventory cycle, recent monetary policy easing, the strengthening external envi-

ronment, and the past decline in oil prices. While there is relatively little policy stimulus in the pipeline compared with the United States, there are also fewer macroeconomic imbalances to constrain recovery (although equity markets in some countries appear highly valued); and corporate profitability remains strong, which should help support a rebound in fixed investment. The main risks to the outlook include a weaker-than-expected upturn in Germany, given its size and close links with other euro area countries; structural weaknesses, particularly in labor markets; and a further increase in oil prices. Among individual countries, the Argentine crisis has adversely affected some banks and corporations in Spain, although there do not appear to be systemic risks; the high current account deficit in *Portugal*—projected at 9 percent of GDP in 2002—and the rising debt burden associated with it, are also of concern.

As growth has slowed, inflationary pressures have eased. After a temporary pickup early in the year due largely to temporary factors, including a modest impact from the changeover to the euro, area-wide CPI inflation has since moderated. Headline inflation is expected to fall below 2 percent in the coming months, underlying inflation remains moderate, and wage growth is reasonably subdued (although much will depend on ongoing wage negotiations, especially in Germany, as well as oil price developments). Since mid-2001, the European Central Bank (ECB) has reduced interest rates by 125 basis points; with growing signs of recovery, the monetary policy stance appears broadly appropriate. On the fiscal side, most countries have appropriately allowed the automatic stabilizers to operate, resulting in a widening of the area-wide deficit in 2001 and 2002. In Germany, the fiscal deficit in 2002 is projected to be close to the 3 percent deficit limit specified in the Stability and Growth Pact (SGP). While measures to meet SGP commitments may need to be taken in Germany if further budgetary shortfalls emerge, at present the risks do not appear to warrant immediate action—action that would seem, however, to be called for in the case of Portugal, par-

ticularly if the authorities' planned deficit review indicated that the deficit would breach the 3 percent limit. Once the recovery takes hold, it will be important for those countries with significant structural deficits to achieve an enduring strengthening in fiscal positions, an opportunity that was missed in the late 1990s; this in turn will require, *inter alia*, that countries stick to the expenditure targets set out in their Stability Plans even if revenues exceed expectations. This will ensure that fiscal policy is able to play an adequately supportive role during subsequent downturns, as well as help address increasing fiscal pressures from aging populations.

The introduction of euro notes and coins is an historic step, and has been accomplished remarkably smoothly (Box 1.3). By increasing price transparency and reducing transactions costs, it will be a powerful force promoting greater economic integration. To maximize the benefits from the introduction of the euro, it will be important to move forward with structural reforms, both in the financial sector and in other areas. Despite important initiatives in a number of countries, the pace of reform has not in general accelerated since the Lisbon European Council in mid-2000, which set out an ambitious agenda for economic and social renewal. At the Barcelona Summit in March, further progress was made in liberalization of energy markets, and EU leaders reaffirmed their intention to accelerate the reform process, including through swift implementation of the Financial Services Action Plan. Reforms in all areas are clearly closely interlinked, but two—labor markets and pension reform—appear to be of particular importance. While progress has been made in reducing taxation of labor and in encouraging part-time work, notably in France and some of the smaller European economies, labor markets remain relatively inflexible and there remains a need to increase wage differentiation (Germany and Italy) and to strengthen incentives for the unemployed to find work (Germany and France). On pensions, the adoption of a privately funded pension pillar in Germany is an important step forward, but

Box 1.3. The Introduction of Euro Notes and Coins

On January 1, 2002, nearly 10 years after the signing of the Treaty on European Union and 3 years after the launch of EMU, cash euros entered circulation in 12 European countries with more than 300 million inhabitants.¹ Despite the unprecedented scale of the operation, the changeover went remarkably smoothly. In short order, the euro—which had been available as an electronic means of payment and was used in financial markets since 1999—had replaced the former national currencies in virtually all cash transactions.

The immediate macro implications of the changeover appear to have been modest, yet the shift to euro pricing is expected to produce long-term benefits in the form of increased price transparency, competition, and integration across the area. While the lack of historical precedent makes it difficult to judge the associated gains in economic efficiency and living standards, many proponents believe that they may be substantial. However, wide-ranging supporting measures are still needed to maximize the gains from market integration.

One-Off Effects

The changeover appears to have had only modest short-term macroeconomic effects. Competitive forces and a relatively weak cyclical position helped to ensure that cases in which retailers took advantage of the redenomination to raise prices (including a bias toward rounding up when setting new “attractive prices”) were broadly offset by price-cutting elsewhere, particularly among large retailers seeking to win market share by promising to round prices down. The small changeover-induced increase in the CPI (estimated to be at most 0.2 percent in January, although some increase may have occurred already in 2001) plausibly reflects a tendency to bring forward planned price changes rather than a sustained increase in margins.

The main author is Mads Kieler.

¹The euro area comprises Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.

Beyond the short term, increased cross-border price transparency and arbitrage are expected to act as a force for lower prices (see below).

The total circulation of banknotes in the legacy currencies declined by one-fourth during 2001 (corresponding to about 1½ percent of GDP) as cash held for store-of-value purposes was either deposited with banks, spent (and then deposited by the receiver), or exchanged for foreign currency. Some of this cash had been held in the informal economy, and some abroad. Most of the currency held abroad (roughly ½ percent of euro area GDP in 2000) was returned before January 1, 2002, after being deposited or exchanged at foreign banks.

Anecdotal evidence of a pickup in sales of luxury items and cars in late 2001 may have been related to spending of hoarded cash—although the increase in retail sales in November also represented a bounce-back from very weak conditions after September 11 and should be seen in the context of a budding revival in confidence.² Spending of hoarded cash may further affect the timing of purchases in early 2002. In addition, shifts in the relative holdings of cash and deposits (affecting the money supply via the money multiplier) have rendered the interpretation of money aggregates for policy purposes more delicate than usual. Finally, despite fluctuations in the euro exchange rate around the time of the changeover, the transition does not appear to have had lasting consequences for the currency.

Longer-Term Benefits of Cash Euro: Price Transparency and Increased Integration

The more durable and important implications of the changeover stem from the facilitation of price comparisons across the area when all countries use the same unit of account. Regulatory obstacles to market integration will also seem more glaring and pressure to remove them is likely to intensify.

²There have also been reports of greater demand for property in parts of the euro area.

Currency unions, price convergence, and trade integration

Although price levels will continue to vary across the euro area as they do across other currency areas—owing among other things to differences in indirect taxes and nontradables prices—the transparency induced by the euro is likely to strengthen price convergence. In conjunction with enabling factors such as better communications, convergence pressures will intensify at both the wholesale and retail levels as well as for nontradables (at least in border regions). Parsley and Wei (2001) show that institutional currency stabilization—in the form of currency boards or currency unions—promotes price convergence far beyond an incremental stabilization of the exchange rate. Between them, currency unions are more effective than currency boards.

By the same token, the institutional commitment to far-reaching integration that is part and parcel of adopting a common currency may promote trade integration far beyond exchange rate stabilization. Although hotly contested, several recent studies suggest that countries trade much more when they share a common currency than when they do not, and that euro-area countries stand to reap substantial welfare gains from the single currency (e.g., Rose, 2000, and Rose and van Wincoop, 2001; for a critique, see Persson, 2001). Perhaps the most important channel through which currency union can have large trade effects is by acting as a catalyst for the removal of a wide range of administrative, legal, and regulatory impediments to integration.

Financial market integration

In financial markets, the euro has already acted as a compelling force for integration—although by doing so it has exposed a web of remaining barriers to cross-border operations

stemming from both private and public policy practices. The arrival of cash euros may only have a small direct effect on retail financial services, but it could well strengthen the constituency for removing such obstacles. Recently, political agreement was reached on a directive to bring the costs of cross-border retail payments in line with national payments, and EU institutions are working on a Financial Services Action Plan (consisting of more than 40 individual measures) that aims to integrate financial markets by 2005.

Reaping the Gains from Integration

The example of financial markets illustrates the need for accompanying measures to allow European Monetary Union (EMU) countries to reap the full benefits of the common currency. The single market still needs to be completed—for example, through the liberalization of energy, gas, and other network industries, and by making progress on common standards. The European Commission's proposal to end exclusive car dealerships (which led to blatant price discrimination across markets) is a good example that the euro cannot achieve price convergence on its own but may be a catalyst for removing other hindrances to integration.

If the euro is successful in furthering the integration of product, capital, and labor markets, the adjustment to a more optimal allocation of resources may accelerate structural change and increase regional specialization. In the absence of sufficiently flexible product and labor markets, the potential of EMU would not be realized to the full, and countries could even find themselves worse off in the new regime. Consequently, the need for structural reforms that facilitate EMU members' ability to adjust to shocks and cope with secular change is more pertinent than ever.

more adjustments in the parameters of the system are likely to be needed; in Italy, it will be important to move forward rapidly with the consultative approach to pension reform that the

authorities propose. In France, reforms have remained on hold and should be a high priority for the new government following the upcoming elections.

In the United Kingdom, growth in 2001 was the strongest among the G-7 economies. Underlying this strong performance, however, were significant disparities in the various sectors of the economy. While private consumption remained strong, external demand weakened, which—along with the continued strength of sterling and weakening confidence in the aftermath of September 11—contributed to a sharp decline in manufacturing output, although this now appears to be stabilizing. During 2002, output growth is expected to remain relatively resilient, underpinned by the substantial interest rate cuts last year, the projected fiscal stimulus in the 2002/03 budget, and the global recovery. Against this background, the Bank of England has appropriately left interest rates on hold for the time being, although if consumption remains strong and the external recovery unfolds as expected, a policy tightening may have to be considered soon—especially given the potential imbalances in the economy, notably the high levels of household and corporate debt. The cyclically adjusted fiscal deficit should not rise above the path projected in the November pre-budget report, and—given the already sharp increase in public spending—caution will need to be exercised on introducing new expenditure measures.

In the countries of Northern Europe, the pace of recovery is expected to be somewhat faster than elsewhere on the continent, as domestic demand remains relatively solid and—given their open economies—they benefit commensurately more from the global recovery. In late March, *Sweden* (along with *New Zealand*) became the first major country to raise interest rates following the recent downturn. Among individual countries, activity is expected to be supported by tax cuts (*Norway* and *Sweden*), an improvement in the IT sector, a highly competitive currency (*Sweden*), and by generally strong labor market conditions. In *Switzerland*, GDP growth is expected to be more moderate, and—in part reflecting the continued strength of the franc—interest rates were recently lowered by 25 basis points.

Latin America: Resisting Spillovers from the Crisis in Argentina

Recent economic attention on Latin America has been focused on the crisis in *Argentina* and its implications for the rest of the region. The outlook for Argentina and the extremely difficult adjustment this country now faces are discussed in more detail below. With the possible exception of *Uruguay*, economic and financial spillovers from the Argentine crisis appear to have been generally limited to date—as indicated, for example, by the muted reactions of bond spreads in most other regional economies and their declining correlation with those of Argentina, together with other favorable trends in financial market access and the general stability of exchange rates over recent months (Figure 1.9). Substantial risks and uncertainties remain, however. For example, more severe spillover effects from the Argentine crisis may still lie ahead, especially if there is no rapid turnaround in policies, if confidence deteriorates further, and if the magnitude of losses for investors and bondholders ends up being greater than estimated so far. Regional economies may also adjust less smoothly than assumed in the current outlook to a sharp improvement in international competitiveness in Argentina. Beyond these concerns, conditions and prospects for individual countries will continue to be shaped by their external trade and financial links—especially with the advanced economies; by developments in commodity markets and other key sectors; by conditions in the world oil market; and by the stance of domestic macroeconomic policies and a range of country-specific factors.

Argentina's short-term economic prospects remain highly uncertain, but a significant contraction in output and acceleration of inflation during 2002 appear unavoidable. Domestic demand is likely to fall substantially this year, given the impact of rising unemployment, lower confidence, the freeze on bank deposits, and other downward pressures on incomes and spending. Exports are likely to pick up in response to the depreciation of the exchange rate and projected strengthening in regional and global economic conditions, although in the short run much will

depend on a strengthening of trade financing. Correspondingly, with imports slumping and external financing largely cut off, the trade surplus is expected to strengthen further and the current account to move into surplus this year. The depth and duration of the downturn in Argentina will hinge primarily on the new government's economic program and on how effectively it is implemented. While many details of this program have yet to be announced, the broad outline of what is required to restore economic stability and growth is reasonably well defined. Of key importance will be reining in the fiscal deficit—despite a sharp fall in tax revenues—to a level that can be covered with available, noninflationary sources of finance; avoiding, in this regard, reliance on the printing of money to fund public spending; ensuring a functioning, solvent banking system; and promoting an open external trade regime.

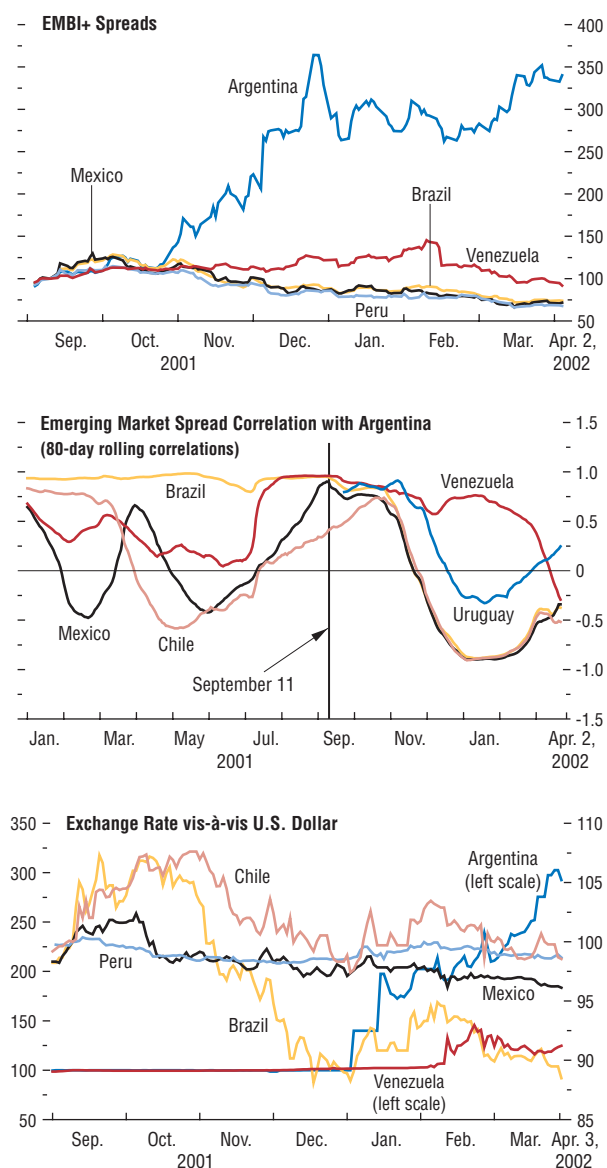
Prospects for Latin America as a whole will be strongly influenced by economic developments in the advanced economies—both through trade links, which vary quite widely across the region in strength and direction (Figure 1.10), and through the financial flows that are needed to meet the region's high external funding requirements (Table 1.5). Such flows appear closely related to investor sentiment in the major financial centers and, as they become dominated by equity-based flows, may well be procyclical.⁹ Mexico and other countries in *Central America* were hit hard in 2001 by the U.S. slowdown, and the *Caribbean nations* suffered from a downturn in tourism after September 11. With both of these influences turning around in 2002, growth among these countries should pick up strength during the year and return to robust rates in 2003 (Table 1.6). In addition to the recent rise in oil prices, strong policy credibility should help Mexico's prospects for a sound recovery: firm monetary and fiscal policies have been maintained during the economic downturn, including through a range of revenue-enhancing meas-

⁹See Chapter II of the October 2001 *World Economic Outlook*.

Figure 1.9. Western Hemisphere: EMBI Plus Spreads and Exchange Rate

(September 11, 2001 = 100, unless otherwise indicated)

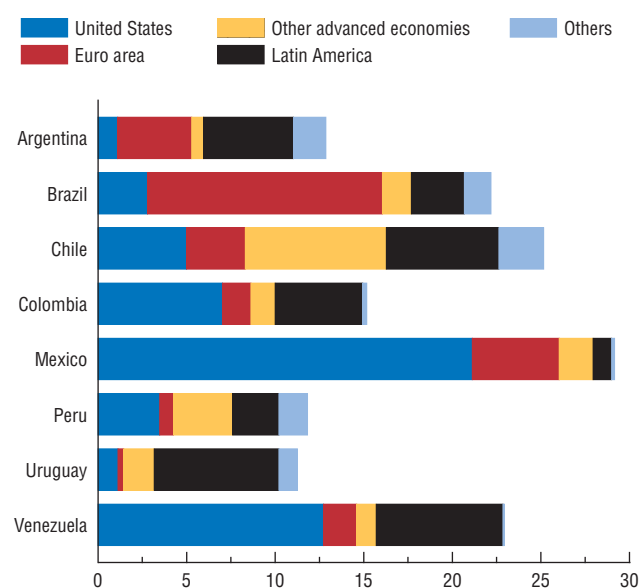
Most Latin American financial markets have strengthened since the September 11 shock and shown little reaction to the crisis in Argentina.



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

Figure 1.10. Selected Latin American Countries: Export Shares, 2001
(Percent of GDP)

Exports account for a relatively low share of GDP in most Latin American countries and are diversified across advanced and emerging economies—apart from Mexico, which has close trade links with the United States.



Source: IMF, *Direction of Trade Statistics*.

ures approved in the 2002 budget (although not the more comprehensive tax reforms originally envisaged). Reflecting this, financial market sentiment has remained favorable, with the peso appreciating against the dollar since September, inflation below its target level, and further upgrades to investment-grade status for foreign currency-denominated sovereign bonds. A continuation of these trends should provide some scope for a further lowering of borrowing costs, thus helping Mexico’s public finances.

With recent indicators suggesting that trade performance is improving and domestic demand recovering, growth in *Brazil* is also expected to gain strength this year and next—helped by recoveries in the United States and Europe, further easing of the power crisis that hurt activity in 2001, and improving domestic confidence. Vulnerabilities remain, especially in view of *Brazil*’s large (though declining) external financing requirement, although recent developments in this regard appear promising: improvements in market access are indicated by the successful placement in the first quarter of three government bond issues, more than covering the government’s 2002 external amortization burden, and by strong foreign direct investment inflows. Monetary policy has eased modestly in recent months, but needs to remain vigilant so as to ensure the achievement of the inflation target, while fiscal policy remains on track. *Uruguay*’s recent difficulties—including a widening bond spread, exchange rate pressures, and a downgrade of sovereign bonds from investment-grade status—have been exacerbated by its relatively high trade exposure to Argentina. But a core problem is *Uruguay*’s vulnerability to exchange rate movements, given that public and private debt is mainly denominated in U.S. dollars—highlighting the need for measures to strengthen the fiscal position, ensure debt sustainability, and support the new more flexible exchange rate regime.

Countries in the *Andean region* have been affected both by the overall slowdown in global trade and, more specifically, by the weakening in certain commodity markets in 2001—notably those for oil (of particular importance for

Table 1.5. Emerging Market Economies: Net Capital Flows¹*(Billions of U.S. dollars)*

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total²										
Private capital flows, net ³	150.9	212.0	234.2	111.9	65.4	69.4	7.7	31.3	58.0	76.8
Private direct investment, net	80.8	100.1	117.0	142.7	154.7	163.8	153.4	175.5	157.1	165.7
Private portfolio investment, net	113.0	41.2	86.9	46.3	-4.6	33.9	-4.3	-30.2	14.6	15.8
Other private capital flows, net	-42.9	70.7	30.3	-77.2	-84.7	-128.2	-141.4	-114.0	-113.7	-104.7
Official flows, net	3.5	26.9	-1.5	64.9	60.5	13.7	5.7	37.2	32.7	15.2
Change in reserves ⁴	-69.1	-116.7	-108.8	-59.8	-45.0	-85.8	-114.3	-134.3	-87.6	-60.6
<i>Memorandum</i>										
Current account ⁵	-72.2	-92.4	-96.8	-69.0	-52.6	32.9	128.3	89.4	16.9	-16.7
Africa										
Private capital flows, net ³	13.4	11.9	16.8	8.2	11.9	10.6	3.9	7.9	7.3	8.4
Private direct investment, net	3.2	2.1	3.8	8.0	6.5	8.9	7.3	22.2	10.8	11.8
Private portfolio investment, net	3.6	3.1	2.8	7.0	3.7	8.7	-2.4	-8.8	3.4	3.5
Other private capital flows, net	6.6	6.8	10.1	-6.8	1.6	-7.0	-1.0	-5.5	-6.9	-6.9
Official flows, net	3.3	4.1	-1.9	1.9	3.1	1.9	1.4	1.1	1.0	1.1
Change in reserves ⁴	-5.5	-1.4	-8.9	-11.0	1.5	-3.4	-13.7	-10.5	-0.5	-5.5
<i>Memorandum</i>										
Current account ⁵	-11.6	-17.3	-6.0	-7.2	-20.0	-15.3	3.1	-2.1	-10.8	-9.9
Developing Asia⁶										
Crisis countries⁷										
Private capital flows, net ³	35.4	56.8	74.3	-5.6	-31.6	-13.9	-15.7	-16.2	-6.4	-3.9
Private direct investment, net	6.5	10.3	11.7	10.2	11.5	14.6	14.3	8.3	10.3	10.6
Private portfolio investment, net	13.3	18.6	26.9	8.9	-9.0	11.8	7.0	3.2	5.1	1.5
Other private capital flows, net	15.6	27.9	35.7	-24.7	-34.1	-40.4	-36.9	-27.7	-21.9	-16.0
Official flows, net	0.7	8.8	-4.7	13.7	17.0	-2.2	6.6	0.6	1.4	3.3
Change in reserves ⁴	-6.5	-17.5	-4.8	40.6	-46.9	-38.2	-22.4	-11.7	-11.3	-12.1
<i>Memorandum</i>										
Current account ⁵	-23.2	-39.8	-53.1	-25.5	69.7	62.7	47.1	32.6	23.1	17.9
Other Asian emerging markets										
Private capital flows, net ³	34.9	40.7	46.0	19.6	-15.4	15.2	0.2	35.4	15.9	9.5
Private direct investment, net	38.2	44.1	43.9	47.3	48.3	47.3	40.1	45.2	49.2	50.1
Private portfolio investment, net	7.5	2.1	3.3	-2.1	-9.2	2.4	-2.6	-17.6	-4.3	-5.9
Other private capital flows, net	-10.8	-5.4	-1.2	-25.6	-54.4	-34.6	-37.3	7.8	-29.1	-34.7
Official flows, net	2.5	-3.3	-7.3	-6.6	3.1	3.8	-2.1	-2.0	4.0	4.8
Change in reserves ⁴	-51.4	-25.4	-41.7	-46.8	-16.6	-38.6	-26.2	-80.7	-42.8	-34.4
<i>Memorandum</i>										
Current account ⁵	18.3	8.5	14.7	51.4	41.0	32.7	35.8	54.7	42.1	36.9
<i>Memorandum</i>										
Hong Kong SAR										
Private capital flows, net ³	-7.3	-7.2	-9.4	11.7	-8.5	1.0	4.2	-5.1	-9.9	-10.4

Venezuela and to a lesser extent Colombia and Ecuador), copper and other metals (Chile, Peru), and coffee (Colombia). In particular, Venezuela is facing severe political and economic pressures, which have affected domestic and foreign investor confidence. Notwithstanding the recent rally in oil prices, a substantial increase in government spending last year combined with lower oil output (under production cuts agreed with OPEC) has led to fiscal pressures, a weakening of the external current account, and a sizable loss of international reserves in the period through mid-February 2002. Subsequently, the

authorities replaced the exchange band system by a floating exchange rate regime and announced a significant reduction in government expenditure relative to the 2002 budget level. Although these measures constitute a step in the right direction, the overall economic situation remains worrisome, particularly because the degree of fiscal restraint is not yet clear. Firmer policies are needed to strengthen the fiscal position and help reduce interest rates, improve the management of oil revenue, reduce the role of the state in the economy, and foster business confidence to stimulate private investment.

Table 1.5 (concluded)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Middle East and Turkey⁸										
Private capital flows, net ³	15.7	9.9	7.2	15.1	9.5	0.6	-24.0	-27.1	-10.2	-0.7
Private direct investment, net	4.8	6.4	4.7	5.2	6.3	5.4	7.3	8.5	8.5	9.7
Private portfolio investment, net	7.6	2.0	1.8	-0.9	-13.2	-3.2	-13.7	-10.2	-7.1	-4.6
Other private capital flows, net	3.4	1.4	0.7	10.8	16.3	-1.7	-17.6	-25.5	-11.6	-5.9
Official flows, net	3.5	4.5	6.6	9.3	2.9	2.4	-0.1	7.1	11.0	3.5
Change in reserves ⁴	-4.7	-11.6	-22.2	-19.4	9.7	-6.5	-27.6	-14.3	-7.5	4.0
<i>Memorandum</i>										
Current account ⁵	-5.7	-4.9	5.0	3.3	-23.3	11.7	63.1	42.9	10.5	-5.8
Western Hemisphere										
Private capital flows, net ³	47.1	44.0	66.4	70.6	71.3	43.2	42.5	27.1	37.7	45.4
Private direct investment, net	22.8	24.2	40.3	56.2	60.6	64.1	61.6	67.2	46.3	53.1
Private portfolio investment, net	65.0	0.8	38.8	25.9	18.7	11.1	4.6	0.9	13.6	17.0
Other private capital flows, net	-40.7	19.0	-12.7	-11.5	-8.0	-32.0	-23.8	-41.0	-22.2	-24.7
Official flows, net	4.7	18.6	3.4	13.7	16.1	7.4	-0.5	29.1	11.8	2.2
Change in reserves ⁴	4.0	-23.3	-29.0	-13.8	8.7	7.8	-2.8	1.7	-5.5	0.2
<i>Memorandum</i>										
Current account ⁵	-52.2	-36.5	-40.5	-67.1	-90.7	-56.7	-47.9	-54.3	-50.2	-49.6
Countries in transition										
Private capital flows, net ³	4.4	48.6	23.5	3.9	19.8	13.9	0.8	4.2	13.8	18.1
Private direct investment, net	5.3	13.1	12.5	15.8	21.4	23.4	22.8	24.0	31.9	30.3
Private portfolio investment, net	16.1	14.6	13.3	7.5	4.5	3.1	2.8	2.4	3.8	4.3
Other private capital flows, net	-17.0	20.9	-2.4	-19.4	-6.1	-12.6	-24.8	-22.2	-22.0	-16.5
Official flows, net	-11.2	-5.8	2.3	32.9	18.2	0.4	0.4	1.4	3.5	0.3
Change in reserves ⁴	-5.1	-37.5	-2.3	-9.4	-1.4	-7.0	-21.5	-18.8	-19.9	-12.8
<i>Memorandum</i>										
Current account ⁵	2.2	-2.4	-16.9	-24.0	-29.4	-2.2	27.1	15.6	2.2	-6.1
<i>Memorandum</i>										
Fuel exporters										
Private capital flows, net ³	18.6	23.4	0.6	-16.6	-1.4	-24.2	-58.3	-38.8	-38.0	-23.2
Nonfuel exporters										
Private capital flows, net ³	132.4	188.6	233.7	128.5	66.8	93.6	66.0	70.1	97.8	100.4

¹Net 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.

²Excludes Hong Kong SAR.

³Because of data limitations, "other private capital flows, net" may include some official flows.

⁴A minus sign indicates an increase.

⁵The 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.

⁶Includes Korea, Singapore, and Taiwan Province of China.

⁷Includes Indonesia, Korea, Malaysia, the Philippines, and Thailand.

⁸Includes Israel and Malta.

Among other Andean nations, activity may remain subdued in most cases at least through the first half of 2002; but then, with non-oil commodity prices—including those for metals and coffee—expected to pick up as global demand firms (see Appendix 1.1), growth is generally projected to strengthen later in the year and in 2003. A strong recovery is expected in Chile, for example, helped by sound institutions. Low inflation has enabled the central bank to lower interest rates in early 2002, and

other financial market indicators have also been positive. The pickup in Colombia may be more subdued, with the outlook clouded by uncertainties stemming from the breakdown of peace negotiations, forthcoming elections, and possible spillovers from economic difficulties in Venezuela. Progress with disinflation and fiscal consolidation, including pension reform, remains important in order to strengthen market sentiment and the base for sustained growth.

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			
	2000	2001	2002	2003	2000	2001	2002	2003	2000	2001	2002	2003
Western Hemisphere	4.0	0.7	0.7	3.7	8.1	6.4	8.2	7.4	-2.4	-2.9	-2.4	-2.5
Mercosur³	2.9	0.2	-0.9	3.0	5.0	4.9	10.5	9.7	-3.8	-3.7	-2.0	-2.1
Argentina ⁴	-0.8	-3.7	-10--15	0-3	-0.9	-1.1	25-30	30-35	-3.1	-2.1	4.2	5.5
Brazil	4.4	1.5	2.5	3.5	7.0	6.8	6.1	3.9	-4.1	-4.6	-3.7	-4.1
Uruguay	-1.3	-3.1	-1.7	3.0	4.8	4.4	7.1	9.4	-2.7	-2.6	-1.7	-1.9
Andean region	3.3	2.2	2.1	4.0	13.0	8.8	8.7	7.6	3.3	-0.1	-1.1	-1.3
Chile	4.4	2.8	3.0	6.0	3.8	3.6	2.3	3.0	-1.3	-1.4	-1.8	-2.4
Colombia	2.8	1.5	2.5	3.3	9.2	8.0	7.1	5.3	0.4	-2.6	-3.2	-3.7
Ecuador	2.3	5.2	3.1	6.0	96.2	37.0	15.5	8.0	5.3	-4.6	-6.1	-3.1
Peru	3.1	0.2	3.7	5.0	3.8	2.0	1.8	2.3	-3.1	-2.0	-2.3	-2.7
Venezuela	3.2	2.7	-0.8	1.3	16.2	12.5	20.8	20.2	10.8	3.6	2.6	2.3
Central America and Caribbean	6.0	0.2	1.9	4.6	8.8	6.6	4.5	4.0	-3.5	-3.2	-3.4	-3.3
Dominican Republic	7.8	3.0	3.5	5.2	7.7	8.9	3.7	3.9	-5.1	-3.9	-4.8	-4.1
Guatemala	3.6	1.8	2.3	3.5	5.1	8.7	5.0	3.9	-5.5	-4.6	-4.5	-4.1
Mexico	6.6	-0.3	1.7	4.9	9.5	6.4	4.3	3.8	-3.1	-2.8	-3.0	-3.0

¹In 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.

²Percent of GDP.

³Includes Argentina, Bolivia, Brazil, Paraguay, and Uruguay.

⁴Because of the high level of uncertainty regarding the economic outlook, projections for output and inflation in Argentina are presented as ranges. The regional aggregates are based on the midpoint of the range.

The Asia-Pacific Region: Turning the Corner

Most economies in the Asia-Pacific region have experienced a sharp fall-off in growth since 2000, but are now showing signs of a turnaround. The path has been largely driven by the external environment including the global electronics cycle, a sector that also contributed significantly to rapid recoveries following the financial crises of 1997-98 (see Figure 1.11). With most countries being oil importers, the oil price cycle has also affected activity, with high oil prices in late 2000 contributing to the subsequent weakening of incomes and demand in many countries, weaker oil prices in 2001 providing support for recovery, and recent increases in oil prices reducing this impetus. The opposite pattern is of course true for the region's oil producers. While Japan's prolonged economic difficulties have not prevented strong growth in other Asian economies over the past decade, Japan remains an important trading partner and source of capital for many of these countries.¹⁰ These links, together with increased

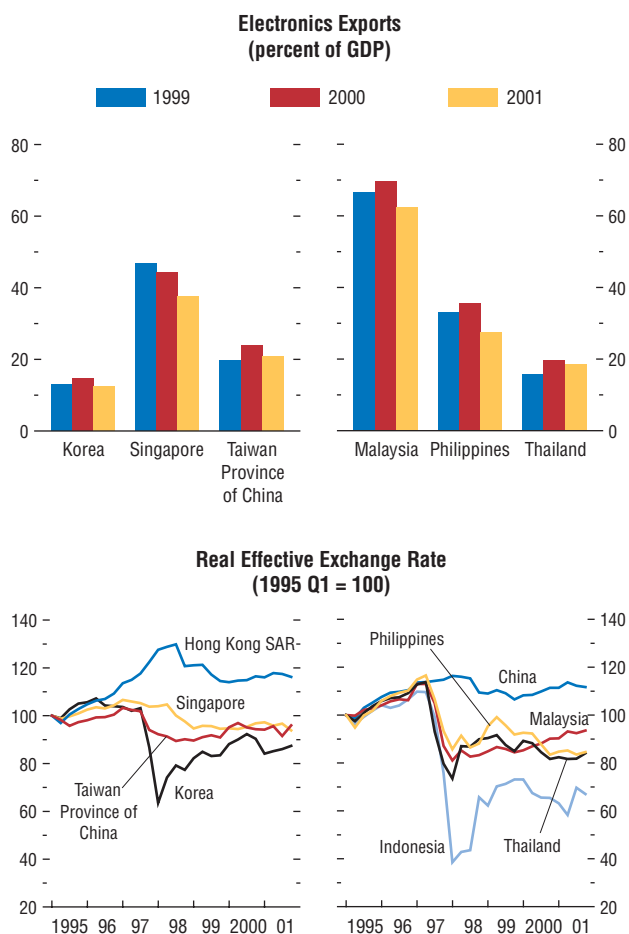
concerns about the implications of the recent depreciation of the yen for other regional currencies (see below), suggest that the current contraction in Japan may be adding to weaknesses in the region more generally. Poorer external conditions during last year also spread into domestically exposed sectors, further lowering demand, confidence, and employment, with other economic and political uncertainties in some countries putting downward pressures on growth. Activity has remained relatively buoyant in China and to a lesser extent India, which are less dependent on external trade than other economies in the region, although they too have experienced a marked decline in exports, lower confidence, and some slowing in growth since 2000.

Recent economic indicators have generally provided encouraging signs about the prospects for recovery. Increases in semiconductor prices, orders, and shipments over recent months, together with the broader strengthening of activity now appearing in the United States and other

¹⁰See Box 1.4 of the October 2001 *World Economic Outlook*.

Figure 1.11. Asia: Slowdown In Electronics Exports

Across Asia, electronics exports as a share of GDP have fallen since 2000. Real exchange rates for most countries remain more depreciated than in the lead up to the financial crises of 1997–98.



Sources: CEIC Data Company Limited; and IMF, *Information Notice System*.

advanced economies, will support export performance and industrial production in Asia. Indeed, production has already picked up a number of countries (including *China, Korea, Malaysia, and Thailand*), as has consumer and/or business confidence, although increases in unemployment across the region may mute the pickup in household spending.

Financial sector indicators have also been generally positive. In particular, most equity markets have recovered from the September 11 shock and continued to rise in 2002, and bond spreads have declined to below their early September levels and shown little reaction to the turmoil in Argentina. Regional exchange rates have not moved substantially over recent months, although the depreciation of the yen has heightened concerns among policymakers in other Asian economies about their competitive positions, particularly China and Malaysia. While allowing more flexibility in the latter currencies would at some point be desirable to provide an additional buffer against external shocks, these and most other exchange rates in the region are still lower in real terms than before the Asian financial crisis of 1997 (Figure 1.11). Moreover, the external vulnerability of these countries has been lowered as a result of the buildup of reserves over recent years and reductions of short-term debt. These trends suggest that most Asian economies still have some capacity to absorb the effects of the weaker yen without this jeopardizing their international competitiveness or financial sector confidence.

Strong economic fundamentals have also allowed many regional economies to use macroeconomic policies in support of recovery. With inflation generally subdued, most countries have been able to ease monetary policy. Sizable fiscal packages have also boosted activity in several countries, although in some cases, notably *India, Indonesia, and the Philippines*, the scope for fiscal easing is constrained by already high levels of public deficits or debt.

Looking at the projections, activity in almost all countries is expected to pick up in 2002 and gain further strength in 2003 (Table 1.7).

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			
	2000	2001	2002	2003	2000	2001	2002	2003	2000	2001	2002	2003
Emerging Asia³	6.9	5.0	5.6	6.2	1.8	2.5	2.3	2.8	2.8	3.1	2.2	1.8
Newly industrialized Asian economies	8.5	0.8	3.6	5.1	1.1	1.9	1.3	1.9	4.5	6.3	5.8	5.3
Hong Kong SAR	10.5	0.1	1.5	3.6	-3.7	-1.6	-2.5	—	5.5	7.4	7.7	7.7
Korea	9.3	3.0	5.0	5.5	2.3	4.1	2.7	2.6	2.7	2.0	1.5	0.6
Singapore	10.3	-2.1	3.2	5.1	1.1	1.0	1.1	1.6	17.0	23.3	21.4	21.4
Taiwan Province of China	5.9	-1.9	2.3	4.8	1.3	—	0.4	1.6	2.9	6.7	6.6	6.6
ASEAN-4	5.1	2.6	3.3	4.1	3.0	6.6	6.6	5.5	7.9	5.7	3.4	2.9
Indonesia	4.8	3.3	3.5	4.0	3.8	11.5	12.4	8.2	5.3	4.5	1.8	1.4
Malaysia	8.3	0.4	3.0	5.5	1.6	1.4	1.8	2.5	9.4	8.2	5.8	5.3
Philippines	4.0	3.4	4.0	4.2	4.3	6.1	5.0	5.1	12.1	5.6	3.6	3.5
Thailand	4.6	1.8	2.7	3.5	1.6	1.7	0.6	2.7	7.6	5.4	4.0	3.1
South Asia⁴	5.3	4.2	5.2	5.6	4.0	3.9	4.2	4.2	-1.2	-0.3	-0.7	-0.7
Bangladesh	5.5	4.5	3.9	4.0	2.3	1.8	3.8	5.3	-1.6	-1.9	-1.8	-1.8
India	5.4	4.3	5.5	5.8	4.0	3.8	4.1	4.0	-0.9	—	-0.5	-0.5
Pakistan	3.9	3.4	4.2	5.1	4.4	3.8	3.7	4.0	-1.9	-1.2	-1.0	-1.4
Formerly centrally planned economies⁵	7.9	7.2	6.9	7.4	0.4	0.7	0.4	1.6	1.9	1.7	1.0	0.4
China	8.0	7.3	7.0	7.4	0.4	0.7	0.3	1.5	1.9	1.7	1.1	0.5
Vietnam	5.5	4.7	5.3	7.0	-1.7	0.1	4.9	3.7	2.1	1.7	-1.6	-2.9

¹In 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.

²Percent of GDP.

³Includes developing Asia, newly industrialized Asian economies, and Mongolia.

⁴Includes Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka.

⁵Includes Cambodia, China, Lao People's Dem. Rep., Mongolia, and Vietnam.

Among the newly industrialized economies, the recovery in global activity and in the electronics sector should support modest growth in *Hong Kong SAR*, *Singapore*, and *Taiwan Province of China* in 2002 following sharp downturns in 2001, and firmer growth is expected in Korea, where the recovery appears to be more advanced. While activity should gain momentum during the year and into 2003, the rebound is not expected to be as strong as that seen in the late 1990s—especially as the rapid growth of investment and exports associated with the information technology sector in that earlier period appears unlikely to be repeated. Domestic sources of growth in these countries may become more important than in the past, therefore, as will ongoing efforts to broaden their manufacturing and export base. Steady pickups are projected for the Association of South East Asian Nations (ASEAN) over 2002 and 2003, also stemming in part from the stronger external environment. Especially in

Indonesia, the Philippines, and Thailand, however, the structural problems that muted their recoveries following the 1997–98 downturns continue to place a damper on current conditions and the outlook. Hence, the strength and robustness of growth in the period ahead will be contingent on progress with reforms needed to strengthen financial and corporate sectors, improve fiscal positions, and boost international and domestic confidence.

Growth in China is expected to be about 7 percent in 2002, supported by robust domestic demand. External demand, however, will continue to contribute negatively to growth, as China's recent entry to the World Trade Organization (WTO) will boost imports, especially of capital goods, more rapidly than the global recovery will increase exports. The recent easing of monetary policy is appropriate, especially as deflationary pressures have reemerged and real interest rates have been edging up. China's vul-

nerability to weaknesses in external demand and confidence appears to be limited, given its high reserves, favorable debt indicators, and rising FDI inflows; as noted above, a gradual move to a more flexible exchange rate regime would also be desirable. But ongoing progress with structural reforms and meeting associated fiscal challenges will be key in sustaining strong medium-term growth (Box 1.4). In this regard, the stronger competition that is likely to arise from WTO membership will increase pressures for reform in such sectors as agriculture, manufacturing, and banking. Reform priorities include the intertwined issues of restructuring the state-owned enterprises, reforming the banking sector—especially addressing the substantial nonperforming loans problem in the state-owned commercial banks—and redesigning the pension system. The capacity of the new asset management companies to dispose of assets effectively also needs to be enhanced.

In India, a modest pickup of growth to 5½ percent is expected in 2002, with robust service sector activity and a projected record level of agricultural output helping to offset lingering weaknesses in external demand and industrial production. As in China, India faces a comfortable external position, given its low current account deficit—reflecting, in part, buoyant transfers from nonresident Indians—together with high reserves and strong capital inflows. The main concerns surrounding the medium-term outlook stem from the continued difficult fiscal position—the public sector deficit is again expected to be over 11 percent of GDP in 2001/02—and inadequate progress with structural reforms. These pressures need to be tackled by moving ahead with fiscal consolidation as envisaged in the fiscal responsibility bill, addressing fiscal pressures at the state level, and implementing the ambitious set of reforms proposed by the Prime Minister's Economic Advisory Council.

Growth in *Pakistan* weakened in 2001 under the impact of the global slowdown, increased regional uncertainty arising from the conflict in Afghanistan and heightened tensions with India, and a fall in cotton production. External bal-

ances have improved, however, contributing to an appreciation of the exchange rate and hence to lower inflation and interest rates. These trends, in the context of firmer global activity and improvements in the regional security situation, should support stronger growth in the period ahead. Also needed to sustain this improved outlook will be ongoing commitments to strengthen the fiscal position—particularly by ensuring adequate revenue performance—and to push ahead with structural reform, where there has been encouraging recent progress with privatization and financial sector reforms. With the conflict apparently winding down and political stability returning, *Afghanistan* should be able to begin laying the groundwork for economic and social recovery (see Box 1.5). Key measures, which will need major financial and technical backing from the international community, are to restore the institutions and infrastructure needed to underpin economic activity. These steps would involve the enactment and implementation of legal and regulatory reforms, the establishment of effective monetary and fiscal arrangements, and a liberal exchange and trade system, to ensure reconstruction under a stable macroeconomic environment.

Growth in *Australia* and *New Zealand* has held up relatively well during the global slowdown. The housing sector has performed strongly in both countries—supported by lower interest rates and, in Australia, by incentives for first-time home buyers and by a rebound following changes in the tax regime. Although exports weakened in the second half of 2001, strong earnings growth in the first half, helped by lower exchange rates, also underpinned robust domestic activity during the year and contributed to a large reduction in each country's current account deficit. Looking ahead, recent improvements in confidence and in employment levels should broaden the base of growth this year and next—with growth of about 4 percent expected in Australia in 2002 and 2003 and 2½ to 3 percent in New Zealand. In New Zealand, given favorable developments in the domestic economy and the stronger external environment, the Reserve Bank

raised its official interest rate by ¼ percentage point in March. It is important that the fiscal positions of both countries remain sound, despite some recent easing and potential pressures that may arise in the year ahead—especially in New Zealand, which faces an election year and where the public sector’s role in the economy has expanded somewhat in the recent past.

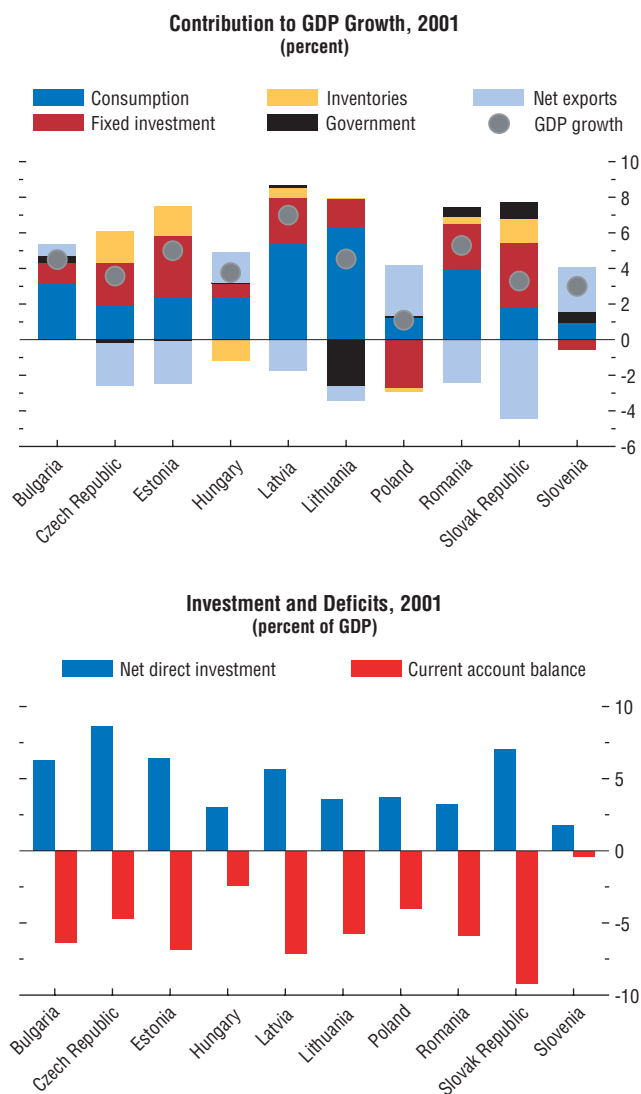
European Union Candidates: Resisting the Global Downturn

Economic performance among the EU accession countries in central and eastern Europe generally held up well compared with other regions during the global slowdown. Not surprisingly, exports—which are largely directed to the European Union—have weakened significantly over the past year as external demand slowed. But this has been largely offset by relatively robust domestic demand, generally underpinned by lower inflation and interest rates, strong investment spending, and fiscal stimulus in several countries (Figure 1.12). There are two important exceptions to this pattern. In *Poland*—by far the largest of the 10 transition countries currently negotiating for EU accession—domestic activity has been weak and growth has slipped sharply since 2000. And *Turkey*—also an EU candidate, although formal negotiations have not yet begun—suffered a severe contraction in 2001 under the impact of domestic and external shocks, although a moderate recovery is expected in 2002. Looking forward, the emerging recovery in western Europe can be expected to provide support to activity in all of these countries in the period ahead, although the possibility of further oil price volatility is for many—including Turkey—an important risk.

Most of the EU candidates in central and eastern Europe continue to run high current account deficits—a potential source of vulnerability should international investor sentiment toward the region or toward individual countries change for the worse (Figure 1.12). So far, though, external financing flows have been well sustained, even during recent periods of height-

Figure 1.12. Growth and External Balances in Central and Eastern Europe

The strength of domestic demand has helped offset external trade weakness among many EU accession candidates, while robust direct investment inflows have contributed to the financing of current account deficits.



Box 1.4. China's Medium-Term Fiscal Challenges

Over the past two decades, China's progress in reforming its economy has resulted in sustained large increases in incomes and deep reduction in poverty. Despite these impressive achievements, a long reform agenda remains to be accomplished. While reforming the financial sector, restructuring the state-owned enterprises, and improving the social safety net are at the top of this agenda, intrinsically linked to these objectives is the need to assure the medium-term sustainability of China's fiscal situation.

At first glance, fiscal sustainability may not appear to be a pressing issue for China. The official debt stock is low and the state budget deficit modest. Official data show that the state budget deficit¹ has hovered at relatively low levels over the last 20 years (see the figure). While the budget deficit widened somewhat in the wake of the Asian crisis, it gradually narrowed over the past two years (to about 3½ percent of GDP in 2001, from its recent peak of 4 percent of GDP in 1999).² Reflecting the low state budget deficits, the stock of explicit government debt stood at 23 percent of GDP at end-2000,³ of which 18 percent of GDP was domestic.

Fiscal activity in China, however, extends well beyond the official state budget. For example, following the formal separation of state-owned

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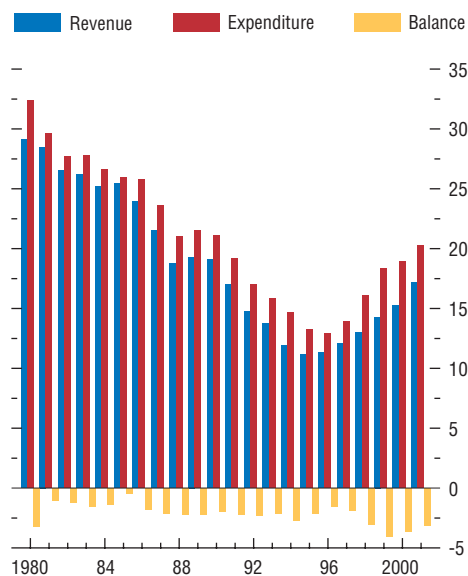
¹Including funds borrowed by the central government and on-lent to local governments and official external lending to government agencies, but excluding quasi-fiscal activities.

²From the early 1980s till the mid-1990s, both revenue and expenditure declined steadily. This was largely due to the separation of the financial accounts of state-owned enterprises from the budgetary accounts, which was undertaken to improve the state-owned enterprises' managerial and financial autonomy. The turnaround in revenue and spending since the mid-1990s reflects, in part, tax reforms that are still ongoing, and the fiscal stimulus packages introduced in response to the Asian crisis.

³Including bonds issued to recapitalize the four state-owned commercial banks in 1998, and bonds used for on-lending to local governments.

China: State Budget

(Percent of GDP)



Sources: Ministry of Finance; and IMF staff estimates.

enterprise finances from the budget, the government extensively used the banking system to support state-owned enterprises, and a significant share of these loans have become nonperforming. The loan losses of the state-owned banks, although not legally a liability of the government, are likely to require additional state resources in the future.

If the government's quasi-fiscal liabilities from the banking system were included, the broader fiscal deficit and public debt-to-GDP ratio would be significantly larger. Although a precise estimation of these liabilities is constrained by data limitations, it is likely that the fiscal deficit including new nonrecoverable bank loans is currently on the order of 5–6 percent of GDP. The stock of nonrecoverable bank loans at end-2000 was estimated at between 50 to 75 percent of GDP (of which an amount equivalent to 15½ percent of GDP has been transferred to asset management compa-

nies).⁴ Hence, taking into account the stock of these loans would raise public debt to 75–100 percent of GDP (as of end-2000).

Furthermore, substantial pressures exist for additional public spending in the coming years.

- Over the next decade, China will need to increase its expenditure on health, education, poverty alleviation, infrastructure, and the environment to meet its stated development goals.
- Progress in state-owned enterprise reform will also entail costs, as the remaining social responsibilities (such as health, education, and pensions) carried out by these entities will have to be taken up at least partly by the government.
- The pension system will need to be reformed with potentially large fiscal costs. The current pay-as-you-go system (which covers mainly state sector employees) will require increasing government support in the long run as the ratio of contributors to beneficiaries declines. In addition, the government intends to move in time toward a new three-pillar nationwide pension system, with one pillar being a publicly funded minimum pension for all workers.⁵

⁴In 1999 and 2000, ¥1.4 trillion of nonperforming loans from the state banks and one policy bank were transferred to four newly created asset management companies (AMCs). The AMCs have started disposing of these assets, including to foreigners, with the assistance of international investment banks. The losses of the AMCs will eventually have to be borne by the government.

⁵As currently envisaged, a nationwide three-pillar pension system would consist of a public pension, mandatory individual pension accounts, and voluntary supplementary individual accounts. A pilot provincial pension reform project was started in late 2001. The government also intends to use part of the proceeds from privatization (sales of state enterprise shares) to finance reforms.

- The current system of fiscal federalism, where each province is more or less fiscally independent, will have to be reexamined with a view toward ensuring that all provincial governments have sufficient resources to provide certain minimum standards of basic government services.

The fairly high level of total (explicit and contingent) debt, combined with the additional pressures described above, suggests that strong economic growth alone will not provide sufficient fiscal resources to meet the country's needs without an unsustainable buildup in public debt.

Stabilizing the fiscal outlook will require

- dealing forcefully with the flow of new bad loans in the banking system, which is a key objective of the ongoing state-owned enterprise and banking reforms;
- reducing the state budget deficit further; given the expenditure needs foreseen, this will have to involve a continued strengthening of the revenue effort through improvements in tax administration and policy (sustaining the buoyancy of revenues), as well as further reorientation of spending to priority areas; and
- reforming the pension system through both parameter changes in existing pension arrangements (including raising the retirement age and increasing contributions) and careful design of new institutional arrangements.

Overall, China's fiscal position, while not calling for sharp and immediate corrective measures, will require a gradual but sustained adjustment effort over the medium term. With such an effort, including measures to reduce the budget deficit and to effect continued state-owned enterprise, financial sector, and pension reforms, the public sector debt burden could be contained and gradually reduced over the medium term.

ened uncertainty following the events of September 11 and the crisis in Argentina. Indeed, increasing optimism regarding these countries' prospects for EU accession in a few

years' time appears to be contributing to strong inflows of foreign direct investment (despite economic weakness in western Europe), which are also reflected in the robustness of domestic de-

Box 1.5. Rebuilding Afghanistan

Afghanistan is one of the poorest members of the Fund, following 20 years of conflict and a prolonged drought. The tasks ahead are daunting: much infrastructure is destroyed, key government institutions have been inoperative for the last six years. Transactions are cash-based, several currencies are circulating, and no banks are operative. Large parts of the population are displaced, and key social indicators are grim.

The Afghan Interim Administration (AIA) was established in December 2001 for six months, to be followed by a two-year transitional administration until a fully representational government can be elected. In January 2002, the donor community pledged over \$4.5 billion for the next five years to assist the reconstruction efforts and finance current expenditure and reconstruction projects in the budget. Currently, however, actual foreign aid inflow is limited to humanitarian aid and payment of civil servant wages in Kabul, through an emergency United Nations Development (UNDP) Trust Fund.

Role of the IMF

The Fund's main task is to provide technical assistance and policy advice in its areas of expertise, to ensure a sound foundation for economic management, and to promote macroeconomic stability during the reconstruction period. This involves assisting in

- rehabilitation of basic institutions for the economy and for the government to conduct policy (such as Ministry of Finance and Central Bank); and
- development of a macroeconomic framework to guide decision making for a sustainable, noninflationary recovery.

Afghanistan may receive postconflict financial assistance under the Fund's Emergency Assistance Facility once there is sufficient capacity for planning and policy implementation. Once a medium-term economic strategy has been elaborated, the Policy Reform and Growth Facility (PRGF) could support reforms.

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Although the central bank and key ministries survived, capacity for essential functions is weak. The IMF is providing technical assistance (TA) to the central bank for currency reform, basic payments system, and a minimum regulatory framework. On fiscal issues, TA is being extended to revive the treasury, prepare a budget, develop tax policy, strengthen revenue administration and expenditure management, and ensure accountability and transparency (of key concern to donors). TA is furthermore provided to rebuild the statistical base (no data has been collected in 6 years), while the IMF will also provide training.

In two key issues the IMF has been offering policy advice. First, currency reform: two domestic currencies now co-circulate (including one counterfeit), along with several foreign currencies. The authorities will at some point introduce a new Afghan currency, once sound financial policies and a well-developed institutional and legal framework are fully in place. IMF staff are advising the authorities on how to ensure a smooth transition from the present situation of co-circulating currencies to the introduction of the new currency. Second, the IMF and the World Bank assisted the authorities with the preparation of a budget for recurrent expenditures for the new fiscal year that started March 21, 2002. These expenditures are projected at about US\$460 million and cover the payment of wages for about 220,000 civil servants and employees of state-owned enterprises and for the military, as well as essential operations and maintenance expenditures. Most of these expenditures will be financed by budget support from donors, although some \$80 million is expected to be collected in revenues.

Regional Impact

Reconstruction should bring substantial benefits to neighboring countries. In the near term, some of the 3.5 million refugees are expected to return to Afghanistan, easing the burden on Pakistan and Iran. Imports for reconstruction are also expected to come largely from the neighbors; activity in Pakistan, such as the ce-

ment industry, has already been boosted. Over the longer term, a calmer regional political situation should improve plans for movement of natural resources, such as gas, across the region. Finally, establishing a strong customs and tax administration in Afghanistan should reduce smuggling across borders with neighbors.

Risks

Considerable risks remain. First, the security situation is still problematic. The AIA is in full

control of Kabul, but not in the provinces, which prevents forward movement with country-wide economic reforms. Second, the interim government will be in office only until June 2002, and then will be followed by another transitional government; the possible lack of continuity among policymakers mitigates against taking difficult decisions. Third, while donors have pledged large amounts of financial assistance, delays in receiving actual cash resources may make it difficult to execute the budget.

mand and import growth. More generally, the EU accession process continues to provide a key anchor for the domestic policy agenda in these countries. This external discipline will be important, for example, in the context of current pressures for higher public spending that are being generated by economic or political tensions in several countries, and in ensuring that the region's generally sound macroeconomic performance can continue. Accession aspirations should also help these countries maintain the momentum of progress that is needed with fiscal reforms, privatization, other structural improvements, and environmental cleanups. Such macroeconomic and structural measures, in turn, will help ensure that the favorable climate for investment and growth is sustained.

Looking at developments and prospects for central Europe, activity remains particularly weak in Poland, reflected in falling employment and record-high unemployment. Given improvements in the current account, appreciation pressures on the zloty, and lower inflation—which ended 2001 well below the target range—the central bank has been able to lower interest rates significantly over the past year (including a reduction of 1½ percentage points in the intervention rate in late January). There should be scope for further monetary easing if weak economic conditions persist and inflation remains subdued. The combination of somewhat easier monetary conditions, improvements in domestic

confidence, and a stronger external environment is expected to lead to a steady pickup in growth this year and next (Table 1.8). Growth has been better sustained in the *Czech Republic*, *Hungary*, and the *Slovak Republic*, supported by relatively strong confidence and domestic demand, lower inflation and interest rates, and varying degrees of fiscal stimulus. A further increase in growth is expected in the period ahead—reaching about 4 percent in 2003—as exports pick up and domestic activity strengthens further. In this context, a winding back of fiscal support will be important—including in Hungary, where a large stimulus is currently expected in 2002—as such stimulus could make it more difficult to reach the key policy objectives of lower inflation, sustainable current account deficits, and medium-term fiscal consolidation. Strong domestic demand in the Slovak Republic has led to a particularly large increase in its current account deficit since 2000 and, while capital inflows have also been strong, this external vulnerability adds to pressures on the authorities to maintain a firm fiscal stance and to push ahead with privatization and other structural reforms.

Robust growth of about 4 to 5 percent is expected to continue in *Bulgaria* and *Romania*, accompanied by falling inflation and a gradual reduction in current account deficits. In Bulgaria, it will be important for the authorities to maintain a cautious fiscal stance to support the currency board and help ensure continued external

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

	Real GDP				Consumer Prices ¹				Current Account Balance ²			
	2000	2001	2002	2003	2000	2001	2002	2003	2000	2001	2002	2003
E.U. candidates	4.9	0.4	3.1	4.2	24.7	21.1	17.7	11.5	-5.2	-2.9	-3.6	-3.6
Turkey	7.4	-6.2	3.6	4.7	54.9	54.4	49.1	26.9	-4.9	1.4	-1.2	-1.2
Accession candidates	3.8	3.0	2.9	3.9	13.1	9.7	6.8	5.7	-5.3	-4.4	-4.5	-4.6
Baltics	5.4	5.4	4.1	5.3	2.2	2.7	3.0	3.1	-6.3	-6.4	-6.4	-6.0
Estonia	6.9	5.0	3.7	5.5	4.0	5.8	3.5	3.5	-6.4	-6.8	-6.8	-6.5
Latvia	6.6	7.0	4.5	6.0	2.6	2.5	3.0	3.0	-6.9	-7.1	-7.0	-6.4
Lithuania	3.9	4.5	4.0	4.8	1.0	1.3	2.8	3.0	-6.0	-5.8	-5.8	-5.5
Central Europe	3.9	2.3	2.4	3.5	8.9	6.2	4.0	3.8	-5.3	-4.0	-4.1	-4.4
Czech Republic	2.9	3.6	3.3	3.7	3.9	4.7	4.0	3.7	-5.6	-4.7	-4.8	-5.0
Hungary	5.2	3.8	3.5	4.0	9.8	9.2	5.4	4.0	-2.9	-2.4	-2.9	-3.5
Poland	4.1	1.1	1.4	3.2	10.1	5.4	3.2	3.2	-6.3	-4.0	-4.2	-4.5
Slovak Republic	2.2	3.3	3.7	3.9	12.0	7.3	4.3	7.0	-3.7	-9.2	-8.8	-7.9
Slovenia	4.6	3.0	2.6	3.6	8.9	8.4	6.5	5.5	-3.4	-0.4	-0.3	-0.4
Southern and south eastern Europe	3.0	4.9	4.3	5.0	32.9	25.0	18.2	12.9	-5.0	-5.8	-5.2	-5.0
Bulgaria	5.8	4.5	4.0	5.0	10.4	7.5	4.5	3.5	-5.8	-6.4	-5.9	-5.8
Cyprus	5.1	4.0	3.0	4.2	4.1	2.0	1.8	2.2	-5.2	-4.3	-3.9	-3.7
Malta	5.4	0.4	4.4	4.9	2.4	2.9	2.0	2.0	-14.8	-6.9	-5.7	-4.4
Romania	1.8	5.3	4.5	5.0	45.7	34.5	25.2	17.5	-3.7	-5.9	-5.3	-5.1

¹In 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.

²Percent of GDP.

and domestic confidence. Macroeconomic policies are broadly on track in Romania, with fiscal policy having been tightened in late 2001 and monetary policy striking an appropriate balance between achieving further disinflation and preventing an excessive appreciation of the currency. Further progress with structural reforms, including in the energy sector, remains important to help sustain the recent recovery in growth.

Turning to the Baltic countries, growth has slowed somewhat from the rapid pace of 2000–01. While domestic demand remains robust, export growth in *Estonia* and *Latvia* has declined—particularly as a result of the EU slowdown and, for Estonia, the additional effects of weaknesses in the information technology sector in Finland and Sweden. In contrast, exports from *Lithuania* have held up relatively well—possibly because Lithuania has greater trade exposure to other emerging markets in Europe—and this is expected to contribute to firm growth of about 4 percent this year. As in the other EU accession countries, however, high current account deficits remain of concern in the Baltic region.

While readily financed through foreign direct investment (FDI) and other inflows, such deficits require that macroeconomic policies remain well-disciplined—for example, in the face of fiscal pressures arising from prospective EU and NATO accession—and that the momentum of structural reforms be maintained, including privatization in Latvia and Lithuania. Sound fiscal and structural policies will also add support to these countries' hard currency pegs, which are at the center of their macroeconomic strategies; in this regard, Lithuania's move from a dollar to a euro peg in February 2002 went smoothly, without disruptions to financial markets or confidence, and should promote prospects for greater trade and financial integration with western Europe.

Turkey suffered its worst recession in over 50 years in 2001, with the events of September 11—particularly through their impact on trade, tourism, and financial market confidence—setting back the tentative signs of recovery that had been emerging following the economic and financial crisis at the start of the year. While recent real and financial have been mixed, GDP

growth is expected to pick up to about 3½ percent in 2002, aided by low interest rates and rising confidence. There are significant risks in the outlook, however, in view of developments in the Middle East, Turkey's high public indebtedness, its record of persistent high inflation, and the need for bank and corporate debt restructuring. The projected recovery will therefore need to be underpinned by continued determined implementation of sound macroeconomic and structural adjustment policies. The IMF-supported program approved in February this year aims to maintain the reform momentum. On the macroeconomic side, this includes maintaining a firm monetary policy, which has already helped to reduce monthly inflation significantly, and a strong primary surplus to achieve a marked decline in government debt ratios. Restructuring efforts are designed to strengthen the banking sector, government operations, enterprise restructuring and privatization, and to encourage private sector development.

Commonwealth of Independent States (CIS): Continued Resilience

Growth in the CIS countries remained remarkably resilient to the global slowdown in 2001, falling only slightly to 6¼ percent, the highest growth rate among the major developing country regions. This was underpinned by continued solid growth in Russia, driven by strong domestic demand (Box 1.6, on pp. 46–47); activity also rebounded strongly in the region's second largest economy, Ukraine, aided by buoyant growth in the agricultural and industrial sectors. Given the strong trade and financial linkages, especially with Russia, this contributed importantly to the strength of activity in the rest of the region, helped in many cases by improved macroeconomic stability and policy implementation, as well as country-specific factors (including a rapidly emerging petroleum sector in Kazakhstan, strong revenues from the oil and gas sectors in Turkmenistan, and growth in cotton and aluminum production in Tajikistan). In general, asset markets (both stock markets and Eurobond

spreads) performed strongly in the CIS in 2001 compared with other regions.

In 2002, regional GDP growth is expected to slow to 4.5 percent (Table 1.9). Within this, GDP growth in Russia is expected to slow modestly to 4.4 percent, mainly due to lower oil exports and the lagged effect of the real appreciation of the ruble over the past year. Among the more *advanced reformers*, GDP growth is generally expected to fall back from the exceptional levels of 2001, partly as a result of slowing demand in Russia, but still to remain relatively resilient. In contrast, growth among the *less advanced reformers* is expected to fall to 2.0 percent, as the impact of the factors that boosted GDP growth in Tajikistan in 2001 fades, while the absence of structural reforms in Belarus and Uzbekistan continues to slow their growth.

Macroeconomic policy challenges vary significantly across the region. In *Russia*, the strength of the balance of payments—reflecting a combination of oil exports, a competitive exchange rate, and declining capital outflows—has continued to complicate economic management. During 2001, the expansionary impact of foreign exchange purchases by the central bank to prevent a nominal appreciation of the ruble was partially offset by a larger-than-expected fiscal surplus. Nonetheless, monetary aggregates grew rapidly and inflation exceeded the authorities' target. Even with the current account surplus expected to decline in 2002, the central bank will need to stand ready to sterilize excess liquidity as necessary to ensure the inflation target is achieved. In *Ukraine* and *Kazakhstan*, where the balance of payments has also been strong, price pressures eased. Fiscal adjustment played a key role in Kazakhstan, while for both countries the process of remonetization continued, allowing rapid monetary growth to be absorbed without an increase in inflation. However, the sharp increase in domestic credit accompanying this remonetization raises concerns with regard to both credit quality and risk, and needs to be carefully monitored.

Elsewhere in the region, inflation has fallen significantly during 2001, but remains a serious problem among a number of the less advanced

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			
	2000	2001	2002	2003	2000	2001	2002	2003	2000	2001	2002	2003
Commonwealth of Independent States	8.3	6.2	4.5	4.6	25.0	19.8	13.4	10.5	13.3	8.4	4.9	3.3
Russia	9.0	5.0	4.4	4.9	20.8	20.7	14.1	10.8	17.4	11.3	7.2	5.3
Excluding Russia	7.0	8.9	4.7	4.1	34.9	18.0	11.9	10.0	2.0	-0.6	-2.4	-3.0
More advanced reformers	6.8	9.5	5.6	4.7	19.7	9.4	6.5	7.1	2.6	-0.8	-2.8	-3.6
Armenia	6.0	7.5	6.0	6.0	-0.8	3.4	3.0	3.0	-14.5	-10.5	-9.6	-9.0
Azerbaijan	11.1	9.0	8.5	8.5	1.8	1.5	2.4	3.3	-2.4	-2.3	-23.4	-33.3
Georgia	1.9	4.5	3.5	4.0	4.0	4.7	4.6	5.0	-5.3	-5.6	-5.5	-5.8
Kazakhstan	9.8	13.2	7.0	5.1	13.3	8.3	6.4	5.1	5.0	-5.3	-3.9	-3.0
Kyrgyz Republic	5.0	5.0	4.5	4.5	18.7	7.0	6.1	5.5	-7.9	-6.2	-6.3	-6.5
Moldova	2.1	4.0	4.8	5.0	31.3	9.8	6.6	6.0	-8.4	-7.4	-8.1	-7.9
Ukraine	5.9	9.1	5.0	4.0	28.2	12.0	7.6	9.4	4.7	3.5	1.5	0.9
Less advanced reformers³	5.1	4.6	2.0	2.7	89.4	45.1	27.6	17.8	-0.4	0.2	-1.0	-0.7
Belarus	5.8	4.1	1.5	2.3	168.9	61.3	33.9	22.4	-1.8	1.7	-0.4	—
Tajikistan	8.3	10.0	6.0	5.0	32.9	38.6	10.5	7.6	-6.5	-7.4	-6.0	-5.2
Uzbekistan	3.8	4.5	2.2	3.0	25.0	27.2	22.2	13.5	1.3	-0.6	-1.0	-0.9
<i>Memorandum</i>												
Net energy exporters ⁴	9.3	6.0	4.7	4.9	19.6	19.2	13.2	10.2	16.1	9.9	5.9	4.1
Net energy importers ⁵	5.3	6.9	3.8	3.6	45.2	22.1	14.0	11.7	1.1	1.1	-0.3	-0.5
Highly indebted countries ⁶	4.0	5.7	4.6	4.7	13.0	9.4	5.6	5.2	-8.4	-7.3	-7.0	-6.9

¹In 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.

²Percent of GDP.

³Updated data for Turkmenistan not available.

⁴Includes Azerbaijan, Kazakhstan, Russia, and Turkmenistan.

⁵Includes Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Tajikistan, Ukraine, and Uzbekistan.

⁶Armenia, Georgia, Kyrgyz Republic, Moldova, and Tajikistan.

reformers—with the exception of *Tajikistan*, where a tightening of monetary policy led to a sharp fall in inflation through 2001—mainly as a result of excessive credit expansion to finance state-sponsored projects and to subsidize state enterprises. Beyond this, there are two major medium-term issues. First, the high level of external debt—averaging close to 200 percent of exports—among five of the poorest CIS countries (*Armenia, Georgia, Kyrgyz Republic, Moldova, and Tajikistan*) remains a serious concern. To address this, a number of these countries are implementing strengthened adjustment programs. Nonetheless, the outlook remains very difficult, particularly if external developments are worse than anticipated or GDP growth falls short of expectations, and additional external assistance may also be required. Second, with oil exporting countries accounting for about 80 percent of regional output, the region remains highly de-

pendent in developments in oil prices (Figure 1.13). To date, however, diversification has been limited—in Russia, for example, investment has been concentrated in the energy and transport sectors—in part reflecting the still difficult environment for private investment, including in some cases governance problems and the limited intermediation provided by underdeveloped financial systems.

The central challenge facing the region continues to be to accelerate progress in structural reforms—notably, institution building and governance, enterprise and financial sector restructuring, and transforming the role of the state—which with some exceptions has been relatively disappointing in recent years. In Russia, structural reforms have focused on strengthening the investment climate through a combination of tax reform, deregulation, strengthening property rights, and developing financial markets and in-

stitutions; and some progress is being made in other countries. In contrast, reforms in a number of countries have remained on hold, in part because progress is being blocked by vested interests that benefit from a situation of partial reforms. It is to be hoped that the acceleration of reforms in Russia will, given its central role in the region, also spur more rapid progress in other countries in the period ahead.

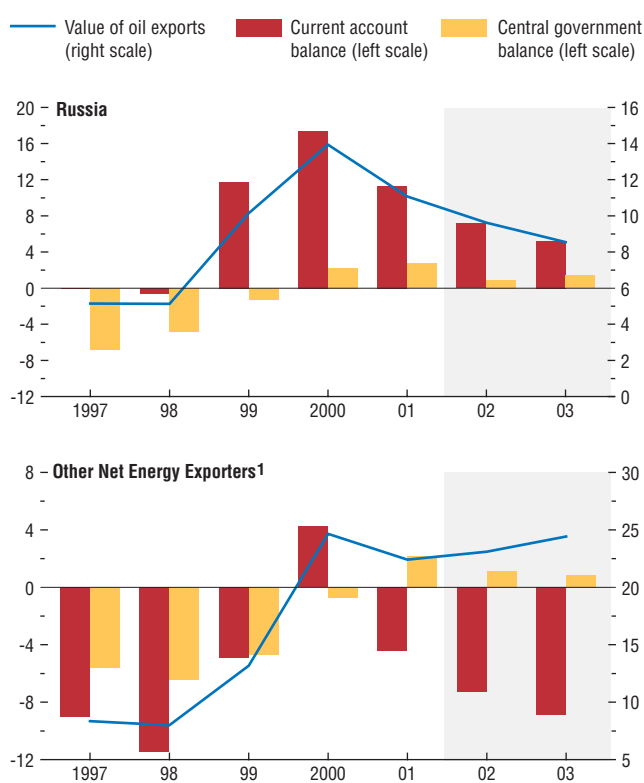
Africa: Solid Growth Despite a Weak External Environment

Despite the weak external environment, growth in Africa held up relatively well in 2001 compared with other parts of the world and, while slowing slightly, is still expected to be respectable in 2002 (Table 1.10). Although conditions and prospects vary widely across individual countries, the key influence on the outlook for much of the region continues to be the interaction between commodity market developments, the conduct of economic policies, and the extent of armed conflict and other sources of civil tension. Recent increases in oil prices are clearly supporting the outlook for Africa's oil producers, but are having a deleterious effect on the many other commodity exporters in the region, which include many of the poorest countries, despite some pickup in non-oil commodity prices. That said, both strong and weak performers can be found within each of these groups, with the quality of domestic policies and the extent of conflict having a key impact on whether countries have been able to resist the external downturn or not.

Growth among the oil exporting countries, including *Nigeria*, generally picked up in 2001 as a whole, supported by the carryover effects of higher oil prices in late 2000, and in the case of Algeria, an increase in public expenditures and a rebound in agriculture output following a severe drought in 2000. The pace of activity slowed among oil exporters during 2001, reflecting the combination of the subsequent decline in oil prices, lower OPEC production quotas, and the broader slowdown in the advanced economies, and is expected to slow further in 2002 despite

Figure 1.13. Commonwealth of Independent States: Managing Oil Price Volatility
(Percent of GDP)

Oil earnings have been correlated with current account balances and fiscal balances.



¹Azerbaijan, Kazakhstan, and Turkmenistan.

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			
	2000	2001	2002	2003	2000	2001	2002	2003	2000	2001	2002	2003
Africa	3.0	3.7	3.4	4.2	14.2	12.6	9.3	6.1	0.7	-0.5	-2.6	-2.3
Maghreb	2.8	4.7	3.1	4.2	1.3	2.5	3.8	3.3	7.1	5.8	1.8	1.8
Algeria	2.4	3.5	2.3	3.4	0.3	4.1	5.6	4.4	16.8	11.3	4.9	4.6
Morocco	2.4	6.3	4.0	4.1	1.9	0.5	1.4	1.8	-1.7	3.0	0.7	1.0
Tunisia	4.7	5.0	3.8	6.4	3.0	1.9	3.4	3.0	-4.2	-4.2	-4.6	-3.8
Sub-Saharan³	3.0	3.9	4.0	4.8	24.7	20.6	12.4	7.7	-2.0	-3.8	-6.4	-5.6
Cameroon	4.2	5.3	4.6	4.9	0.8	2.8	2.9	2.5	-1.7	-2.3	-5.0	-5.0
Côte d'Ivoire	-2.3	-0.9	3.0	4.5	2.5	4.4	3.6	3.4	-2.8	-2.4	-1.7	-1.1
Ghana	3.7	4.0	4.5	5.0	25.2	33.0	15.9	10.2	-8.4	-4.0	-6.4	-5.1
Kenya	-0.2	1.1	1.4	2.4	6.2	0.8	3.2	3.9	-2.1	-2.5	-3.7	-4.3
Nigeria	3.8	4.0	-1.1	3.4	6.9	18.9	14.7	11.2	4.9	-0.2	-10.9	-5.5
Tanzania	5.1	5.1	5.5	6.0	6.2	5.2	4.4	3.9	-1.6	-1.6	-3.5	-3.4
Uganda	4.0	4.9	5.8	6.3	6.3	4.6	0.2	5.5	-9.0	-8.4	-9.1	-8.8
South Africa	3.4	2.2	2.3	3.0	5.4	5.7	8.1	5.2	-0.3	-0.5	1.1	0.7
<i>Memorandum</i>												
Oil importers	3.0	3.6	3.6	4.4	13.6	11.0	7.8	5.4	-2.8	-2.5	-3.3	-3.2
Oil exporters	3.1	4.1	2.7	3.5	16.3	18.0	14.6	8.3	10.6	5.0	-0.9	0.2

¹In 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.

²Percent of GDP.

³Excludes South Africa.

recent rises in oil prices. This weakness is likely to be particularly severe in Nigeria, aggravated by fiscal policy and other domestic uncertainties (see below).

Despite signs of recovery in global output, many countries in Africa continue to face low prices for their non-oil commodities—including the very weak prices of coffee (a key export of *Kenya*, *Ethiopia*, and *Uganda*) and cotton (exported by *Benin*, *Burkina Faso*, *Cameroon*, *Chad*, *Côte d'Ivoire*, and *Mali*), and cyclical falls in most metals prices (affecting South Africa, *Ghana*, *Zambia*, and others). Relatively favorable growing conditions—especially the absence of the severe floods or drought that affected some countries in the late-1990s and 2000—are helping to support agricultural output across much of the region, although drought conditions continue in some parts of southern Africa, and severe food shortages are occurring in some areas. Countries with sizable tourism sectors—including *Morocco*, *Tunisia*, and *Kenya*—were hit by the sharp drop in travel and tourism following September 11, although this downturn does not appear to have been as sharp or prolonged as earlier feared.

Overall, the oil importing countries of Africa are expected to grow about 3½ percent on average in 2002, as in 2001. Most non-oil commodity prices are expected to pick up as global activity strengthens, supporting a further strengthening in growth among these countries in the period ahead.

Sound economic policies have also enabled a sizable number of African economies—including *Botswana*, *Cameroon*, *Senegal*, *Tanzania*, and *Uganda*—to offset the effects of export price weaknesses and the global slowdown, and instead to reach and sustain strong rates of growth over recent years (Figure 1.14). Progress is most apparent in the macroeconomic sphere, with a tight fiscal stance being maintained in many countries and inflation generally coming down (although remaining high in Ghana and Nigeria). However, uneven policy implementation has constrained growth in some countries (*Kenya*, *Malawi*, and *Seychelles*), while continued inappropriate economic policies and political turmoil have led to a marked contraction in economic activity and a surge in inflation in *Zimbabwe*. Structural reforms still lag behind in

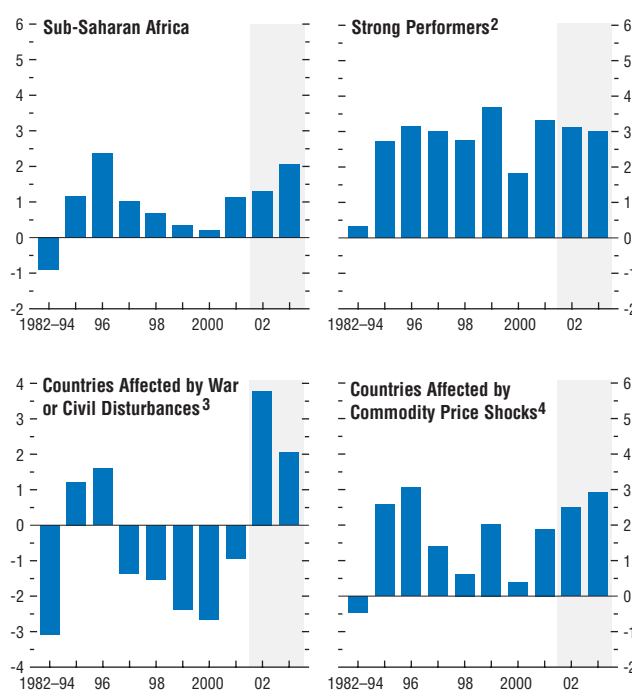
much of the region, and prospects for economic growth and diversification would be improved by better governance and public service delivery, including education, poverty alleviation, improving the security of property rights, and reducing corruption. Adding to these difficulties are poor infrastructure and insufficient liberalization. Conflict management also remains important, especially in sub-Saharan Africa; it is encouraging to note, however, that the number of countries involved in armed conflict has recently diminished, and this appears to be contributing to the sharp improvement in growth forecast for the group of countries affected by conflict over recent years.

Policies and initiatives at a multilateral level can also help to provide the basis for stronger growth in Africa. An important recent development within the region is the New Partnership for Africa's Development, which emphasizes African ownership, leadership, and accountability in improving the foundations for growth and eradicating poverty. In addition, 20 of the poorest countries have now become eligible for debt relief under the enhanced Initiative for Heavily Indebted Poor Countries (HIPC) and a number of others are expected to qualify in 2002. With this step, the countries concerned have been able to free up budgetary funds for public expenditure and investment—focused particularly on education, health, and other forms of human capital development—in accordance with commitments undertaken in their poverty reduction strategies. Further trade liberalization by the advanced economies—particularly opening their markets to agricultural goods and reducing their own production subsidies in this sector—would provide a major boost to the region's export performance and hence to prospects for sustained growth and poverty reduction. Ongoing international support is also needed to fight HIV/AIDS, which is taking a staggering toll on young and working age people in many southern African countries. Priorities include building up the medical infrastructure, better education, and making available advanced drug therapies to combat the pandemic.

Figure 1.14. Sub-Saharan Africa: Solid Growth in 2002 and 2003¹

(Per capita real GDP growth, percent)

After a strong pickup in 1995–96, per capita GDP growth has slowed markedly, mainly due to war and civil disturbances and commodity shocks. However, growth in countries with strong policies has been better sustained.



¹Excluding South Africa.

²Countries with generally strong macroeconomics and structural policies; comprises Benin, Botswana, Burkina Faso, Cameroon, Mali, Mauritius, Mozambique, Tanzania, Senegal, and Uganda (24 percent of sub-Saharan African GDP).

³Countries experiencing war or significant civil disturbances during 1998–2000; comprises Angola, Burundi, Comoros, Congo, Dem Republic of, Congo, Republic of, Côte d'Ivoire, Ethiopia, Guinea-Bissau, Lesotho, and Sierra Leone (18 percent of sub-Saharan African GDP).

⁴Countries experiencing adverse commodity price shocks exceeding 10 percent in 2000 compared with the 1995–97 average; comprises Benin, Burundi, Burkina Faso, Central African Republic, Chad, Côte d'Ivoire, Ethiopia, Ghana, Madagascar, Mali, Mauritius, Rwanda, São Tomé and Príncipe, Tanzania, Togo, Zambia, and Uganda (31 percent of sub-Saharan African GDP).

Box 1.6. Russia's Rebound

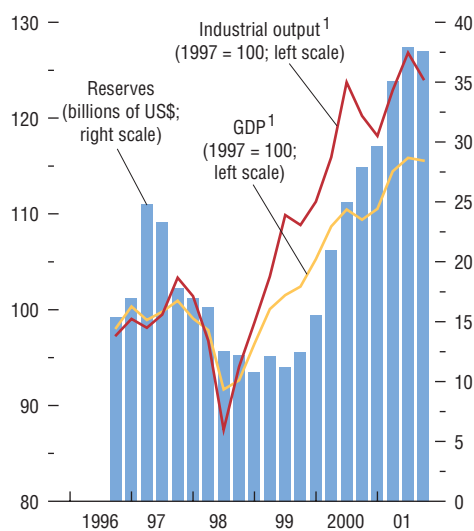
Russia's economic performance since the 1998 crisis has far surpassed most observers' expectations. Growth rates have averaged 6 percent a year over the last three years, after almost a decade of output declines, while inflation has been gradually reduced to about 20 percent. Large precrisis fiscal deficits have turned into overall surpluses exceeding 2 percent of GDP; current account deficits have given way to surpluses exceeding 11 percent of GDP; and international reserves have risen to record levels (see the figure). Similarly, the authorities have not only formulated a wide-ranging structural reform program but, in marked contrast with earlier experience, have already secured approval of some of the crucial underlying legislation. Reflecting this, the Russian stock market has soared, yields spreads on sovereign debt have narrowed, and nonsovereign borrowers are regaining access to international capital markets, even as other emerging markets have faced sharp losses of confidence.

The sharp turnaround in Russia's macroeconomic performance stems from a combination of a large real depreciation, a major terms-of-trade improvement, and significant fiscal retrenchment. After the crisis, the *real effective exchange rate* depreciated by 40 percent, dramatically improving competitiveness, and it still stands about 15 percent below its precrisis level. In addition, Russia's *terms of trade* improved by about 45 percent between 1998 and 2000, as world prices for oil and gas, two key exports, strengthened considerably. This positive terms-of-trade shock (equivalent in magnitude to about 13 percent of Russia's GDP), combined with the real depreciation, led to a significant increase in industrial profitability and investment, and eventually to higher economy-wide real wages and consumption. The energy price increase directly accounted for more than half of the turnaround on the current account; it also strengthened fiscal balances, largely because of increased crude-oil export tariffs and gas excises.

Fiscal policy in general displayed considerable prudence after the crisis. Federal revenues rose as

The main author is Nikola Spatafora.

Output Dynamics and International Reserves



Sources: Goskomstat; and the Central Bank of the Russian Federation.

¹ Seasonally adjusted.

major efforts were launched to raise tax compliance, reduce tax arrears, increase the share of taxes paid in cash, and reverse the steady erosion of revenues in favor of the regions. Meanwhile, the authorities restrained noninterest expenditures, so that the federal government's primary balance strengthened by nearly 8 percent of GDP between 1997 and 2000. This fiscal effort both helped support a sustained reduction in inflation and contained the pressures for real appreciation and "Dutch disease," which would otherwise have arisen in the face of massive current account surpluses.

So far, Russia has weathered the slowdown in the world economy, reflecting the large share in its exports of oil and gas. However, some weakening of growth is expected in 2002. Further, the continued uncertainty about future developments in the external environment poses significant risks for the economic outlook. Staff estimates indicate that each \$1 decline in Russian oil prices would lower GDP growth by 0.5 percentage points, export rev-

venues by 0.6 percent of GDP, and government revenues by 0.4 percent of GDP. A significant worsening of the external environment and an economic slowdown could also undermine recently achieved gains in strengthening financial discipline, including the improved tax compliance and the reduced reliance on barter and non cash transactions.

At a more fundamental level, prospects for sustained growth depend critically on success in passing and, above all, implementing structural reforms. In the past two years, impressive progress has been made on a broad front. In particular, the investment climate has improved through a combination of tax reform, deregulation, strengthening property rights, and developing financial markets and institutions. *Tax reforms* simplified the tax system, broadened the tax base, and reduced the tax burden. Key elements included simplifying mineral-resource taxation, reducing turnover and payroll taxes, introducing a flat personal income tax with a marginally reduced effective rate, and lowering the statutory profit-tax rate while eliminating most exemptions. These reforms will significantly reduce distortions and—with continued improvements in tax compliance—ensure fiscal sustainability. *Deregulation and strengthening property rights* involved a significant reduction in the number of business activities requiring a license; a new Land Code, which allows ownership of urban land and significantly reduces the uncertainty associated with fixed investment; and a new Labor Code, which liberalizes hiring and firing procedures. New reform strategies for railways and the electricity sector aim to restructure, liberalize, and privatize potentially competitive segments. Some progress was also made with *financial sector reform*: the legal framework for banking supervision and restructuring was strengthened, a pilot scheme for adopting international accounting standards was initiated, and new anti-money-laundering legislation was enacted.

Nevertheless, after over a decade, much remains to be done to complete the transition process. For the immediate future, the authorities' agenda faces three challenges. First, continuing the financial sector reforms, and in particular strengthening finan-

cial regulation and supervision, as well as stimulating competition within the banking sector, including by clarifying the future role of the currently dominant state banks. Second, completing the negotiations on WTO accession. This will require agreement on tariff rates, passage of a new customs code, and measures aimed at broader business deregulation. Third, completing and implementing other reforms, including allowing trade in agricultural land; restructuring the gas sector; strengthening bankruptcy procedures to eliminate the current scope for asset-stripping; simplifying small-business taxation; increasing cost-recovery in public housing; and overhauling pensions and the judiciary.

Looking beyond Russia, its strong performance has supported economic recovery throughout the CIS, where growth averaged over 8 percent in 2000 and 6 percent in 2001. Russia's influence reflects both the relatively large size of its economy, accounting for about three-fourths of the region's GDP, and the generally close trade linkages within the region: the CIS forms a free-trade area, and typical export-to-GDP ratios are about 40–50 percent. Overall, Russia is the main export market for almost all CIS countries, absorbing on average over 25 percent of their total exports. Cross-border financial linkages with Russia are also significant; in the past, they mainly took the form of energy trade-related credits, but in recent years FDI flows have increased, as investment climates have improved. Looking ahead, staff estimates suggest that a slowdown in Russian growth of 2 percentage points would reduce average growth in other CIS countries by 0.5 percentage point. The largest impact would be in those countries with the closest trade links with Russia: growth in Belarus and Moldova could slow by 1 percentage point, with an even larger decline in Turkmenistan.

In sum, the rebound in Russia has been truly impressive. Prudent policies, aided by a large and positive terms-of-trade shock, have produced strong improvements in key macroeconomic indicators. The acceleration in structural reform and the commitment to strengthening the investment climate raise hopes that the rebound can be sustained and that Russia will continue to be an engine of growth for the region.

Looking at the region's largest economies, *South Africa*—which constitutes just under 40 percent of sub-Saharan African GDP—has experienced some slowing in growth as a result of lower commodity prices and the global slowdown. However, these influences are expected to turn around and contribute to a steady pickup later this year and in 2003. The rand continued to weaken in 2001, sharply so in the final quarter, but appears to have stabilized in early 2002—supported by an appropriate increase in interest rates by the central bank. The reasons for the sharp depreciation are not entirely understood, but seem to follow a pattern of similar exchange rate weakness in other countries, such as Australia, Canada, and New Zealand, where commodities comprise an important share of exports. In part, though, it may reflect growing regional uncertainties, including the turmoil in Zimbabwe, and delays in the implementation of the privatization program. Looking ahead, confidence in the currency should be supported by the expected closing in 2002 of the central bank's net open forward position, and by the maintenance of firm monetary policies to keep inflation under control and build credibility in the inflation-targeting regime. Also important—for the currency and for prospects more generally—will be ongoing fiscal restraint, progress with privatization, and structural reforms to improve the business climate, boost investment, and hence make inroads on extremely high levels of unemployment and poverty.

In *Algeria*, growth is expected to slip to under 2½ percent in 2002, owing partly to cuts in oil output. Activity continues to be sustained by an expansionary fiscal stance. Despite considerable economic and policy progress since the early 1990s, the Algerian economy still suffers from growth well below potential, high unemployment, and vulnerability to developments in energy markets.

The situation in Nigeria remains a source of concern despite recent increases in oil prices, as OPEC production cuts are taking their toll following a period of above-quota production. Fiscal policy has been too expansionary, particu-

larly in the context of oil market volatility; but monetary conditions have tightened considerably, with the central bank trying to offset the effects of fiscal expansion and to slow inflation. In addition, some parts of the banking sector appear to be in distress, and the system as a whole faces poor governance and supervision; and distortion in the foreign exchange market between official, interbank, and parallel market rates has increased. Domestic confidence has been further disrupted by recent disasters and incidents of conflict.

Middle East: Oil Price Volatility and Regional Security

Growth in the Middle East is projected to slow significantly in 2002, continuing the pattern of 2001, largely reflecting lower oil production and the regional security situation. For the developing countries in the region, growth is expected to slow in 2002, while in Israel, after a fall in activity in 2001 partly reflecting weakness in the IT sector, growth is expected to resume (Table 1.11). The curtailment of oil production associated with OPEC agreements to limit global supply has depressed activity in the oil exporting countries although recent increases in oil prices, if sustained, will help support growth. The security situation has also had a significant negative impact on activity, including tourism, in particular in the Mashreq countries and Israel.

For the oil exporting countries, growth is expected to slow from 5.0 percent in 2001 to 3.4 percent in 2002, largely reflecting lower oil production and the lagged impact of lower oil prices in late 2001. The slowdown in growth has generally been limited by the use of more prudent macroeconomic policies. In particular, the boom and bust cycle of the past associated with sharp increases and decreases in government spending as oil revenues rose and fell has been much more muted. As a result, current account and fiscal balances have broadly followed oil price developments (Figure 1.15). This pattern is particularly evident in the smaller Gulf states (*Kuwait, United Arab Emirates, Bahrain, Oman*, and

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			
	2000	2001	2002	2003	2000	2001	2002	2003	2000	2001	2002	2003
Middle East³	5.3	4.5	3.1	4.4	9.8	8.0	9.5	8.3	12.1	6.9	2.5	-0.2
Oil exporters⁴	5.7	5.0	3.4	4.7	12.6	10.0	11.5	9.8	16.5	9.6	4.4	0.8
Saudi Arabia	4.5	2.2	-0.5	3.2	-0.6	-1.4	—	1.1	9.0	4.9	-1.3	-6.5
Iran, Islamic Rep. of	4.9	5.1	5.3	5.1	12.6	11.7	15.0	12.0	12.5	5.4	4.6	1.7
Kuwait	1.7	2.7	-1.8	3.3	1.7	2.5	2.5	2.5	39.3	32.2	20.9	20.2
Mashreq⁵	4.2	3.2	2.4	3.6	1.9	1.9	3.2	3.9	-2.2	-2.3	-3.8	-3.6
Egypt	5.1	3.3	1.7	3.5	2.8	2.4	3.2	4.4	-1.2	—	-2.3	-1.5
Jordan	4.0	4.2	5.1	6.0	0.7	1.8	3.5	2.4	0.7	0.4	-0.3	-0.4
<i>Memorandum</i>												
Israel	6.4	-0.6	1.3	3.8	1.1	1.1	3.1	2.1	-1.2	-1.5	-1.7	-2.1

¹In 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.

²Percent of GDP.

³Includes 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.

⁴Includes Bahrain, Islamic Rep. of Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and United Arab Emirates.

⁵Includes Egypt, Jordan, Lebanon, and Syrian Arab Republic.

Qatar). In *Saudi Arabia*, however, the slowdown in activity has been more pronounced, and growth is expected to be negative in 2002, partly reflecting the more difficult fiscal situation. In order to reduce inflation and avoid a sustained appreciation of their real exchange rates, oil exporting countries should maintain prudent macroeconomic policies.

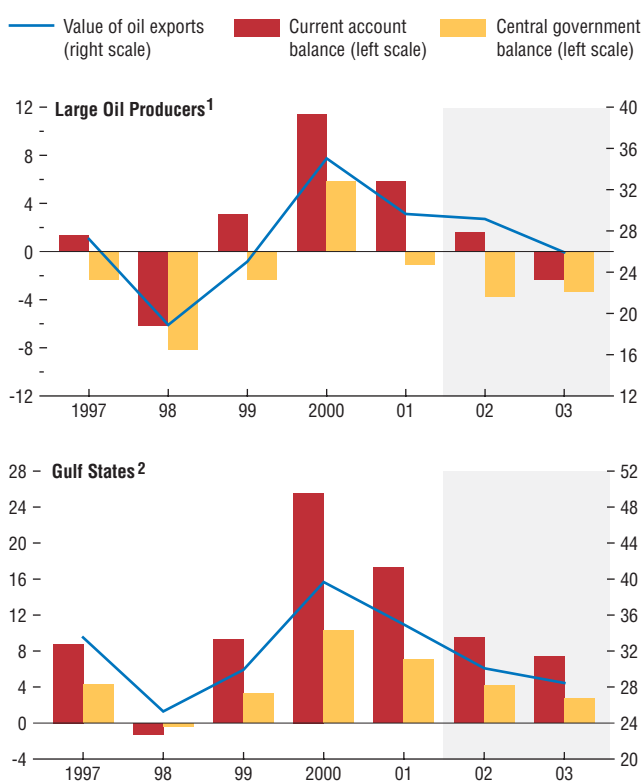
The main policy priority, however, remains the need to diversify production into other sectors than energy, to make these economies less dependent on oil revenues. The benefits of past reforms can be seen in the increased availability of imported capital and intermediate goods in many countries. If these economies are to remain attractive to both foreign and domestic investors, however, a broadening and deepening of structural reform is required, including in the areas of trade and exchange rate reforms, price liberalization, financial sector deregulation, public enterprise restructuring and privatization, and labor market and social safety net reforms. Recently, progress in some of these areas has been made by the *Islamic Republic of Iran*, where expanding non-oil private sector activity is expected to provide significant support to activity, as a result of which growth in 2002 is projected at 5.3 percent, slightly higher than in 2001. The

Gulf Cooperation Council (GCC) countries, which already have liberal trade, exchange rate, price systems, and free movement of capital, have also taken some steps to promote private sector activity, resulting in a more gradual expansion in non-oil activity.

In the Mashreq, *Egypt* was adversely affected by the events of September 11, especially through lower tourism earnings. While there are indications that tourism is beginning to recover, the balance of payments is expected to show a sizable overall deficit in 2002. Growth is projected to slow to under 2 percent this year, down from 3.3 percent in 2001, before recovering in 2003. The depreciation of the Egyptian pound over the past 18 months will help strengthen Egypt's balance of payments performance, and continuing flexibility will also be important in the period ahead. On fiscal policy, the deficit has widened, partly reflecting the operation of automatic stabilizers, and a reduction in the deficit will be important as activity recovers. Steps to reinvigorate structural reform will be required to achieve the sustained strong employment growth needed to absorb Egypt's rapidly rising labor force and reduce unemployment. The situation in *Lebanon* remains extremely difficult, with a large fiscal deficit and government debt of over

Figure 1.15. Middle East: Responding to Oil Price Volatility
(Percent of GDP)

In most countries, the recent windfall increases in oil prices have been prudently used, and the projected decline in 2002–03 will be manageable.



¹Iran, Islamic Republic of, Libya, and Saudi Arabia.
²Bahrain, Kuwait, Oman, Qatar, and United Arab Emirates.

170 percent of GDP. The fiscal situation and the debt dynamics have led to a loss of international reserves of the central bank in the context of a fixed exchange rate regime, and a comprehensive policy package will be needed to achieve a sustainable macroeconomic framework. Owing to limited regional links, developments in Lebanon would be unlikely to significantly affect neighboring countries. In *Jordan*, growth in 2002 is projected to be 5.1 percent, boosted by strong performance in exports and additional fiscal stimulus under the authorities' Plan for Social and Economic Transformation. The government continues to build on its structural reform program.

After a fall in activity in 2001, largely reflecting weakness in exports as demand for IT goods decelerated rapidly and growth in the United States slowed, growth in *Israel* is expected to pick up modestly to 1.3 percent in 2002 as these effects reverse. This will depend, however, on an early and substantial improvement in the extremely difficult regional security situation, in the absence of which the growth rate will be considerably lower. The design and execution of fiscal policy have improved in recent years, but further progress with fiscal reform is needed as ratios of general government expenditures and of public debt to GDP remain high relative to those of many other advanced economies. The Bank of Israel's decision to raise interest rates by 0.6 percentage points in late February, partly reversing the 2 percentage point cut in December 2001, was aimed at confirming the Bank's commitment to medium-term price stability, against the background of potential inflation pressures stemming from the significant depreciation of the sheqel since the December easing. In the *West Bank and Gaza*, the security situation—in particular the border closure with Israel and internal blockades—has severely affected economic activity, which is estimated to have declined by over 30 percent in 2001. Economic conditions have worsened markedly in 2002 with the escalation of hostilities, which have inflicted widespread damage on physical infrastructure.

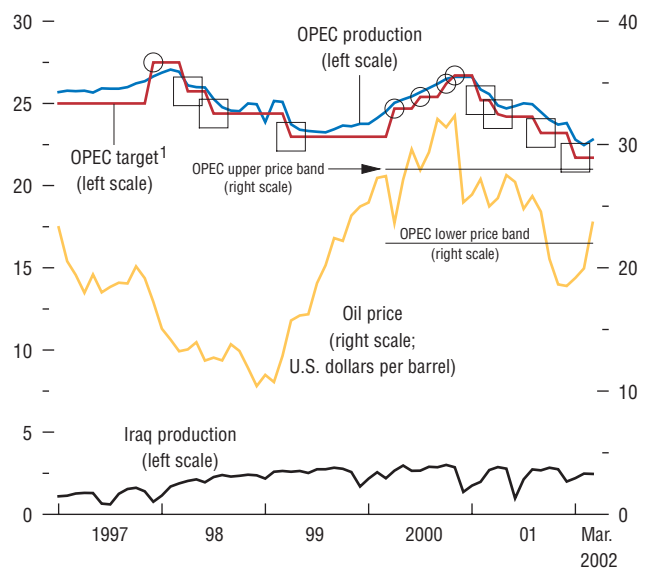
Appendix 1.1. Commodity Markets¹¹

Recent Developments

Following the surge to \$32 a barrel in the third quarter of 2000, crude oil prices weakened in reaction to the slowing world economy (Figure 1.16).¹² Despite a short-lived spike immediately following the September 11 terrorist attacks, prices tumbled to less than \$19 a barrel by end-2001. In conjunction with lower crude prices, refining margins were compressed by weak product demand and mounting inventories. Heating oil consumption fell in response to unseasonably warm weather in North America, while jet fuel demand slumped amid cutbacks in travel activity.

The softening in world oil markets during 2001 occurred despite efforts by OPEC to maintain prices within the target range of \$22–28. Production cuts of 3½ million barrels a day (4½ percent of global supply) were insufficient to offset falling demand, and prices fell well below the lower edge of the range. In December 2001, after negotiating commitments to cuts of close to half a million barrels a day with major non-OPEC producers, OPEC announced further cuts of 1½ million barrels a day to start in the beginning of 2002 for a period of six months. Against the background of these cuts, and with signs of unexpected strength in U.S. activity, oil market conditions firmed in early 2002 to close to \$23 a barrel. These factors were reinforced in March and early April by fears of disruptions in supply due to possible military intervention in the Middle East and the deteriorating security situation in Israel and the West Bank and Gaza. As a result of these concerns, oil prices spiked up by early April to about \$27 a barrel before falling subsequently as fears of significant disruptions of supply eroded. That said, the situation remains highly volatile, with oil prices depending as much on political as economic developments. To help assess future developments, Table 1.12 pro-

Figure 1.16. OPEC Target and Actual Production of Oil
(Millions of barrels per day unless otherwise indicated)



Source: Bloomberg Financial Markets, LP.

¹Circles denote increases in OPEC target production and squares denote decreases in OPEC target production. In 2001, Iran announced it would move its April cuts to May.

¹¹The main author is Guy Meredith.

¹²References to oil prices relate to the IMF's un-weighted average of West Texas Intermediate (WTI), U.K. Brent, and Dubai crude oil prices.

vides some indicators of the impact of changes in oil prices on output and trade balances.

As regards demand, International Energy Agency projections show global oil demand growing by about 420,000 barrels a day in 2002, up about ½ percent over 2001. This would be similar to expectations of increased production by non-OPEC producers, including those not covered by production agreements. Hence, if OPEC's production cuts are maintained, but no further disruptions occur, this would result in a relatively stable balance between supply and demand in markets. The WEO baseline reflects such a scenario, with a weighted-average price of \$23 a barrel in 2002 and \$22 in 2003. As discussed above, the recent spike in oil prices appears to reflect market concerns over possible additional reductions in supply.

In undertaking production cuts, OPEC faces the issue of its declining share in global oil supply (Figure 1.17).¹³ OPEC has traditionally produced almost 40 percent of world oil, and holds more than 77 percent of proven reserves. Its members include 11 of the top 20 world oil producers; OPEC also holds most of the world's excess capacity, as non-OPEC producers tend to produce close to their maximum output. This position has allowed OPEC to have a significant effect on the market at times when there are no major imbalances. Its share of the world market declined to about 36 percent in late 2001, however, following last year's production cuts, and could drop further to close to 35 percent this year if recent cuts are maintained. This decline could raise concerns in OPEC about a secular decline in their ability to influence the market, and an erosion of revenue in favor of alternative producers. The equilibrium in oil markets is thus likely to remain rather fragile as OPEC navigates the trade-off between losing market share and supporting prices.

Conditions in nonenergy commodity markets have remained basically unchanged in early

Table 1.12. Impact of a \$5 a Barrel, Permanent Increase in Oil Prices After One Year
(Percentage points of GDP)

	Real GDP	Trade Balance
World GDP	-0.3	—
Industrial countries	-0.3	-0.2
United States	-0.4	-0.1
Euro area	-0.4	-0.1
Japan	-0.2	-0.2
Other	-0.2	0.2
Developing countries	-0.2	0.2
Of which:		
Latin America	-0.1	—
Asia	-0.4	-0.5
Emerging Europe and Africa	0.1	0.2

Source: IMF staff estimates based on IMF (2000).

2002, with global recovery prospects arresting the downward trend in prices through 2001. The staff's nonfuel price index rose by 2.9 percent in February over January, but remained 3.2 percent below the level a year ago. Metals prices, especially for copper and aluminum, have shown the clearest signs of recovery from recent lows, as they are perceived to be relatively sensitive to cyclical conditions. Gold prices also picked up early in the year, in response to falling equity prices and aggressive Japanese buying. But the fundamentals in metals markets have not changed significantly, and increasing stocks should dampen near-term price increases.

Market conditions for agriculture commodities have been mixed, as brighter global recovery prospects have been offset by rising supply. Wheat and sugar prices have been relatively weak in expectation of increasing exports from Argentina and Brazil, respectively. Cotton prices, in contrast, have shown some signs of strengthening from depressed levels; the outlook is clouded, however, by the risk that agricultural policies in industrial countries could further exacerbate problems of global oversupply.

The global market for semiconductors collapsed in 2001, with a decline in the value of

¹³OPEC's members are Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, and Venezuela. Although it remains a member of OPEC, Iraq is outside the quota system, with exports instead being currently governed by the U.N. food-for-oil agreement.

sales of about 30 percent, and in unit shipments of 20 percent. An important factor was a decline in global sales of personal computers—the first since 1986. The volatile market for memory chips was hit particularly hard, as prices plunged amid oversupply and rising inventories. Some signs of a turnaround in the market were evident toward the end of the year, however, as both prices and volumes firmed in response to a recovery in final demand for electronics products, and the closure of some production facilities as prices fell below production costs.

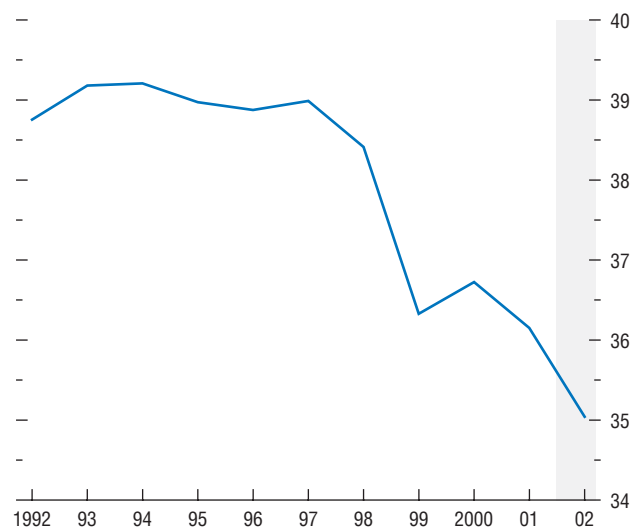
Assuming a general recovery in global activity, the semiconductor market is expected to regain momentum in 2002. In particular, the market for memory chips is showing signs of rebounding, helped by innovations such as double-data rate (DDR) technology and the erosion of inventories. The last major replacement purchases for computers took place in 1999 in anticipation of Y2K. With historical replacement cycles being in the range of 3–4 years, there will likely be significant demand for renewal of this equipment, although firms appear less willing to embrace new technology, as the operational boundaries of current hardware and software are not being pushed.

Industrial reorganization is also affecting supply. Some traditional producers have suffered large losses during the recent slump, resulting in facilities' closures. There have also been merger talks among the largest producers of memory chips that would concentrate control of supply in the hands of fewer decision makers. Finally, China is becoming an increasingly important location for production.

Cyclical Movements in Nonfuel Commodity Prices

Commodity price movements appear to have closely tracked changes in the outlook for growth in major industrial countries recently. It is interesting to compare this correspondence with the typical historical relationship between commodity prices and activity. Looking ahead, most forecasters anticipate a pickup in global activity through 2002 and 2003: should this be expected to reverse the recent weakness in commodity

Figure 1.17. Share of World Oil Production of OPEC¹
(Percent)

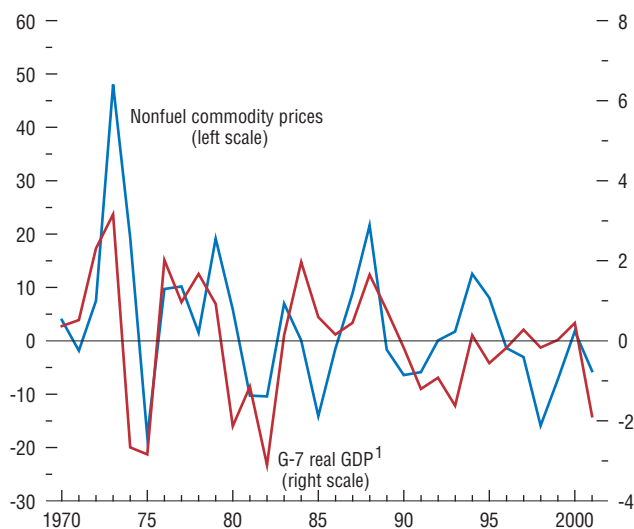


Sources: International Energy Agency; and IMF staff estimates.

¹OPEC is defined here as not including Iraq, whose production amounts are affected by the Oil-for-Food program, and includes Natural Gas Liquids, which for our purposes are considered oil products.

Figure 1.18. Movements in Nonfuel Commodity Prices and G-7 Real GDP

(Annual log change multiplied by 100)



Sources: OECD; and IMF staff estimates.

¹Adjusted by subtracting the mean of the log change from 1970 to 2001.

prices, or do current prices already reflect expectations of a future recovery in activity?

Conceptually, the relationship between commodity prices and activity in industrial countries will reflect both supply and demand factors. On the supply side, shocks in commodity markets that raise prices are likely to reduce output in importing countries; as industrial countries are, in aggregate, net importers of commodities, this would imply a negative correlation between prices and activity. On the demand side, higher activity in industrial countries will tend to raise world commodity consumption and thus prices.

Figure 1.18 shows the historical movements in nonfuel commodity prices and real GDP in G-7 countries from 1970 to 2001. A strong pattern of positive comovements between prices and activity is apparent, suggesting that demand shocks have dominated during the historical period; for the period as a whole, the correlation coefficient between the two series is 0.49. Commodity prices have been considerably more volatile than output, though, with typical annual movements about six times as large.

Against this background, the sharp declines in nonfuel commodity prices since the mid-1990s are somewhat anomalous, in that they have been associated with relative stability in G-7 GDP growth. Instead, they appear to have reflected, at least in part, the impact of the Asian financial crisis and external financing constraints on emerging market countries more generally, which put downward pressure on exchange rates of some commodity exporters and reduced demand outside of the industrial countries. Other supply factors, including improved technology and agricultural support policies in some developed economies, have also played a role. The further drop in prices in 2001 was, more typically, associated with the sharp slowdown in G-7 activity.

Looking ahead, an important question is whether the projected upturn in global activity in the period ahead will generate a rebound in nonfuel commodity prices. Taken at face value, the historical correlation suggests that it should, but the issue is potentially more complicated. In particular, one must address the question of

whether current commodity prices already reflect expectations of global recovery. If they do, prices may not respond to the actual upturn when it occurs; if they do not, a rebound is more plausible. The answer depends on two factors—the relationship between spot and futures prices in commodity markets; and the extent to which futures prices already reflect recovery prospects. If futures prices are “efficient” in reflecting future growth prospects, and arbitrage is feasible between spot and futures markets, then current prices should embody future growth prospects. If these conditions fail, however, commodity prices could still pick up, even though the recovery in activity is generally expected.

The scope for arbitrage between spot and futures markets can be assessed by comparing prices in the two markets at a point in time. In general, in competitive markets, the futures price should exceed the spot price only by the financial and physical costs of storing commodities—otherwise, risk-free profits could be made by buying commodities in the spot market for future delivery. The financial storage cost is represented by the nominal interest rate, while the physical cost will vary from commodity to commodity. Figure 1.19 shows the relationship as of early February between the spot and futures prices for several non-fuel commodities. Gold is included as a reference price, because the low storage costs of gold and competitive markets make for efficient arbitrage. The pattern is mixed. For cotton and coffee, futures prices are well above spot prices, suggesting that storage opportunities are limited. The futures premium for wheat and copper, in contrast, is only moderately higher than that for gold. Finally, for sugar, the futures price is well below the spot price. This varied pattern among commodities raises questions about the general tightness of the link between spot and futures markets.

The second issue is whether futures prices accurately predict future spot prices. Futures prices will be the best available predictor if markets are efficient and investors are risk-neutral. Looking backward, these conditions could be assessed by comparing futures prices with those actually realized in spot markets to see whether the errors are systematic. A lack of long time-series data on futures and spot prices for identical commodities, though, makes this approach difficult to implement.

Rather than attempting to test separately for the predictive ability of futures prices and the scope for arbitrage between spot and futures markets for commodities, a more general approach is taken here to addressing the question of whether expected output movements are already reflected in existing commodity prices. This involves separating actual output growth into its expected and unexpected components. If futures markets are efficient and physical storage is costless, only the *unexpected* component of output growth should affect prices, after controlling for the impact of nominal interest rates on financial storage costs. If, in contrast, these conditions do not hold, *expected* growth should also play a role.

To distinguish between expected and unexpected output growth, the OECD’s forecast for growth in aggregate real GDP of the G-7 countries was used as a proxy for expected growth (defined as the forecast published in December for the following year); the unexpected component was the difference between actual growth and this forecast. The 12-month change in commodity prices from December to December of the following year was then regressed on these two components of growth, as well as the December interest rate on 12-month U.S. treasury bills.¹⁴ The results are as follows (*t*-statistics in parentheses):¹⁵

¹⁴The growth forecast is based on annual average data, while the commodity price change is December-to-December. This difference in definition should bias the results against finding a significant lagged effect from expected growth, because the December level of commodity prices would already embody part of the impact of the growth forecast. Hence, the lagged effect of expected growth is potentially stronger than the estimates indicate.

¹⁵The nominal change in the commodity price index was used as the dependent variable to be consistent with the use of the nominal interest rate as the financial cost of storing commodities. The slope parameters are very similar, and the overall fit somewhat higher, if the commodity price index is expressed in real terms by deflating by the U.S. CPI.

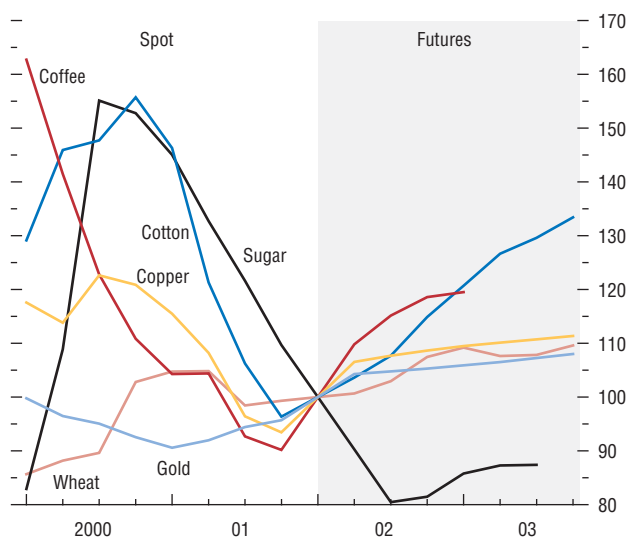
$$\begin{aligned} \Delta \ln PCOM = & -0.10 + 6.1 \text{ growth_expected} \\ & (1.0) \quad (3.3) \\ & + 3.2 \text{ growth_unexpected} - 0.7 \text{ tbill_rate} \\ & (1.6) \quad (0.6) \\ R^2 = & 0.36 \quad \text{Sample period} = 1970\text{--}2001 \end{aligned}$$

Interestingly, the coefficient on expected GDP growth is positive, significant, and large: an increase in expected growth of 1 percentage point is associated with a rise in the commodity price index of about 6 percentage points over the following 12 months. The coefficient on unexpected growth is only about one-half the size, and marginally significant at conventional levels. Finally, the (insignificant) negative coefficient on the interest rate is contrary to the value of +1 that would be expected if it captured the financial cost of storing commodities.

The strong role for expected growth is contrary to what one might expect if arbitrage were costless between futures and spot markets and markets were efficient. One implication, then, is that these conditions have not held over the historical period—consistent with the evidence for limited arbitrage provided above by the relationship between spot and futures prices. The relatively weak coefficient on unexpected growth is, at first sight, more difficult to explain. It can be rationalized, however, by considering the nature of the shocks underlying the correlation between commodity prices and unexpected growth. If these reflect a larger component of (unexpected) supply shocks in commodity markets, which in turn have a negative impact on activity in G-7 countries, the lack of a strong positive relationship between unexpected innovations in activity and commodity prices becomes more plausible.

Looking ahead, what would this relationship imply for nonfuel commodity prices? To answer this question, the expected component of growth was set to the WEO forecast for G-7 activity in 2002 and 2003, the U.S. interest rate was set to its WEO baseline value, and the unexpected component of growth was set to zero. Under these assumptions, the nonfuel price index is predicted to stay relatively flat in 2002,

Figure 1.19. Spot and Futures Commodity Prices
(2002:Q1 = 100)



Source: Bloomberg Financial Markets, LP.

given the weak growth projection for G-7 output. Some recovery is then predicted in 2003 given the pickup in growth, but even then the rise is moderate, as the projected growth rate of G-7 output does not significantly exceed its average historical value. The implications of the regression, then, are that the strong historical relationship between expected output growth and commodity prices would not translate into a marked rise in prices over the next two years—growth would have to significantly exceed its historical average for this to occur.

Appendix 1.2. Weakness in Japan, Global Imbalances, and the Outlook¹⁶

This appendix explores how two underlying risks to the forecast—further weakness in Japan and global imbalances—could affect the outlook. The baseline contains a scenario in which recovery in the three main currency areas is relatively synchronized, as was the slowdown in activity in 2000 and 2001. In the United States and the euro area, recovery starts in early 2002 and gains momentum in the second half of the year, while in Japan there is a similar profile, albeit at lower rates of growth. As always, however, there is a high degree of uncertainty about the future path of output. This appendix explores some of the consequences coming from two of the more important risks and uncertainties to the outlook: the difficult situation in Japan, including the limited room for macroeconomic policy stimulus and continuing problems in the banking sector, which make the economy particularly vulnerable to unexpected negative shocks; and the limited progress made during the slowdown in reducing significant imbalances in the global economy, most notably the large current account deficit and low household saving rate in the United

States. This in turn reflects the synchronization of the slowdown in activity across most of the major regions of the global economy and, in particular, the inability of the euro area to maintain robust growth in the face of weakness in the United States. Combined with the mildness of the U.S. recession, this means there has been much less adjustment of the external imbalances across the major currency areas and of the U.S. household saving rate than had been anticipated in most “hard landing” scenarios (see, for example, Box 1.1 in the May 2000 *World Economic Outlook*). Consequently, many of the medium-term concerns over the late 1990s associated with the sustainability of the U.S. current account remain pertinent.

These observations are incorporated into an alternative scenario using the Fund’s macroeconomic model, MULTIMOD, through the following assumptions:

- In *Japan*, a continuation of the deterioration in the financial system is assumed to increase the risk premium on all assets by 1 percentage point compared to baseline for the next 10 years. As a result, in early 2002 there is a 12 percent depreciation in the real exchange rate against the U.S. dollar and a somewhat larger fall in the equity market.
- Investors in the *euro area* and parts of the *other industrial countries* become increasingly unwilling to further extend their exposure to the United States and other industrial countries that have structural current account deficits (such as the United Kingdom).¹⁷

In the simulation, monetary policy is assumed to follow a Taylor-type rule in which interest rates respond to core inflation and to the output gap (unless constrained by the zero nominal interest rate bound, as happens in Japan). Fiscal policy is assumed to be passive, with the authori-

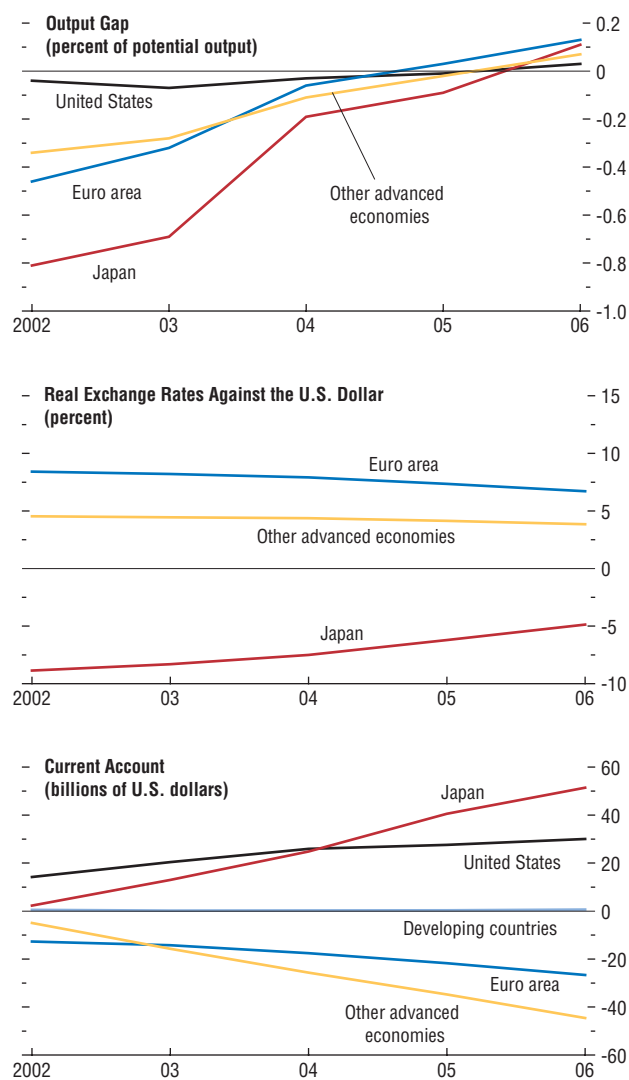
¹⁶The main author is Tamim Bayoumi.

¹⁷This shift in portfolio preferences is modeled by assuming that each percentage point increase in ratio of U.S. net foreign assets to GDP above a fixed target level leads to a 10 basis point increase in the risk premium on the U.S. dollar. To simulate a loss of confidence, the target level of net foreign assets to GDP is set 2½ percentage points below its level in 2001 (which is slightly over 20 percentage points of GDP). This causes the euro to appreciate by some 8 percent against the U.S. dollar while the other industrial countries as a group appreciate by some 4 percent—implying a reduction in capital flows to the United States of some \$20 billion.

Figure 1.20. Alternative Scenario

(Derivative from baseline)

A faster recovery in the United States and weaker activity in Japan could delay recovery in the euro area.



Source: IMF MULTIMOD simulations.

ties initiating no active policy changes but allowing automatic stabilizers to operate.

The result is a scenario in which Japanese activity remains weak through the medium term, recovery in the euro area is delayed, while the United States is little affected (see Figure 1.20 and Table 1.13). In Japan, the increase in the risk premium on assets leads to a significant fall in growth in 2002 because of falling asset prices exacerbated by constraints on countercyclical macroeconomic policies. The loss of market confidence in growth prospects translates into significant additional wealth destruction, resulting in a sharp fall in investment as equity prices dive and financial intermediation becomes less efficient. Consumption also falls significantly compared with the baseline, as wealth destruction and the loss of incomes reduce the desire and ability to spend and—while net exports provide some support for activity as a result of the depreciation of the yen—the impact is limited by the relatively closed nature of the economy. Most important, the macroeconomic policy response cannot provide stimulus because of the lack of policy maneuver. Monetary policy is unable to cushion activity because of the zero bound on interest rates—indeed, real interest rates rise as deflationary forces intensify—while fiscal policy is constrained by the high level of government debt. As a consequence, a modest shock to financial markets translates into a significant reduction in activity and increased deflationary pressures. Reflecting the depreciation in the yen and the weakness of activity, the current account improves some \$25 billion by 2004.

Despite the fact that there are no direct effects on domestic activity, recovery in the euro area is delayed by developments in Japan and the appreciation of the euro. The downward pressure on growth in the short term comes through trade and wealth channels. Turning first to trade, the appreciation of the real multilateral exchange rate by 7 percent results in a fall in real net exports compared to baseline, an effect that accounts for about half of the reduction in activity in 2002, again compared with the baseline. In addition, significant wealth losses on holdings of

foreign assets due to the appreciation in the exchange rate and the wealth destruction in Japan dampen real consumption and investment over the short term. Monetary policy provides some support to activity, but the limited pass-through of real exchange rate appreciation to core inflation—continuing a trend that has been seen in many industrial and emerging market countries over the last decade—constrains the vigor of the response. The current account deteriorates by over \$15 billion by 2004 compared with the baseline. A similar set of considerations, although in a somewhat less virulent form, pertain to the other industrial countries as a group. Again, net exports tend to reduce activity while losses on overseas holdings of financial assets constrain domestic demand, and the current account deteriorates significantly.

In contrast, the impact on the United States is quite limited. Activity is barely affected as the loss of output from lower external demand is largely offset by stronger net exports. There is a modest improvement in the current account of \$25 billion (0.2 percentage points of GDP) by 2004. Turning to developing countries, weakness in the industrial countries has a modest negative impact. Given the differences in behavior across the major currency regions, however, the impact varies significantly depending on where the country is located and its exchange rate regime. Continued weakness in Japan, including a depreciation of the yen, leads to generally weaker growth in the rest of east Asia, particularly those countries with links to the dollar. For Africa and the countries in transition, whose links are greatest with the euro area, the short-term impact is mixed, depending on whether the increase in demand created by euro depreciation outweighs the loss in demand from slower activity. Latin America is largely unaffected, reflecting its limited trade with the rest of the world (see the first essay in Chapter II) and links to the United States.

The results in this scenario underline some of the vulnerabilities attached to the baseline forecast. The first is how the recession and limited room for macroeconomic maneuver in Japan in-

Table 1.13. Alternative Scenario: Japanese Weakness and Exchange Rate Adjustment

(Percent deviation from baseline unless otherwise specified)

	2002	2003	2004	2005	2006
World real GDP growth	-0.3	—	0.2	—	0.1
United States					
Real GDP growth	-0.1	—	—	—	—
Output gap	—	-0.1	—	—	—
Real domestic demand growth	-0.1	-0.1	-0.1	—	—
Real effective exchange rate	-1.1	-1.1	-1.2	-1.4	-1.5
Current account (\$billion)	14.2	20.4	25.9	27.6	30.1
Core inflation (percentage points)	—	-0.1	-0.1	—	0.1
Short-term real interest rate (percentage points)	—	-0.1	—	—	0.1
Euro area					
Real GDP growth	-0.5	0.2	0.3	0.1	0.1
Output gap	-0.5	-0.3	-0.1	—	0.1
Real domestic demand growth	-0.2	0.2	0.3	0.1	0.2
Real effective exchange rate	6.9	6.7	6.3	5.6	5.0
Real U.S. dollar exchange rate	8.4	8.2	7.9	7.4	6.7
Current account (\$billion)	-12.7	-14.2	-17.5	-21.7	-26.6
Core inflation (percentage points)	-0.1	-0.1	-0.2	-0.2	-0.1
Short-term real interest rate (percentage points)	-0.4	-0.4	-0.3	-0.2	-0.2
Japan					
Real GDP growth	-1.0	-0.1	0.4	-0.1	0.1
Output gap	-0.8	-0.7	-0.2	-0.1	0.1
Real domestic demand growth	-1.7	-0.3	0.3	-0.1	0.1
Real effective exchange rate	-11.7	-11.1	-10.2	-8.8	-7.3
Real U.S. dollar exchange rate	-8.9	-8.3	-7.5	-6.2	-4.9
Current account (\$billion)	2.3	13.0	24.9	40.5	51.4
Core inflation (percentage points)	-0.2	—	-0.1	-0.2	-0.1
Short-term real interest rate (percentage points)	—	0.1	-0.4	-0.5	-0.4
Other industrial economies					
Real GDP growth	-0.4	0.1	0.3	0.1	0.2
Output gap	-0.3	-0.3	-0.1	—	0.1
Current account (\$billion)	-4.9	-15.7	-25.6	-34.7	-44.6
Industrial countries					
Real GDP growth	-0.4	—	0.2	0.1	0.1
Output gap	-0.4	-0.3	-0.1	—	0.1
Current account (\$billion)	-1.1	3.5	7.6	11.7	10.3
Developing countries					
Real GDP growth	-0.1	—	0.1	—	—
Current account (\$billion)	1.1	-3.5	-7.6	-11.7	-10.3

creases vulnerability to unanticipated problems. The second is how exchange rate weakness of the yen and the U.S. dollar can hurt short-term prospects for the euro area (and some other countries).

Looking to the medium term, the simulation also illustrates some of the difficulties in resolv-

ing the large imbalances across the globe even with an appreciation of the euro against the U.S. dollar, particularly in the face of weak activity in Japan. The necessary slowdown of activity in the United States, which was showing increasing evidence of being above its potential, has not led to a significant reduction in global imbalances. This reflects the continued resilience of U.S. consumption and the inability of the other major currency areas and emerging market regions to maintain robust growth in the face of weakness in the United States. It also implies that significant exchange rate movements may be needed to make notable progress on the imbalances.

How, under such circumstances, will an orderly adjustment of the U.S. current account deficit be achieved? Ideally, the counterpart to any significant reduction in the U.S. current account balance would be a more modest deterioration in the external position of a number of other regions, rather than a large adjustment in one, although weakness in Japan would complicate such an adjustment. As emphasized in previous *World Economic Outlooks*, adjustment in external imbalances would be facilitated by greater progress on structural reform in the euro area, Japan, and emerging markets regions such as emerging Asia. Such reforms would make these regions a more attractive location for investment, thereby reducing the flow of world saving to the United States, which reflects, at least in part, disappointing potential output growth and unattractive climates for investment elsewhere. For example, if productivity growth in the rest of the industrial countries were to increase relative to the United States by $\frac{1}{2}$ percent a year, this could reduce the U.S. current account balance by almost \$100 billion after 5 years.¹⁸ In the United States, it will be important

to ensure that fiscal policy is conducted in a manner that does not reduce domestic saving over the medium term. In short, a generalized failure to make significant progress on structural reforms across a range of countries would exacerbate global vulnerabilities.

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¹⁸See Appendix II of the October 2001 *World Economic Outlook*. The actual simulation was of an increase in productivity growth in the United States, relative to other countries, rather than a fall in relative growth.