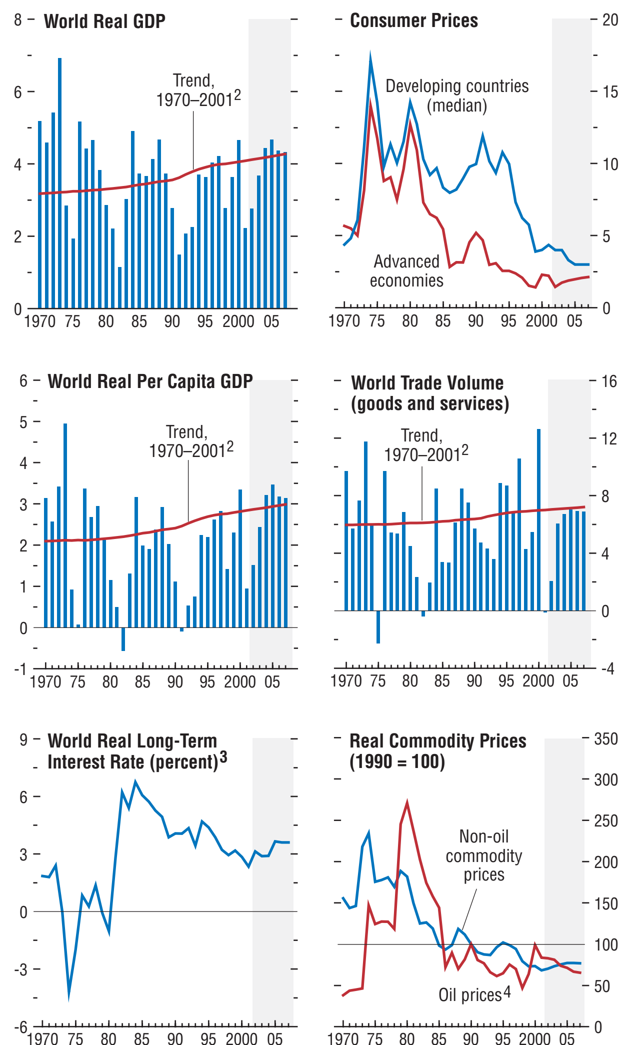
CHAPTER I ECONOMIC PROSPECTS AND POLICY ISSUES

Since late 2001, a global recovery has been under way, with trade and industrial production picking up across the globe. However, after a strong first quarter, concerns about the pace and sustainability of the recovery have risen significantly. Financial markets have weakened markedly, with equity markets falling sharply since end-March accompanied by a depreciation of the U.S. dollar; financing conditions for emerging markets have deteriorated, particularly in South America and Turkey; and incoming data in both the U.S. and the euro area have fallen short of expectations. The recovery is still expected to continue, but global growth in the second half of 2002 and in 2003 will be weaker than earlier expected (Figure 1.1 and Table 1.1), and the risks to the outlook are primarily on the downside. With inflationary pressures generally subdued, macroeconomic policies in advanced countries will now need to remain accommodative for longer than had earlier seemed necessary; if incoming data were to suggest that the recovery is faltering, additional monetary easing would need to be considered. Attention also needs to focus on policies to reduce dependence on the United States as the global engine of growth, and to support an orderly reduction in the global imbalances, which remain a serious risk to the world economy.

Since the turn of the year, a global recovery has been under way, led by the United States and underpinned by a pickup in global industrial production and trade (Figure 1.2). Even allowing for the recent substantial downward revision to GDP growth in 2001 in the United States, the global slowdown in 2000–01 has proved to be more moderate than most previous downturns. This owed much to an aggressive policy response, particularly following the events of September 11, in turn made possible by the improvement in economic fundamentals during the 1990s. Other contributing factors included the decline in oil prices in 2001; the resilience of the global financial infrastructure to a variety of substantial shocks; and a

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

After a sharp slowdown in 2001, global output is projected to pick up in 2002–03, although remaining below trend.



[1]Shaded areas indicate IMF staff projections. Aggregates are computed on the basis of purchasing-power-parity weights unless otherwise indicated.
[2]Average growth rates for individual countries, aggregated using purchasing-power-parity weights; the aggregates shift over time in favor of faster growing countries, giving the line an upward trend.
[3]GDP-weighted average of the 10-year (or nearest maturity) government bond yields less inflation rates for the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada. Excluding Italy prior to 1972.
[4]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil.

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

			Current Projections		Difference from April 2002 Projections[1]	
	2000	2001	2002	2003	2002	2003
World output	**4.7**	**2.2**	**2.8**	**3.7**	**—**	**–0.3**
Advanced economies	3.8	0.8	1.7	2.5	—	–0.5
Major advanced economies	3.4	0.6	1.4	2.3	–0.1	–0.5
United States	3.8	0.3	2.2	2.6	–0.1	–0.8
Japan	2.4	–0.3	–0.5	1.1	0.5	0.3
Germany	2.9	0.6	0.5	2.0	–0.4	–0.7
France	4.2	1.8	1.2	2.3	–0.2	–0.7
Italy	2.9	1.8	0.7	2.3	–0.7	–0.6
United Kingdom	3.1	1.9	1.7	2.4	–0.3	–0.4
Canada	4.5	1.5	3.4	3.4	0.9	–0.2
Other advanced economies	5.3	1.6	2.6	3.3	0.1	–0.4
Memorandum						
European Union	3.5	1.6	1.1	2.3	–0.4	–0.6
Euro area	3.5	1.5	0.9	2.3	–0.5	–0.6
Newly industrialized Asian economies	8.5	0.8	4.7	4.9	1.1	–0.2
Developing countries	5.7	3.9	4.2	5.2	–0.1	–0.3
Africa	3.0	3.5	3.1	4.2	–0.3	—
Developing Asia	6.7	5.6	6.1	6.3	0.2	–0.1
China	8.0	7.3	7.5	7.2	0.5	–0.2
India	5.4	4.1	5.0	5.7	–0.5	–0.1
ASEAN-4[2]	5.1	2.6	3.6	4.2	0.3	0.1
Middle East and Turkey[3]	6.1	1.5	3.6	4.7	0.3	0.2
Western Hemisphere	4.0	0.6	–0.6	3.0	–1.3	–0.7
Brazil	4.4	1.5	1.5	3.0	–1.0	–0.5
Countries in transition	6.6	5.0	3.9	4.5	—	0.1
Central and eastern Europe	3.8	3.0	2.7	3.8	–0.3	–0.2
Commonwealth of Independent States and Mongolia	8.4	6.3	4.6	4.9	0.1	0.3
Russia	9.0	5.0	4.4	4.9	—	—
Excluding Russia	6.9	8.9	5.2	4.9	0.5	0.8
Memorandum						
World growth based on market exchange rates	3.9	1.1	1.7	2.8	–0.1	–0.4
World trade volume (goods and services)	**12.6**	**–0.1**	**2.1**	**6.1**	**–0.4**	**–0.5**
Imports						
Advanced economies	11.8	–1.3	1.7	6.2	–0.4	–0.4
Developing countries	15.9	1.6	3.8	7.1	–2.6	–0.6
Countries in transition	13.4	11.7	6.9	8.0	–1.1	0.3
Exports						
Advanced economies	12.0	–1.1	1.2	5.4	0.3	–0.9
Developing countries	15.0	2.6	3.2	6.5	–1.6	–0.5
Countries in transition	14.7	5.9	5.3	6.2	0.1	0.1
Commodity prices (U.S. dollars)						
Oil[4]	57.0	–14.0	0.5	–0.8	5.8	3.5
Nonfuel (average based on world commodity export weights)	1.8	–5.4	4.2	5.7	4.3	–1.5
Consumer prices						
Advanced economies	2.3	2.2	1.4	1.7	0.1	–0.1
Developing countries	6.1	5.7	5.6	6.0	–0.2	0.9
Countries in transition	20.2	15.9	11.3	8.8	0.5	0.1
Six-month London interbank offered rate (LIBOR, percent)						
On U.S. dollar deposits	6.6	3.7	2.1	3.2	–0.8	–1.3
On Japanese yen deposits	0.3	0.2	0.1	0.1	—	—
On euro deposits	4.6	4.1	3.4	3.8	–0.3	–0.8

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during July 19–August 16, 2002.
[1]Using updated purchasing-power-parity (PPP) weights, summarized in the Statistical Appendix, Table A.
[2]Includes Indonesia, Malaysia, the Philippines, and Thailand.
[3]Includes Malta.
[4]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil. The average price of oil in U.S. dollars a barrel was $24.28 in 2001; the assumed price is $24.40 in 2002, and $24.20 in 2003.

degree of good luck, in that the impact of the terrorist attacks on confidence proved surprisingly short lived.

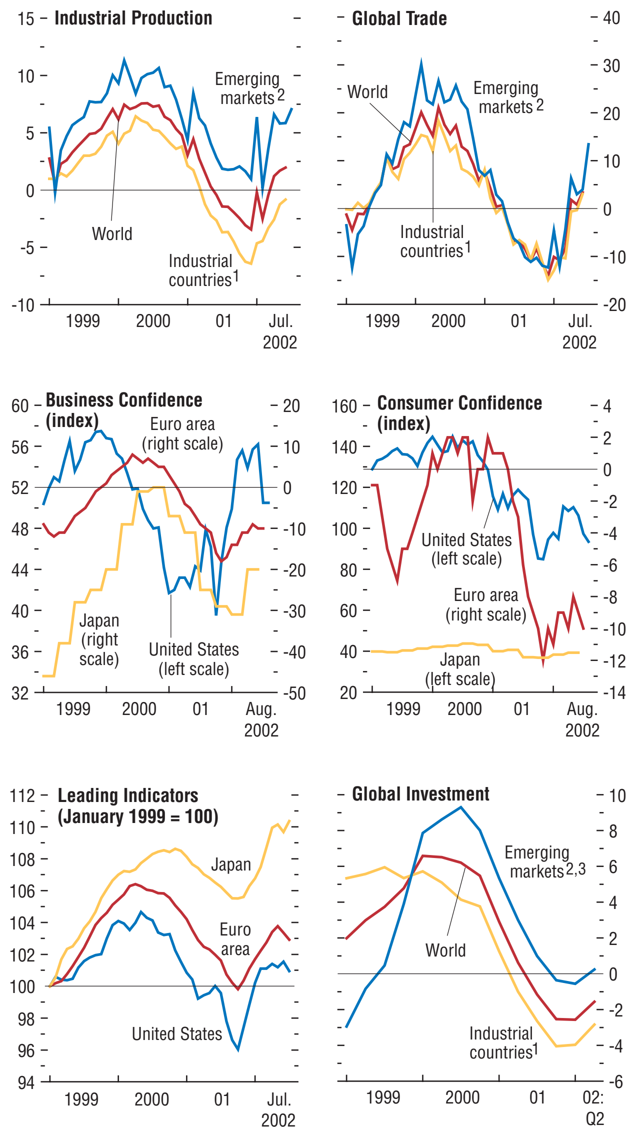
During the first quarter of 2002, activity was surprisingly strong, with GDP growth in a number of regions—particularly North America and emerging markets in Asia—exceeding expectations. Since that time the pace of recovery has slowed, except in emerging markets in Asia, and incoming data have generally been weaker than expected. Forward-looking indicators—while still stronger than at end-2001—have also fallen back markedly (Figure 1.2). Domestic demand growth so far has been relatively weak outside North America and the United Kingdom, the cyclically most advanced of the major industrial countries, making the upturn elsewhere heavily dependent on external demand. Moreover, there is as yet limited evidence of a pickup in global investment, which will be critical to maintain the momentum of the projected upturn in the second half of the year.

Notwithstanding the upturn, global financial markets have weakened significantly.[1] Industrial country equity markets have fallen sharply—and with surprising synchronicity—since end-March (Figure 1.3). This has reflected a combination of factors, including downward revisions of earlier—and always optimistic—profit forecasts; concerns about the sustainability of the recovery; and widespread concerns about accounting and auditing practices, particularly in the United States. While a portion of those losses have been recouped since late July, markets remain volatile. In the face of increased risk and uncertainty, demand for government bonds and high-quality corporate paper has risen, which—together with expectations that monetary tightening will be postponed—has driven long-run interest rates down significantly. Spreads for riskier borrowers have risen, and risk appetite has also declined, although not to the point of outright risk aversion. In currency markets, the U.S. dollar has

[1]See the September 2002 *Global Financial Stability Report* for a detailed discussion of financial market developments and risks.

Figure 1.2. Current and Forward-Looking Indicators
(Percent change from a year earlier unless otherwise indicated)

Current and forward-looking indicators have generally strengthened since late 2001, although there is as yet little evidence of a pickup in investment.



Sources: Haver Analytics. 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 indicators produced by OECD, *Main Economic Indicators.*

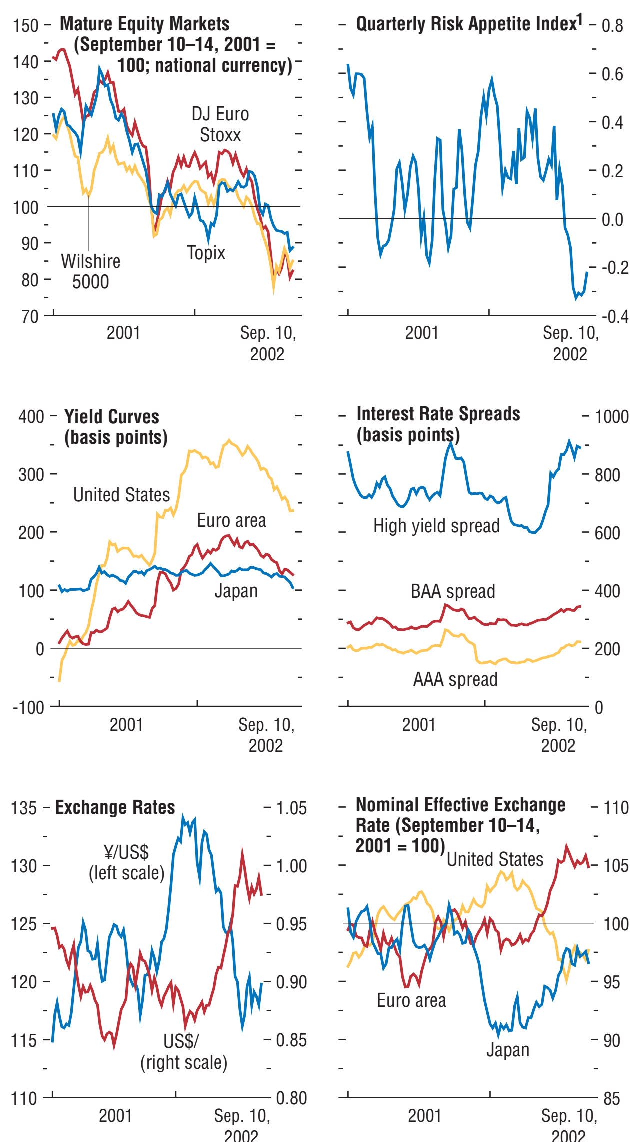
[1]Australia, Canada, Denmark, euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom, and the United States.

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

[3]2002:Q1–Q2 data for China, India, and Russia are interpolated.

Figure 1.3. Developments in Mature Financial Markets

Equity markets have fallen sharply since end-March, accompanied by a depreciation of the U.S. dollar, and some increase in risk aversion.



Sources: Bloomberg Financial Markets, LP; State Street Bank; and IMF staff estimates.
[1]IMF/State Street risk appetite indicators.

depreciated markedly against the euro and yen, although more moderately in trade-weighted terms. In part, this appears to have reflected a diminution in the attractiveness of U.S. assets, a slowdown in euro area institutions' diversification away from euro-denominated assets,[2] and growing concerns about the large U.S. current account deficit.

While the timing of market adjustments is always difficult to predict, these developments should not be particularly surprising. Recent issues of the *World Economic Outlook* and the *Global Financial Stability Report* have explicitly warned about the risk of a further decline in equity markets, and the overvaluation of the U.S. dollar has also been a long-standing concern in these pages. From a medium-term perspective, recent developments in equity and currency markets may help reduce global imbalances, but—as discussed in detail in Box 1.1—they make the short-term outlook more difficult. The fall in equity markets, if sustained, will significantly affect U.S. consumption and investment, although the impact will be partly offset by lower long-run interest rates as well as the weaker dollar. In the euro area and Japan, the effect of equity market declines is smaller, but not negligible; however, long-term interest rates have fallen less than in the United States and stronger currencies will weaken exports, so far the mainstay of recovery. This is of particular concern in Japan, where the upturn is likely to be weakest, and which has least room for offsetting policy maneuver.

There has also been substantial turbulence in many emerging markets, partly reflecting higher risk aversion and global uncertainties but also, more fundamentally, country-specific factors. From mid-April, sentiment toward Latin America and Brazil in particular has deteriorated, prompted by rising political uncertainties and concerns about debt dynamics. As spreads rose, these concerns became increasingly self-reinforcing, culminating in mid-June with a full-scale

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

Box 1.1. How Will Recent Falls in Equity Markets Affect Activity?

Industrial country equity markets have fallen precipitately between late March and early September of this year, with prices down by one-fifth or so in all major industrial countries. Indeed, over these five months the fall in prices is of a comparable magnitude to that between the bursting of the technology bubble in early 2000 and late March this year, with the exception of Japan (first table). While any fall in equity values of this size and speed is notable, this one is of particular interest for several reasons. First, it has been accompanied by additional significant shifts in asset prices, including a depreciation of the dollar against other major currencies as well as a generalized decline in long-term interest rates as fears of inflation and expectations of monetary tightening recede. Second, the recent fall has been widespread, while over the previous two years it was focused on the technology sector. Third, the timing is unusual as activity is recovering from the downturn in 2001, and partly reflects concerns over accounting scandals.

This box examines the likely impact of these equity price falls on activity, and how they may be mitigated or exacerbated by changes in other asset market prices. A fall in equity markets affects the real economy through three main channels: it increases borrowing costs for households and corporations as collateral is eroded; it raises the cost of equity capital for firms, lowering investment; and it reduces household wealth and hence consumption.[1] The size and nature of these effects differ considerably across countries, depending on the size of the equity market, the proportion of equities held by households, and the extent to which corporations rely on equity markets for funding. In general, it is found to be largest in countries with market-based financial systems, including North America and the United Kingdom, characterized by high equity market capitalization, broader ownership of equities by households, and significant financing of firms through equity issues. In contrast, the impact in bank-based economies—such as continental Europe and Japan—is generally found to be smaller, although not negligible (and because banks in these countries have large equity holdings, there can be substantial effects on their balance sheets, particularly in Japan given the precarious state of the banking system and negative impact of falling equity prices on bank capital). In both cases, the impact of equity markets on activity appears to have been increasing over time, as financial systems get deeper and more flexible, a trend that is likely to continue in the future.

It should be emphasized at the outset that any calculation of the impact on activity is highly speculative as asset prices can move rapidly (particularly in volatile trading conditions of the type experienced lately) and estimated impacts on activity are imprecise, and in any case can vary with circumstances. With these caveats in mind, the second table reports rough estimates of the impact on consumer spending assuming that the equity price falls as of the first full week in September are sustained. The calculations are based on IMF staff estimates of the marginal propensities to consume, after two years, out of equity wealth of 4¼ cents per dollar in the United States and the United Kingdom and 1 cent in the euro

Changes in Equity Prices
(Percent)

	United States	Euro Area	Japan	United Kingdom
End-March 2002 to early September[1]				
Total	–21	–27	–16	–22
Technology	–34	–40	–25	–32
Nontechnology	–17	–24	–13	–20
End-March 2000 to end-March 2002[2]				
Total	–28	–28	–39	–18
Technology	–63	–64	–63	–69
Nontechnology	4	–7	–26	–24

Source: Datastream.
[1]Average March 25–29, 2002 to September 2–6, 2002.
[2]Average March 27–31, 2000 to March 25–29, 2002.

Note: The main authors of this box are Tamim Bayoumi and David J. Robinson.

[1]See "Asset Prices and the Business Cycle," in the May 2000 *World Economic Outlook,* for a detailed description of the channels through which asset price movements affect activity.

Box 1.1 *(concluded)*

Impact on Activity of Asset Price Changes, Late March to Early September 2002[1]

(Percent of GDP unless otherwise stated)

	United States	Euro Area	Japan	United Kingdom
Equity markets				
Stock market capitalization	–23	–20	–12	–23
Marginal propensity to consume out of wealth (cents per dollar)	4¼	1	1	4¼
Impact on spending	**–1**	**–¼**	**¼**	**–1**
Monetary conditions				
Effective exchange rate (percent)	–9	5	7	–1
Real 10-year bond yield[2] (percentage points)	–1¼	–¾	¼	–¾
Impact on spending[3]	**1**	**–¼**	**–¼**	**½**

Source: IMF staff calculations.
[1]Average March 25–29 versus September 2–6, 2002.
[2]Government bond yield, except in the case of the United States where AAA corporate bonds were used, adjusted for the change in projected inflation between the April 2002 *World Economic Outlook* and this one.
[3]Coefficients on the bond yield are –0.55 for the United States, –0.35 for the United Kingdom, and –0.27 for the euro area and Japan; on the real effective exchange rate –0.05 for Japan and the United States, –0.07 for the euro area, and –0.18 for the United Kingdom. The coefficients are derived from the Goldman-Sachs financial conditions index for the United States and United Kingdom (although in the United States, Goldman Sachs uses A bonds rather than AAA bonds), and IMF staff estimates of a similar index for the euro area and for Japan (where the coefficient on bond yields was made equal to that in the euro area).

area and Japan. (See “Is Wealth Increasingly Driving Consumption?” Chapter II in the April 2002 *World Economic Outlook*.)[2] Such numbers are broadly consistent with other academic work and with macroeconomic models such as MULTIMOD or Oxford Analytics.

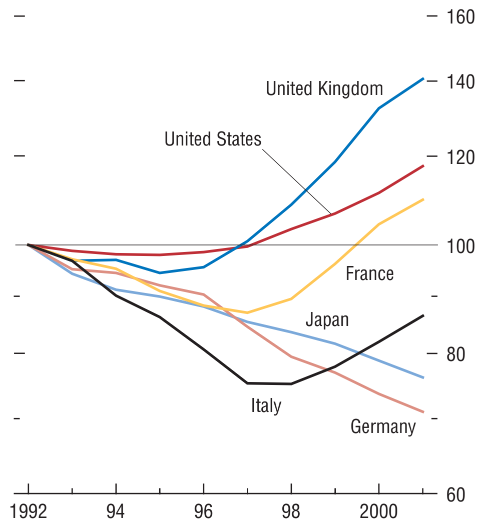
Taken in isolation, the estimated fall in consumer spending from equity prices is about 1 percentage point of GDP in the United States and the United Kingdom and a ¼ percentage point in the euro area and Japan over the next two years, reflecting different propensities to consume out of wealth. That said, other sources of private wealth can provide an offset. In particular, buoyant housing markets can provide some support to demand (especially as the stock of housing wealth is estimated to be larger than that of equities, and an increase in housing wealth has a larger impact on consumption than a similar increase in equity wealth). Over recent years, real house prices have risen significantly in the United Kingdom and some smaller European countries, and to a lesser extent the United States and France, but have declined in Japan and Germany (see the figure).

[2]Estimates of the impact on investment are less precise, but could raise the impact by one-half or more.

The second table also reports the likely first-year impact of associated changes in monetary conditions over the past five months, comprising changes in effective exchange rates and lower long-term interest rates (short-term policy interest rates have remained unchanged in the major economies except Canada). Lower long-term rates and exchange rate depreciation boost activity in the United States and, to a lesser extent, the United Kingdom, while in Japan, and the euro area to a lesser extent, the erosion in activity due to the appreciation in the exchange rate is estimated to be somewhat larger than the benefit from lower real long-term interest rates.[3]

The net result of all of these asset price changes is likely to be a broad-based slowdown in activity in industrial countries. Aggregating the impact is complicated by the fact that wealth effects are generally thought to have a longer-lasting effect than interest and exchange rates,

[3]It should, however, be noted that futures markets also imply a greater change in the expected monetary stance in the euro area than elsewhere, which is not reflected in changes in bond yields. In addition, the appreciation in the euro may help support activity in the short term by reducing inflation and boosting real incomes.



peaking after about two years rather than one, and because aggregation compounds the uncertainties inherent in each individual calculation. That said, it appears reasonable to assume that the effects of lower wealth will outweigh looser monetary conditions in the United States (taking into account the potential impact on investment), although—as in France—this may be partly offset by continuing strength in the housing market. In the United Kingdom, buoyant household consumption suggests that the effect of housing prices may have more than offset the adverse effects of equity market declines. In other major economies, the appreciation in the effective exchange rate will be a more important factor, exacerbating the decline in the value of equities and, in the case of Japan and Germany, housing.

Developments in equity markets in industrial countries also feed through to emerging market countries. Given the increasing correlation between equity markets across the world, declines in industrial country equity markets have been mirrored in most emerging markets (although country-specific factors continue to play an important and in some cases offsetting role). With financial systems in most developing countries still largely bank-based, and equity markets often small, the direct impact on activity in general will be moderate (although most countries will be affected by weaker activity in industrial countries).

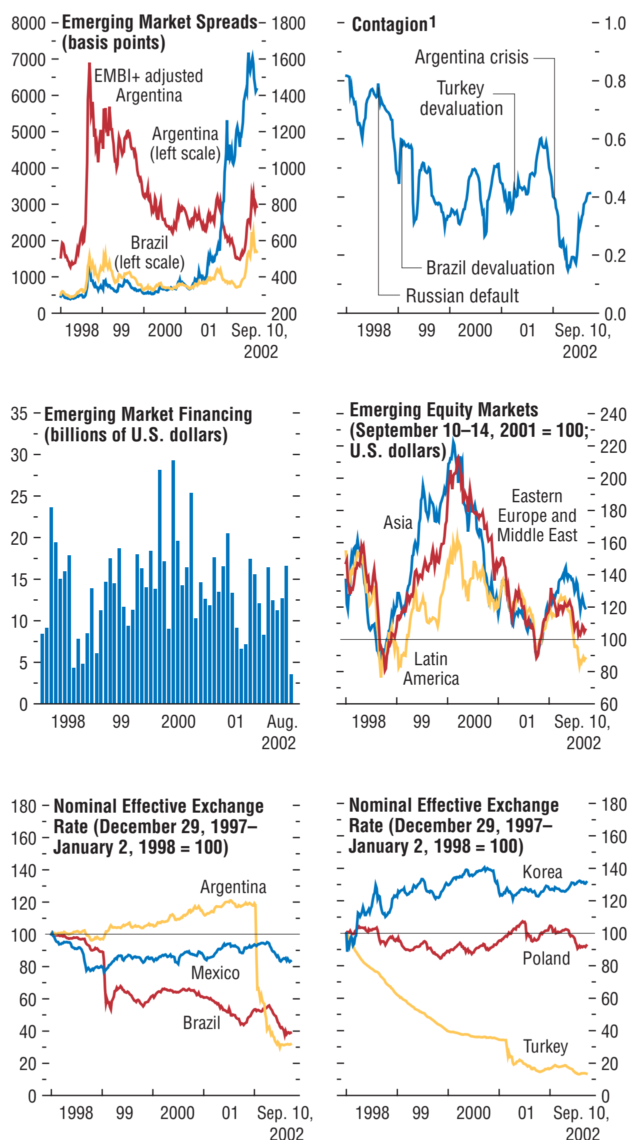
In practice, the indirect impact through financial markets is often more important. On the positive side, as discussed above, lower equity prices have been accompanied by lower interest rates in industrial countries, which benefits emerging market countries. However, the general shift out of risky assets has raised spreads for emerging markets. Since late March, the rise in the emerging market bond index plus spread has been on the order of 2 percentage points (with a similar increase in spreads in U.S. junk bonds, generally regarded as being in the same asset class), significantly larger than the fall in bond rates, implying some tightening of financing conditions for the average borrower.

In sum, recent movements in asset prices appear to be providing a downward impetus to global activity, although the main sources vary across regions, with equity declines dominating in North America and the United Kingdom, exchange rate appreciation mattering more in the euro area and Japan, and increasing bond spreads being the main conduit to emerging markets.

sell-off of emerging market debt and a decline in emerging market financing (Figure 1.4). Since early August, financing conditions have improved, led by Brazil where spreads have tightened significantly since the announcement of a new IMF package, accompanied by a commitment by the major presidential candidates to pursue sound economic policies. However, spreads still remain at high levels, and unsecured access remains difficult to subinvestment-grade borrowers in Latin

Figure 1.4. Emerging Market Financial Conditions

Emerging market spreads have risen markedly, particularly in Argentina and Brazil, accompanied by signs of increased contagion.



Sources: Bloomberg Financial Markets, LP; and IMF staff estimates.
[1]Average of 60-day rolling cross-correlation of emerging debt markets.

America. Equity markets in most emerging markets have fallen back over recent months, although developments in foreign exchange markets have been mixed. In some Latin American countries and Turkey, currencies have fallen sharply against the dollar, and by even more in trade-weighted terms. Elsewhere, currencies have generally risen against the dollar, but weakened against the euro and yen. With some exceptions, this has generally resulted in a modest depreciation in trade-weighted exchange rates.

While the global recovery is expected to continue, it will be weaker than earlier expected. Global growth is projected at 2.8 percent in 2002, rising to 3.7 percent in 2003, underpinned by the turn in the inventory cycle and continued accommodative policies, with interest rate increases in the United States and the euro area now expected to be deferred to 2003. While global growth in 2002 is the same as that projected in the April 2002 *World Economic Outlook*, this reflects the stronger-than-expected outturn in the first quarter of 2002, as well as upward revisions for Asia, partly offset by much lower growth in Latin America. From the second quarter onward, the pace of recovery has generally been marked down to reflect the impact of recent financial market developments (Figure 1.5); correspondingly, GDP growth in 2003 is somewhat lower than earlier projected. Looking across individual countries and regions, we find the following:

- Among the industrial countries, the recovery in the United States is now expected to be considerably weaker than earlier thought with GDP growth in 2002—and more so 2003—marked down significantly (Table 1.2). In the euro area, projections have also been reduced; in the short run GDP growth will be boosted by a turn in the inventory cycle, but final domestic demand growth is likely to pick up more slowly than previously expected. In Japan, where the economy appears to have bottomed out, GDP growth has been revised upward in both 2002 and 2003. However, with final domestic demand still weak, there are downside risks to the outlook given the appre-

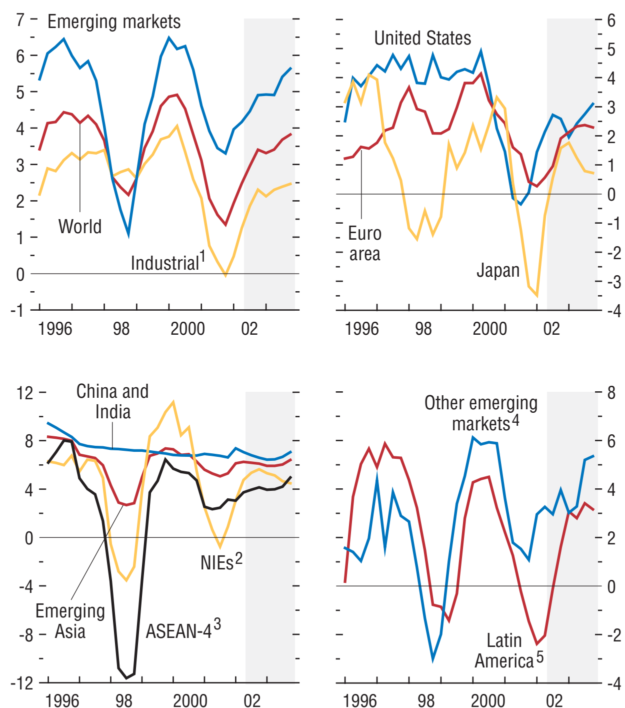
ciation of the yen and the more subdued recovery elsewhere.

- The outlook for the major emerging market countries has become increasingly diverse. In Latin America, the outlook has seriously deteriorated, and output is expected to decline in 2002. Growth is picking up in Mexico and is expected to in Chile; both countries are relatively open and have strong credit ratings. However, Argentina is experiencing an almost unprecedented collapse in economic activity (outside transition and conflict countries), Uruguay is facing serious difficulties, and the outlook for Brazil, Venezuela, and a number of smaller countries has deteriorated markedly. In emerging markets in Asia, in contrast, the recovery has so far proved stronger than expected, driven by the rebound in global trade and a nascent recovery in information technology (see Appendix 1.1), and in some countries—notably China, India, and Korea—domestic demand. While there are signs that final domestic demand growth is becoming more broadly based, the recovery remains dependent on external demand, and the prospect of a weaker global recovery has added to downside risks. In the Middle East, while the outlook for oil prices is somewhat stronger, the forecast has remained broadly unchanged; however, the difficult security situation has affected growth in Israel and its neighbors. GDP growth in Turkey has somewhat exceeded expectations, although political turmoil and a sharp deterioration in financial indicators, combined with its large financing needs, have increased risks looking forward. The outlook for the countries in transition remains solid, underpinned by strong growth in Russia and Ukraine, and in central and eastern Europe, by buoyant foreign direct investment.
- Among the poorest countries, GDP growth in Africa has held up surprisingly well, supported by improved macroeconomic policies, fewer conflicts, and debt relief under the HIPC (heavily indebted poor countries) Initiative. Serious problems exist in certain parts of the continent, however—most importantly, a

Figure 1.5. Global Outlook

(Percent change from four quarters earlier)

While GDP growth is expected to continue to pick up during 2002 and 2003, the recovery will be slower than earlier anticipated.



Sources: Haver Analytics; and IMF staff estimates.

[1]Australia, Canada, Denmark, euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom, and the United States.

[2]Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.

[3]Indonesia, Malaysia, the Philippines, and Thailand.

[4]Czech Republic, Hungary, Israel, Poland, Russia, South Africa, and Turkey.

[5]Argentina, 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	**3.8**	**0.8**	**1.7**	**2.5**	**2.3**	**2.2**	**1.4**	**1.7**	**5.9**	**5.9**	**6.4**	**6.5**
Major advanced economies	3.4	0.6	1.4	2.3	2.3	2.1	1.2	1.6	5.7	6.0	6.6	6.7
United States	3.8	0.3	2.2	2.6	3.4	2.8	1.5	2.3	4.0	4.8	5.9	6.3
Japan	2.4	–0.3	–0.5	1.1	–0.8	–0.7	–1.0	–0.6	4.7	5.0	5.5	5.6
Germany	2.9	0.6	0.5	2.0	2.1	2.4	1.4	1.1	7.8	7.8	8.3	8.3
France	4.2	1.8	1.2	2.3	1.8	1.8	1.8	1.4	9.5	8.6	9.0	8.9
Italy	2.9	1.8	0.7	2.3	2.6	2.7	2.4	1.8	10.6	9.5	9.3	8.9
United Kingdom[1]	3.1	1.9	1.7	2.4	2.1	2.1	1.9	2.1	5.5	5.1	5.2	5.3
Canada	4.5	1.5	3.4	3.4	2.7	2.5	1.8	2.1	6.8	7.2	7.6	6.7
Other advanced economies	5.3	1.6	2.6	3.3	2.4	2.9	2.3	2.2	6.2	5.7	5.8	5.7
Spain	4.2	2.7	2.0	2.7	3.5	3.2	2.8	2.4	13.9	10.5	10.7	9.9
Netherlands	3.4	1.2	0.4	2.0	2.3	5.1	3.8	2.4	2.6	2.0	2.9	3.2
Belgium	4.0	1.0	0.6	2.2	2.7	2.4	1.6	1.2	6.9	6.6	6.9	7.1
Sweden	3.6	1.2	1.6	2.5	1.0	2.6	2.3	2.2	4.7	4.0	4.2	4.2
Austria	3.0	1.0	0.9	2.3	2.0	2.3	1.8	1.6	3.7	3.6	4.3	3.8
Denmark	3.0	1.0	1.5	2.2	2.9	2.2	2.2	2.1	5.2	5.0	5.1	5.1
Finland	5.6	0.7	1.1	3.0	3.0	2.7	2.2	1.9	9.8	9.1	9.4	9.3
Greece	4.1	4.1	3.7	3.2	2.9	3.7	3.8	3.3	11.2	10.4	10.2	10.3
Portugal	3.2	1.7	0.4	1.5	2.8	4.4	3.7	2.7	4.0	4.1	4.7	5.1
Ireland	11.5	5.9	3.8	5.3	5.3	4.0	4.4	3.0	4.3	3.9	4.5	4.7
Luxembourg	7.5	3.5	2.7	5.1	3.2	2.7	2.0	1.8	2.6	2.6	2.9	2.8
Switzerland	3.0	0.9	—	1.9	1.6	1.0	0.7	1.0	2.0	1.9	2.7	2.7
Norway	2.4	1.4	1.7	1.9	3.1	3.0	1.5	2.5	3.4	3.6	3.6	3.6
Israel	7.4	–0.9	–1.5	1.8	1.1	1.1	6.2	3.0	8.8	9.3	10.7	10.9
Iceland	5.5	3.1	–0.5	1.7	5.0	6.7	5.2	2.2	1.3	1.7	2.3	2.6
Cyprus	5.1	4.0	2.5	4.0	4.1	2.0	2.5	2.2	3.4	3.6	3.8	4.0
Korea	9.3	3.0	6.3	5.9	2.3	4.1	2.7	3.3	4.1	3.7	3.0	3.0
Australia	3.1	2.6	4.0	3.8	4.5	4.4	2.8	2.5	6.3	6.7	6.3	6.0
Taiwan Province of China	5.9	–1.9	3.3	4.0	1.3	—	0.4	1.6	3.0	4.6	5.0	4.9
Hong Kong SAR	10.4	0.2	1.5	3.4	–3.7	–1.6	–3.0	–0.5	4.9	5.0	7.5	7.1
Singapore	10.3	–2.0	3.6	4.2	1.1	1.0	—	1.0	3.1	3.3	3.0	2.3
New Zealand[2]	3.8	2.5	3.0	2.9	2.7	2.7	2.6	1.9	6.0	5.3	5.4	5.6
Memorandum												
European Union	3.5	1.6	1.1	2.3	2.3	2.6	2.1	1.8	8.2	7.4	7.7	7.6
Euro area	3.5	1.5	0.9	2.3	2.4	2.6	2.1	1.6	8.8	8.0	8.4	8.2

[1]Consumer prices are based on the retail price index excluding mortgage interest.
[2]Consumer prices excluding interest rate components.

deepening famine in southern Africa. Growth in 2003 is projected to pick up to 4.2 percent, aided by stronger commodity prices. However, it should be noted that—in part due to unanticipated natural disasters and conflicts—WEO forecasts have consistently overestimated African growth in the past.[3]

Inflationary pressures across the globe remain relatively subdued and—despite some concerns in the euro area—wage increases have generally been moderate. Partly reflecting the pickup in global activity, commodity prices have turned upward. Since early August, spot oil prices have risen markedly owing to concerns about a further deterioration in the security situation in the Middle East (at the time the *World Economic Outlook* went to press, oil price futures for 2003 were about 5 percent higher than assumed in the WEO baseline). Nonetheless, inflation is expected to remain moderate in 2003, a testament to the increased effectiveness and credibility of anti-inflationary policies in both industrial and emerging markets in recent years. However, deflation remains a serious issue in Japan, and will be exacerbated by the recent appreciation of

[3]See Box 3.1 in the December 2001 Interim *World Economic Outlook*.

the yen; it is also a concern in China and Hong Kong SAR, although in these cases the recent depreciation of the U.S. dollar will be helpful. In contrast, inflationary risks have sharply increased in a number of countries in Latin America, especially Argentina, where, despite some recent progress, a sustainable monetary framework is not yet in place.

Developments since the first quarter have intensified concerns about the durability and sustainability of the recovery. While it is possible that the outlook could be better than projected, for example if productivity growth in the United States were to surprise on the upside, the risks to the forecast—judged in April to be relatively balanced—are primarily to the downside.

- *The recovery continues to depend heavily on the outlook for the United States,* especially with the pickup in western Europe not yet self sustaining and domestic demand growth in Japan likely to remain constrained by banking and corporate sector difficulties for some time. There is a significant risk of a more subdued recovery, especially if the impact of recent equity market declines in both the United States and Europe proves greater than presently expected; if housing markets, which have been providing significant support to demand in the United Kingdom and some smaller European countries, and to a lesser extent the United States (Box 1.1), were to weaken; if final domestic demand in Germany, which has a strong influence on the rest of the euro area, remains weak; or if the tentative recovery in Japan is derailed by adverse shocks—such as an appreciation of the yen—as on previous occasions in the 1990s. Such an outcome would clearly also have an important impact on emerging market economies.
- *Oil prices could spike sharply if the security situation in the Middle East were to deteriorate further.* Depending on its extent and duration, this increase could have a significant negative effect on global growth both directly and indirectly through its effects on confidence (see Appendix 1.1). It would also increase the likelihood of other risks to the outlook occurring, and exacerbate their impact.
- *Equity markets remain very volatile, and could fall further.* While a considerable portion of the irrational exuberance that characterized stock valuations in the late 1990s may now have been eliminated, recent accounting and auditing scandals have seriously weakened confidence. The U.S. authorities have moved quickly to strengthen corporate governance and auditing, and other initiatives are also under consideration. It is encouraging that the deadline for certification of financial statements by major U.S. corporations in mid-August passed without significant disruption. Nonetheless, there remains a risk that markets could overshoot on the downside—particularly if new accounting scandals were to emerge or if productivity growth and profitability disappointed—with the impact aggravated by relatively high levels of corporate and household debt in some countries. The fall in equity markets could also pose risks for some financial institutions, particularly in Europe and Japan.
- *Risks in emerging markets, in particular South America and Turkey, have increased.* As described above, the tightening in emerging market financing conditions has resulted in a serious deterioration in the outlook for a number of countries in South America, and has begun to affect a number of those elsewhere. To date, most countries outside South America retain access to global capital markets, and—with some exceptions—flexible exchange rate regimes have facilitated a relatively smooth adjustment to the movements in major currencies. The prospect of more widespread contagion is also reduced by the relatively low level of capital flows, as well as less extensive leverage in global financial markets (Table 1.3). Nonetheless, were problems in South America to intensify—especially if accompanied by weaker growth in industrial countries—the potential for a more widespread impact on the emerging market asset class, including through cross-border bank lending, would increase significantly.

Table 1.3. Emerging Market Economies: Net Capital Flows[1]

(Billions of U.S. dollars)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total[2]										
Private capital flows, net[3]	151.7	211.5	228.8	102.2	62.1	84.8	29.4	24.9	62.4	64.9
Private direct investment, net	80.6	98.2	114.4	141.7	153.6	164.0	158.0	172.1	151.3	160.9
Private portfolio investment, net	113.0	42.7	90.2	46.7	–0.1	34.3	–4.3	–42.6	–3.0	–4.0
Other private capital flows, net	–41.9	70.5	24.1	–86.2	–91.5	–113.4	–124.3	–104.6	–85.9	–91.9
Official flows, net	3.5	26.5	–2.3	68.3	69.9	12.2	0.2	15.4	20.6	18.2
Change in reserves[4]	–68.9	–118.2	–108.1	–68.8	–48.2	–87.9	–113.2	–119.9	–146.6	–129.7
Memorandum										
Current account[5]	–71.6	–91.1	–96.5	–69.1	–52.3	34.1	128.4	94.7	61.3	41.7
Africa										
Private capital flows, net[3]	14.3	12.7	11.9	9.4	11.6	15.1	6.1	6.9	8.8	8.9
Private direct investment, net	3.0	1.9	3.6	7.8	6.4	9.3	7.7	22.3	11.8	10.1
Private portfolio investment, net	3.6	2.5	2.8	7.0	3.7	8.2	–2.2	–9.0	–1.0	–1.3
Other private capital flows, net	7.8	8.3	5.5	–5.4	1.5	–2.5	0.6	–6.4	–2.0	0.1
Official flows, net	3.2	4.1	–3.6	2.0	3.3	0.7	1.7	1.3	1.0	0.4
Change in reserves[4]	–5.3	–2.5	–7.9	–11.1	2.5	–3.5	–13.3	–12.7	–4.7	–8.4
Developing Asia[6]										
Private capital flows, net[3]	70.3	96.9	122.1	7.1	–45.9	6.8	–12.9	16.7	31.6	7.9
Private direct investment, net	44.7	52.6	53.4	56.8	59.7	61.2	54.2	47.1	58.7	59.0
Private portfolio investment, net	20.8	22.7	32.8	7.3	–17.9	14.4	4.3	–13.5	0.7	–9.7
Other private capital flows, net	4.7	21.6	35.9	–56.9	–87.7	–68.8	–71.4	–16.8	–27.8	–41.3
Official flows, net	3.2	4.5	–12.4	16.9	26.1	4.4	5.1	–5.7	–1.4	3.3
Change in reserves[4]	–57.8	–43.3	–46.9	–15.4	–67.4	–78.9	–48.7	–84.7	–97.4	–67.8
Memorandum										
Hong Kong SAR										
Private capital flows, net[3]	–4.1	–3.5	–7.1	11.7	–8.5	1.0	4.2	–5.1	–10.4	–10.9
Middle East and Turkey[7]										
Private capital flows, net[3]	15.7	9.9	7.2	15.0	9.1	0.2	–22.4	–48.4	–19.6	–9.4
Private direct investment, net	4.8	6.5	4.8	5.5	6.5	5.5	7.9	10.8	8.8	11.5
Private portfolio investment, net	7.6	2.0	1.8	–0.9	–13.2	–3.2	–13.7	–22.0	–9.8	–6.6
Other private capital flows, net	3.3	1.4	0.6	10.4	15.8	–2.1	–16.7	–37.1	–18.6	–14.4
Official flows, net	3.5	4.5	6.6	9.3	3.0	2.1	0.4	6.6	8.8	4.7
Change in reserves[4]	–4.7	–11.6	–22.2	–19.4	9.7	–6.3	–27.0	–6.7	–10.8	–10.4
Western Hemisphere										
Private capital flows, net[3]	47.1	43.5	64.9	69.3	72.7	49.7	48.6	22.8	10.3	26.5
Private direct investment, net	22.8	24.2	40.3	56.1	60.1	64.1	64.7	66.9	40.4	45.6
Private portfolio investment, net	65.0	0.8	39.5	25.9	22.3	11.9	4.7	–2.2	1.0	7.6
Other private capital flows, net	–40.7	18.5	–14.9	–12.7	–9.8	–26.3	–20.8	–41.9	–31.1	–26.7
Official flows, net	4.7	19.2	4.7	14.9	16.0	1.5	–3.5	21.1	15.8	14.6
Change in reserves[4]	4.0	–23.3	–28.9	–13.5	8.4	7.9	–2.5	1.2	–3.3	–16.5
Countries in transition										
Private capital flows, net[3]	4.3	48.4	22.6	1.3	14.6	13.0	10.0	26.8	31.2	31.1
Private direct investment, net	5.3	13.1	12.3	15.5	20.9	23.9	23.4	25.1	31.5	34.7
Private portfolio investment, net	16.1	14.6	13.3	7.5	5.0	2.9	2.6	4.2	6.1	6.0
Other private capital flows, net	–17.1	20.7	–3.0	–21.6	–11.3	–13.8	–16.0	–2.5	–6.4	–9.6
Official flows, net	–11.2	–5.8	2.3	25.3	21.4	3.6	–3.6	–7.9	–3.6	–4.8
Change in reserves[4]	–5.1	–37.5	–2.2	–9.5	–1.4	–7.1	–21.7	–17.1	–30.5	–26.7
Memorandum										
Fuel exporters										
Private capital flows, net[3]	18.6	23.4	–4.8	–9.6	–5.4	–28.5	–53.3	–43.6	–31.4	–24.8
Nonfuel exporters										
Private capital flows, net[3]	133.2	188.0	233.6	111.8	67.4	113.4	82.7	68.6	93.8	89.8

[1]Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing. Emerging markets include developing countries, countries in transition, Korea, Singapore, Taiwan Province of China, and Israel.
[2]Excludes Hong Kong SAR.
[3]Because of data limitations, "other private capital flows, net" may include some official flows.
[4]A minus sign indicates an increase.
[5]The sum of the current account balance, net private capital flows, net official flows, and the change in reserves equals, with the opposite sign, the sum of the capital and financial account and errors and omissions. For regional current account balances, see Table 27 of the Statistical Appendix.
[6]Includes Korea, Singapore, and Taiwan Province of China in this table.
[7]Includes Israel and Malta.

- *While the fall in the dollar has so far been orderly, the U.S. current account deficit remains very high, and—as discussed in Chapter II—a more abrupt and disruptive adjustment cannot be ruled out.* Given the synchronicity of the global slowdown, the U.S. current account deficit has improved very little since 2000, and in the short run appears likely to widen (Table 1.4). The question is not whether the U.S. deficit will be sustained at present levels forever—it will not—but more when and how the eventual adjustment takes place. While history is modestly reassuring, the overvaluation of the dollar has not yet been corrected and an abrupt and disruptive adjustment remains a significant risk. A particular concern is that medium-term growth in countries with surpluses—including Japan, emerging markets in Asia, and to a lesser extent Europe—is constrained to differing degrees by structural problems. This makes it more difficult to achieve an orderly rebalancing of domestic demand from deficit to surplus countries, increasing the prospect that the adjustment in the U.S. current account will be accompanied by weaker global growth. Moreover, if in some countries current account surpluses do not decline, the adjustment that will fall on other countries—and therefore the potential appreciation in their exchange rates—will be correspondingly greater.

With macroeconomic policies in most industrial countries still accommodative, a shift to a more neutral stance will eventually be needed. At the same time, however, the short-term outlook has deteriorated, and the risks appear to be primarily on the downside; inflation remains relatively subdued; and anti-inflationary credibility is high. The situation varies somewhat across countries, reflecting their relative cyclical positions, as well as the relative risks associated with greater equity market and exchange rate uncertainty (Box 1.2). However, in most cases the balance of risks appears to favor maintaining relatively accommodative policies for longer than earlier seemed necessary, and in Japan further easing is warranted. If incoming data were to suggest that the recovery is faltering, additional monetary easing would also need to be considered elsewhere. Against this background, the main policy priorities appear to be the following.

- *Macroeconomic policies in industrial countries should continue to be supportive of activity.* In the United States, the Federal Reserve has held interest rates steady, and a continued accommodative stance remains appropriate; if the outlook weakens further, additional interest rate cuts should be considered. With the budget deficit (excluding social security) projected to remain in deficit in coming years, medium-term fiscal consolidation is a priority

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

	2000	2001	2002	2003
Advanced economies	**–0.9**	**–0.8**	**–0.8**	**–0.9**
Major advanced economies	–1.5	–1.4	–1.5	–1.5
United States	–4.2	–3.9	–4.6	–4.7
Japan	2.5	2.1	3.0	2.9
Germany	–1.1	0.1	1.9	2.1
France	1.5	1.8	1.9	1.4
Italy	–0.5	0.1	0.2	0.2
United Kingdom	–2.0	–2.1	–2.1	–2.3
Canada	2.6	2.8	1.7	1.9
Other advanced economies	1.9	2.4	2.3	2.1
Spain	–3.4	–2.6	–1.7	–1.8
Netherlands	3.8	2.8	3.2	3.0
Belgium-Luxembourg	4.5	5.2	4.7	4.5
Sweden	3.3	3.2	3.2	3.2
Austria	–2.5	–2.2	–2.3	–2.3
Denmark	1.6	2.6	2.8	3.4
Finland	7.4	6.5	7.3	7.6
Greece	–6.8	–6.2	–5.1	–5.4
Portugal	–10.4	–9.2	–8.0	–7.5
Ireland	–0.6	–1.0	–0.7	–0.9
Switzerland	12.9	10.0	10.5	11.0
Norway	15.0	15.4	11.4	9.5
Israel	–1.7	–1.7	–1.9	–1.8
Iceland	–10.1	–4.4	–2.0	0.1
Cyprus	–5.2	–4.4	–5.5	–3.6
Korea	2.7	2.0	1.5	0.9
Australia	–4.0	–2.6	–3.6	–3.9
Taiwan Province of China	2.9	6.7	5.8	5.9
Hong Kong SAR	5.4	7.3	9.2	9.7
Singapore	16.7	20.4	21.7	22.3
New Zealand	–5.5	–2.9	–3.5	–4.1
Memorandum				
European Union	–0.4	—	0.6	0.5
Euro area[1]	–0.3	0.4	1.1	1.0

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

Box 1.2. Market Expectations of Exchange Rate Movements

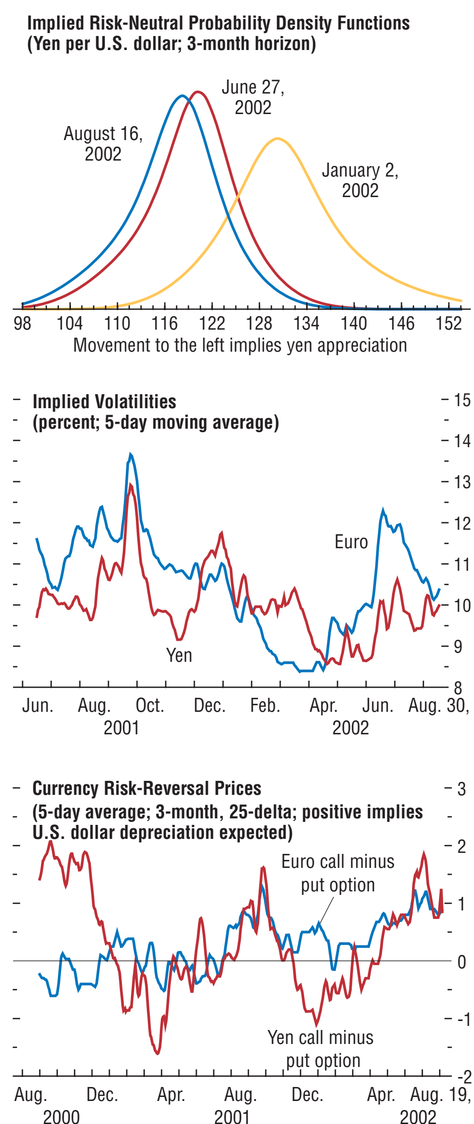
After continuing to strengthen in the face of last year's global downturn, the U.S. dollar has fallen sharply against other major currencies since mid-April. Yet it remains well above longer-term historical values, while the U.S. current account deficit has swelled to a record level. These developments raise the question of whether a much larger, and possibly disorderly, adjustment in major exchange rates presents a risk to the global outlook.

In assessing this issue, it is interesting to consider how market participants view the outlook for exchange rates, both in terms of direction and volatility. Futures and options prices can be used to shed light on market perceptions, specifically by constructing implied "probability density functions" (PDFs) for future exchange rate values. Under the assumption that market participants are risk neutral, PDFs indicate the perceived likelihood of the exchange rate reaching different levels at a future date.[1]

Such implied PDFs for the yen-dollar rate are shown in the figure (top panel). They reflect expectations for the 3-month-ahead level of the exchange rate at three different dates: January 2, 2002, June 27, 2002, and August 16, 2002. The mean of the yen-dollar PDF shifted down over this period, in line with the appreciation in the yen against the dollar. Indeed, covered interest arbitrage ensures that the mean of the PDF (i.e., the forward rate in markets) equals the spot rate plus an adjustment for the interest differential on short-term assets in the two currencies. As interest rates have been stable in recent months, so has the gap between spot and forward exchange rates. The forward yen-dollar rate implies further yen appreciation, as the short-term interest rate on yen assets is below that on U.S. dollar assets; conversely, the forward euro-dollar rate implies euro depreciation given the higher yield on euro assets.

Because of the mechanical link between spot rates, forward rates, and the interest differential, "higher moments" of the PDF often reveal more

U.S. Dollar Implied Risk and Volatilities



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

Note: The main authors of this box are Peter Breuer and Guy Meredith.

[1]The risk-neutrality assumption implies that changes in options prices reflect changes in expected volatility ("riskiness"), as opposed to investor attitudes toward risk. See Breuer (2002) for an approach to accounting for risk aversion in constructing PDFs.

interesting information about market expectations. For instance, the expected *volatility* of the future exchange rate is reflected in the variance of the implied PDF. The path of expected volatility for the yen-dollar and euro-dollar rates since mid-2001 is shown in the figure (middle panel). Expected volatility rose following the onset of dollar weakness in April. The rise in euro-dollar volatility was particularly sharp during June, but most of this increase was retraced over the summer. Yen-dollar volatility has been more stable, showing only a modest increase from the trough in the spring. On balance, these data do not suggest that markets perceive an abnormally high risk of abrupt currency movements relative to recent history.

Another interesting feature of implied PDFs is their "skew." Skew reflects asymmetries in the shape of the two sides of the PDF, which arise when markets perceive the risk of equal-sized currency movements in opposite directions as differing. In practice, skew is measured by the cost of insuring against a dollar depreciation relative to a dollar appreciation of the same degree—the risk-reversal price.[2] Recent data on risk-reversal prices are shown in the figure (bottom panel). The relative cost of insuring against dollar depreciation versus both the euro and yen has risen significantly since the begining of the year. This suggests that markets place greater weight on the possibility of a sharp dollar depreciation relative to the forward rate than was the case earlier, even as the spread between the forward and spot rate has remained roughly constant.

It must be emphasized that the assumption of risk neutrality is needed to interpret PDFs as measures of market expectations. Furthermore, the value of market expectations as predictors of future exchange rates depends on whether markets efficiently use all available information. Many studies have indicated that the forward rate is a biased predictor of the future spot rate, indicating that at least one, and possibly both, of these assumptions do not hold.[3] There has been less conclusive analysis of the relationship between higher moments of implied PDFs and future exchange rates, so it is more difficult to gauge their usefulness as predictors of exchange rate movements or volatility.

Independent of the forecasting power of market expectations, however, implied PDFs provide information that is potentially useful in assessing the interaction between market developments and policy actions. For instance, an environment of high uncertainty about future exchange rates could raise concerns about excessive market reactions to policy initiatives, while a significant skew in expectations implies the risk of large one-way movements in rates. Either situation might create a rationale for taking a cautious approach to policy actions to avoid destabilizing currency markets. Recent market information does not suggest that perceptions of volatility or asymmetric outcomes have become abnormal from a historical perspective, suggesting that policies would not be constrained by concerns about exceptional market sensitivity.

[2]A risk reversal is the price of an out-of-the-money foreign currency call option relative to the price of an equally out-of-the-money short foreign currency put option.

[3]See Meredith and Ma (2002).

(Table 1.5), especially in view of impending demographic pressures. In the euro area, concerns about inflationary pressures have been mitigated by the appreciation of the euro as well as the weaker-than-expected recovery. Correspondingly, the scope for easing has increased, and should be used if activity remains weak and inflationary pressures ease as expected. In Japan, aggressive monetary easing remains essential to address deflationary pressures. If structural reforms—which could adversely affect activity in the short run—are significantly accelerated, further steps to contain the withdrawal of stimulus

Table 1.5. Major Advanced Economies: General Government Fiscal Balances and Debt[1]

(Percent of GDP)

	1986–95	1996	1997	1998	1999	2000	2001	2002	2003	2007
Major advanced economies										
Actual balance	–3.9	–3.6	–2.1	–1.6	–1.1	–0.1	–1.7	–3.0	–2.8	–0.9
Output gap[2]	–0.5	–1.1	–0.5	–0.5	–0.1	0.7	–1.1	–2.2	–2.4	—
Structural balance	–3.6	–3.0	–1.7	–1.3	–1.0	–0.8	–1.3	–2.2	–1.9	–0.9
United States										
Actual balance	–4.5	–2.4	–1.3	–0.1	0.6	1.5	–0.2	–2.6	–2.8	–1.0
Output gap[2]	–1.3	–1.6	–0.5	0.3	1.1	1.6	–1.2	–2.0	–2.6	—
Structural balance	–4.0	–1.9	–1.1	–0.2	0.3	0.9	0.1	–1.9	–1.9	–1.0
Net debt	53.2	59.2	57.0	53.4	48.9	43.9	43.0	44.1	45.0	41.7
Gross debt	67.3	72.8	70.3	66.6	63.4	57.7	56.4	57.0	57.4	51.5
Japan										
Actual balance	–0.4	–4.9	–3.7	–5.5	–7.0	–7.3	–7.1	–7.2	–6.1	–1.0
Excluding social security	–3.2	–7.0	–5.8	–7.1	–8.5	–8.4	–7.4	–7.1	–5.9	–1.5
Output gap[2]	0.7	0.9	1.0	–1.7	–2.2	–1.1	–2.4	–3.8	–3.8	0.2
Structural balance	–0.6	–5.2	–4.1	–4.9	–6.1	–6.8	–6.1	–5.7	–4.6	–1.0
Excluding social security	–3.4	–7.2	–6.0	–6.8	–8.0	–8.1	–6.8	–6.2	–5.0	–1.5
Net debt	13.8	21.6	27.9	38.1	45.2	57.5	65.5	74.0	80.2	80.3
Gross debt	71.8	91.7	97.4	108.6	120.9	135.6	145.1	155.1	161.2	152.3
Euro area										
Actual balance	–4.6	–4.2	–2.6	–2.3	–1.3	0.1	–1.6	–1.9	–1.5	–0.5
Output gap[2]	–0.2	–1.8	–1.6	–1.0	–0.6	0.5	–0.4	–1.7	–1.8	—
Structural balance[4]	. . .	–3.1	–1.5	–1.5	–0.8	–1.1	–1.4	–1.1	–0.6	–0.4
Net debt	46.1	58.4	62.9	61.4	60.8	58.7	57.9	58.1	57.3	53.3
Gross debt	60.9	76.1	75.4	73.7	72.6	70.2	69.2	69.4	68.2	60.2
Germany[3]										
Actual balance	–2.2	–3.4	–2.7	–2.2	–1.5	1.1	–2.8	–2.9	–2.2	–0.6
Output gap[2]	0.2	–0.5	–1.0	–0.9	–0.7	0.3	–1.0	–2.3	–2.3	—
Structural balance[4]	–1.8	–2.8	–1.7	–1.4	–1.0	–1.5	–2.2	–1.6	–0.9	–0.6
Net debt	27.6	51.1	52.3	52.2	52.5	51.5	50.8	52.5	53.1	49.2
Gross debt	45.1	59.8	61.0	60.9	61.2	60.2	59.5	61.2	61.8	57.9
France										
Actual balance	–3.5	–4.1	–3.0	–2.7	–1.6	–1.3	–1.4	–2.5	–2.1	–1.4
Output gap[2]	–0.5	–3.3	–3.1	–1.8	–1.1	0.6	—	–1.1	–1.2	—
Structural balance[4]	–3.0	–1.9	–1.0	–1.5	–0.9	–1.6	–1.6	–1.9	–1.4	–1.3
Net debt	30.3	48.1	49.6	49.8	48.8	47.6	48.2	47.6	47.3	53.3
Gross debt	39.0	57.0	59.3	59.5	58.5	57.3	56.9	57.2	57.0	53.3
Italy										
Actual balance	–10.4	–7.1	–2.7	–2.8	–1.8	–0.5	–2.2	–2.0	–1.5	–0.8
Output gap[2]	–0.1	–1.7	–1.6	–1.7	–2.0	–1.0	–1.0	–2.3	–2.0	—
Structural balance[4]	–10.4	–6.2	–1.9	–2.0	–0.9	–1.3	–1.8	–1.7	–1.2	–0.8
Net debt	97.8	116.1	113.8	110.1	108.4	104.6	103.9	104.0	100.9	89.7
Gross debt	103.7	122.7	120.2	116.4	114.5	110.6	109.8	109.8	106.6	94.8
United Kingdom										
Actual balance	–3.4	–4.2	–1.6	0.2	1.4	4.0	0.2	–0.8	–1.1	–1.4
Output gap[2]	–0.2	–1.3	–0.4	0.5	0.2	1.1	0.4	–0.9	–1.1	—
Structural balance[4]	–3.3	–3.4	–1.0	0.3	1.2	1.3	–0.1	–0.6	–0.5	–1.4
Net debt	24.2	46.2	44.6	41.9	39.0	34.0	30.8	29.5	29.0	28.5
Gross debt	42.6	51.8	49.6	46.6	43.8	40.4	37.9	36.3	35.7	35.1
Canada										
Actual balance	–6.6	–2.8	0.2	0.1	1.7	3.1	1.8	1.1	1.2	1.2
Output gap[2]	0.3	–1.4	–0.9	–0.8	0.5	1.2	–0.8	–0.6	–0.1	—
Structural balance	–6.6	–2.0	0.8	0.5	1.6	2.5	2.2	1.6	1.2	1.1
Net debt	70.1	88.1	85.6	81.8	75.6	65.4	61.2	57.4	53.1	39.7
Gross debt	101.9	120.7	118.8	115.3	112.6	102.1	100.9	95.4	89.0	69.5

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

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

[2]Percent of potential GDP.

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

[4]Excludes one-off receipts from the sale of mobile telephone licenses (the equivalent of 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). Also excludes one-off receipts from sizable asset transactions.

that is in prospect from the latter part of FY2002 may be desirable.

- In *emerging markets*, the deterioration in the outlook has partly reflected lower risk appetite and contagion, but country-specific factors—including political uncertainties and concerns about debt dynamics—have played a more important role. Particularly in Latin America and Turkey, a restoration of financial market confidence will require that these issues be comprehensively addressed. Elsewhere, policy priorities vary widely, as described in detail below. However, given the more difficult global economic outlook, macroeconomic policies in countries with room for policy maneuver—as in industrial countries—will likely have to remain accommodative longer than earlier expected.
- *Medium-term policies should continue to foster sustained and broad-based economic growth and an orderly reduction in global imbalances.* Since the mid-1990s, much attention has been given to the pickup in productivity growth in the United States, particularly in relation to other major industrial countries. This pickup appears due in part to the greater flexibility of the U.S. economy (Box 1.3). In the euro area, flexibility can be boosted by reform of labor and product markets—measures that would also help raise employment rates, which remain well below U.S. levels. In Japan, reform of banking and corporate sectors takes center stage; despite different circumstances, that is also a priority for emerging markets in Asia. Higher potential growth in the rest of the world is desirable in its own right, but would also help reduce dependence on the United States as the global engine of growth, and promote an orderly correction of the global imbalances. Beyond that, as discussed in the *Global Financial Stability Report,* there is a clear need to strengthen corporate governance and transparency in the United States and elsewhere. While corporate malpractice has been a common feature of past technological revolutions, the weaknesses in accounting and auditing practices likely exacerbated the information technology (IT) bubble and contributed to the global imbalances. The recent reform package in the United States provides a welcome improvement in the framework for regulating corporate governance and accounting; the challenge going forward will be to ensure its effective implementation and enforcement.
- *Continued efforts are required to strengthen resilience to future economic shocks.* In industrial countries, aging populations pose a serious threat to future fiscal and economic stability, particularly in Japan, many countries in Europe, and to a lesser degree the United States. While the solutions are multidimensional—raising potential growth would help substantially—accelerated reforms of pension and health systems, supported by medium-term fiscal consolidation, are now urgent. Fiscal issues are also a key concern in Latin America, where high levels of public debt constitute a continuing and major source of vulnerability and constrain the scope for countercyclical policies, and increasingly in Asia, where public debt has risen sharply recently. With Asia facing a period of substantial structural change, particularly as it adapts to the challenges and opportunities posed by China's rapid development, completion of remaining corporate and financial sector reforms is also a priority.

Since the mid-1990s, most countries in Africa have made substantial progress in achieving macroeconomic stability, but GDP growth remains well below what is needed to achieve sustained poverty reduction. In part, this reflects low investment and savings, but it also reflects the low efficiency with which existing resources are used.[4] Low efficiency, in turn, stems from a host of problems, including the impact of conflicts and disease, weak institutions and infrastructure, poor governance, and low life expectancy, the last much exacerbated by the HIV/AIDS pandemic. The New Partnership for Africa's Development, put forward by African leaders in late 2001, sets

[4]Hall and Jones (1999).

Box 1.3. Reversal of Fortune: Productivity Growth in Europe and the United States

The surge in labor productivity growth in the United States since the mid-1990s has attracted significant attention—not just for its beneficial effects on output performance, earnings, and inflation, but also because it has not been matched elsewhere, particularly in Europe. This box assesses the level and growth rate of productivity in the United States and four major European countries in recent years and shows the following: (1) the persistent differences in GDP per capita between the United States and Europe are due much more to differences in labor utilization than those in labor productivity (as measured by output per hour); (2) productivity growth in Europe exceeded that in the United States up to the mid-1990s, but since then European performance has slackened while the United States has picked up and taken a lead; and (3) there is a consensus that high tech sectors have played an important role in the acceleration of productivity growth in the United States; these benefits are yet to be fully realized in Europe.

Following rapid catch-up in the three decades after World War II, GDP per capita in Europe since the late 1970s has generally settled at about 65–70 percent of the U.S. level (see the table). This persistent gap does not appear to be due to differences in productivity (output per hour); rather it reflects marked differences in the operations of labor markets and in labor utilization. Three elements stand out: labor force participation rates, especially of females and of individuals aged 55 and above, are substantially lower in continental Europe; unemployment rates are much higher in Europe; and average annual hours worked per employee are about 20 to 30 percent lower than in the United States. These three elements more than account for the gap in GDP per capita between the United States and the major continental economies; output per hour in France, Germany, and Italy is similar to, or exceeds, the U.S. level. The United Kingdom has similar high rates of participation and employment to the United States but, as on the continent, hours worked are lower; overall, output per hour appears to be lower than in the United States.

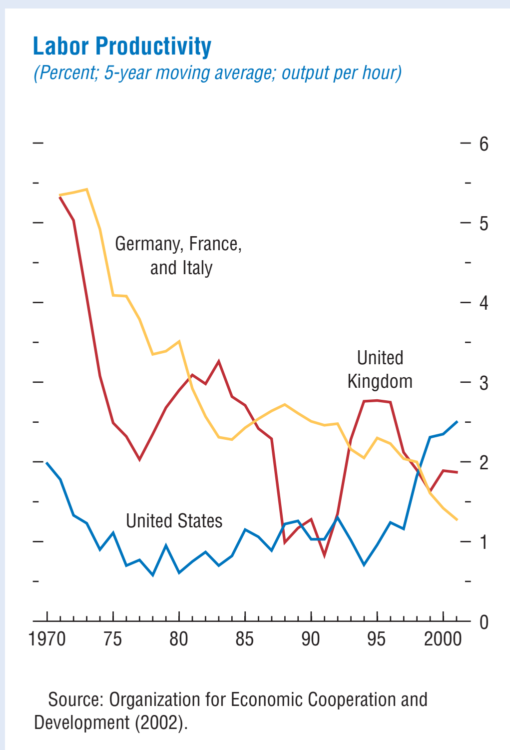
The past decade reveals some striking differences in the factors driving growth in output per capita across the two regions. For much of the 1990s, U.S. GDP growth per capita exceeded that in Europe. In the first half of the decade, however, growth in output per hour in the United States lagged substantially behind that in Europe. This continued the trends that had been evident since as far back as the 1960s, with the average annual growth in U.S. productivity per hour less than half that in Europe (as well as in Japan). (See the figure.) Indeed, it was this persistent shortfall in U.S. productivity growth that led to pessimistic assessments of U.S. productivity and growth prospects in the 1980s and even as late as the mid-1990s (see, for instance, Gordon, 1996). Over this period, however, the United States was able to maintain its lead in terms of GDP per capita through higher utilization of labor, as

Note: The main authors of this box are Manmohan S. Kumar and Maitland MacFarlan.

Growth and Productivity in the United States and Europe

	2001				1990–95	1995–2001	1990–95	1995–2001
	GDP per capita	GDP per hour	Average hours worked	Labor force participation	Growth in GDP per capita		Growth in GDP per hour	
United States	100.0	100.0	100.0	100.0	1.2	2.4	1.0	2.4
Germany[1]	71.8	106.2	69.7	93.2	0.8	1.5	2.3	1.8
France	72.3	115.0	73.8	88.5	0.9	2.0	1.7	1.7
Italy	69.0	117.0	77.2	79.0	1.5	1.8	2.5	1.1
United Kingdom	66.3	85.1	80.6	97.5	1.2	2.4	2.5	1.8

Sources: IMF staff estimates and Organization for Economic Cooperation and Development (2002).
[1]Growth data for Germany—average from 1992–95 only.



Source: Organization for Economic Cooperation and Development (2002).

noted above. Moreover, during the first half of the 1990s, the relative weakness in hourly productivity growth in the United States was more than offset by stronger employment growth and total hours worked, leading to a widening differential with Europe in terms of GDP per capita.

In the second half of the decade, there was a marked and surprising acceleration in U.S. productivity growth. In sharp contrast, productivity growth slowed substantially in Germany, Italy, and the United Kingdom and showed no change in France—in all cases falling well behind that in the United States. Rising productivity growth in the U.S. was accompanied by an acceleration in employment growth: even though European employment growth also picked up strongly over this period, it still lagged behind that in the United States. As a result of higher growth in both productivity and employment, growth in GDP per capita in the U.S. exceeded that in Europe even more than in the first half of the 1990s.

What accounts for these divergences in relative productivity performance in the second half of the decade? In the United States, the bulk of the acceleration in productivity growth reflects the production and use of information technology.[1] The take-up of new technologies has been slower in Europe, which meant that—at least until very recently—Europe did not benefit to the same degree from the productivity boost that came for the technology revolution.[2] But in addition, there were a number of other developments—particularly in labor markets—that may have contributed to the pickup in employment growth in Europe, but that also probably contributed to the slowing in productivity growth.

In particular, the relatively rapid employment growth in the euro area in the second half of the 1990s resulted in part from strong wage moderation as well as from steps taken to liberalize labor markets. These entailed reductions in tax wedges (especially in France and Italy), and provision for more flexible employment contracts, which opened up employment opportunities, especially for temporary and part-time workers.[3] Over this period, the long-standing trends of falling participation and rising rates of unemployment were reversed. It is striking that for much of this period part-time employment, especially of females, accounted for the bulk of the employment gains. For some countries such as France, this employment growth may have been concentrated primarily among lower skill workers; in general, though, much of the gains occurred among higher skilled nonmanual workers. (See, for example, European Commission, 2000.) But even there, growth was concentrated in sectors typically associated with low productivity—

[1]See Nordhaus (2001), Baily (2002), Gust and Marquez (2002), Oliner and Sichel (2002), and the October 2001 *World Economic Outlook*.

[2]A large number of factors, including cross-country regulatory differences, may affect the reallocation of labor and capital and the rate of adoption of information technologies. See, for example, Gust and Marquez (2002).

[3]The steps also included employment subsidies for private employers and public employment schemes.

Box 1.3 *(concluded)*

notably the service sectors, including health and social services. In addition, the increase in youth employment, likely to reflect relatively lower-skilled workers, may also have contributed to the weaker productivity growth. (See Kumar and MacFarlan, forthcoming.)

The downturn in labor productivity growth in Europe may have been just a temporary side effect of the labor market adjustments noted above: there is some indication that productivity growth picked up in 2000, before the current cyclical downturn. More broadly, however, the weakness of labor productivity growth may also reflect slower growth in capital-labor ratios in Europe, which had been unusually high. This slowdown in the growth of labor productivity in itself need not be a cause for concern, as it would normally be associated with some concomitant increase in capital productivity, which may leave total factor productivity broadly unchanged. Recent data suggest, however, that total factor productivity growth in Europe may also have declined somewhat, while in the United States it may have increased.

There is a great deal of uncertainty about the future evolution of productivity growth, not least reflecting the recent turmoil in the high tech sector and its longer-term implications. However, the fact that, in the United States, high rates of productivity growth have been maintained even during the recent period of weak activity—when productivity would normally have been expected to decline as employment reductions lagged behind the fall in output—augurs well for the sustainability of the robust performance of recent years. For Europe, there is some evidence that the information technology diffusion is following similar patterns to that experienced in the United States, but at a somewhat slower pace.[4] This, together with a cyclical pickup, should support a rebound in productivity growth, but, to take full advantage of the benefits of new technologies, it is essential to broaden structural reforms in labor, product, and financial markets. Such reforms would also help accelerate participation and employment growth more broadly in these economies, setting up a virtuous cycle of higher productivity, higher domestic demand growth, and higher GDP per capita.

[4]See, for instance, Ark, Inklaar, and McGuckin (2002).

out a bold and consistent strategy to address these issues. But while the first responsibility lies with Africa's governments and people, external support is also essential. The G-8 Africa Action Plan announced at the Kananaskis Summit in June—along with the commitment to double aid flows at the Monterrey Summit three months earlier—is therefore particularly welcome. Higher aid flows will, over time, result in a large increase in public expenditures in recipient countries. Correspondingly, receiving countries will need to press ahead with efforts to improve their absorptive capacity, including strengthening public expenditure management systems and addressing governance issues. This would be facilitated if, on the donors' side, new aid commitments were as concrete and predictable as possible.

As the IMF's Managing Director has repeatedly stressed, while increased aid flows are essential, trade—the theme of this issue of the *World Economic Outlook*—is even more important.[5] Industrial country barriers impose significant costs on the developing world, by some estimates not that much smaller than annual aid flows (Chapter II). Moreover, as discussed in Chapter III, openness to trade is an essential underpinning of financial liberalization. As has been seen in Latin America, if countries have open financial markets but are relatively closed to trade, this can substantially increase the risk of crisis.

[5]"Building a Better Future in Africa," address by Horst Köhler, Ghana, May 2002 (available via the Internet: www.imf.org/external/np/speeches/2002/050302.htm).

The biggest gains come from countries liberalizing their own markets, and the biggest barriers to developing country trade are in fact in developing countries themselves. Even so, industrial countries—which have relatively much smaller agricultural and industrial sectors, and are much more able to manage the transitional costs of restructuring—have a special responsibility to lead the way. Given this, the intensification of protectionist pressures earlier this year, including as a result of the passage of the U.S. Farm Bill, is particularly regrettable, although recent proposals to reduce agricultural protection announced by the United States and the European Commission are encouraging. Every effort needs to be made to ensure that protectionist pressures are contained and that substantive progress is made with the Doha Round.

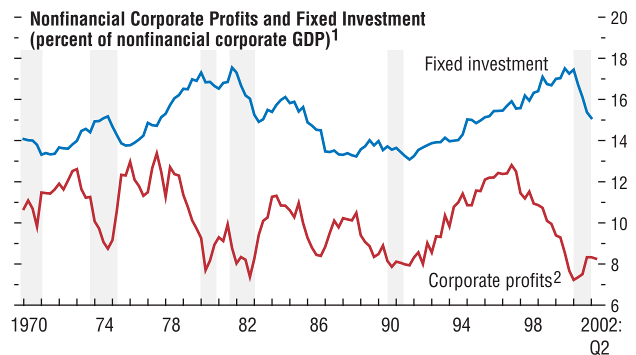
North America: How Well Will the Recovery be Sustained?

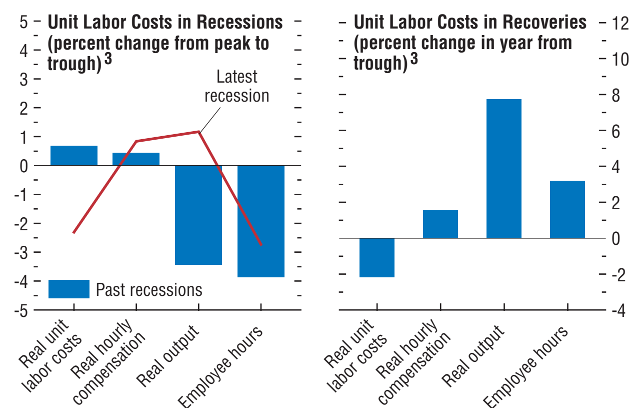
In the United States, growth picked up strongly in late 2001 and early 2002, although since then it has slowed markedly. Recent data revisions reveal that GDP growth in much of 2000 and the first half of 2001 was considerably weaker than earlier thought, although the 2001 recession was still somewhat shorter and milder than the historical norm. This owed much to the aggressive and timely policy response of U.S. policymakers to the downturn, in turn aided by the significant improvement in the fiscal position during the 1990s as well as the credibility of monetary policy management. But it also reflected strong productivity growth in the second half of 2001 and early 2002; these productivity gains supported higher real wages and prevented a further decline in profits, which by early 2001 had fallen close to historic lows (Figure 1.6).

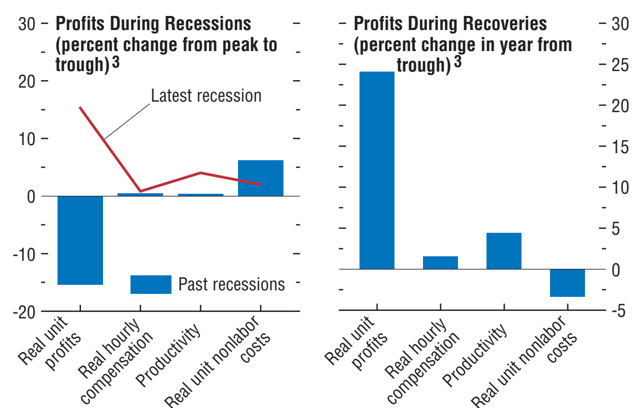
During the first quarter of 2002, the recovery was driven by an upturn in the inventory cycle and by robust household spending, particularly on automobiles and housing. The latter reflected the combined impact of past policy easing, solid wage growth, and buoyant real estate values, which have helped offset the negative

Figure 1.6. United States: Productivity, Profitability, and Investment

With corporate profits still relatively low, companies have cut back employment sharply, resulting in strong productivity growth. Despite high real wage growth, unit labor costs have fallen and profits have also begun to pick up.







Sources: DRI·WEFA, Inc.; and IMF staff estimates.
[1]Shading indicates business cycle from peak to trough.
[2]Profits before tax, adjusted for inventory valuation and capital consumption.
[3]All data for nonfinancial corporate sector. Latest recession assumed to begin in the first quarter of 2001 and end in the fourth quarter of 2001.

effect of lower equity prices.[6] In the second quarter, however, GDP growth slowed significantly, reflecting partly a sharp jump in import growth but also a weakening in consumption. At the same time, financial market conditions have deteriorated markedly. The S&P 500 has fallen sharply since end-March, reflecting mounting concerns about corporate accounting and auditing practices, a revision of earlier optimistic profit forecasts, and concerns about the sustainability of the recovery. Associated with this, and also reflecting growing concerns about the financing of the current account deficit, the U.S. dollar depreciated significantly against the euro and the yen, although more moderately in trade-weighted terms. Business and consumer confidence have also weakened markedly, although they remain above their late 2001 lows.

Looking forward, the outlook depends crucially on the strength of final demand in the second half of the year and beyond. Clearly, the recent sharp decline in equity markets will have a significant impact on demand looking forward, particularly in 2003, although this will be partly offset by the recent fall in long-run interest rates and the depreciation of the dollar (Box 1.1). While consumption has picked up in recent months, this has largely reflected higher auto sales—underpinned by generous incentives—which are unlikely to be sustained. Correspondingly, much continues to depend on a pickup in private investment. While the recovery is expected to continue, its pace is likely to be significantly more moderate than earlier thought, with growth remaining below potential until well into 2003. Consumption growth is expected to remain subdued, mainly reflecting the effects of lower equity prices, and investment is projected to recover more slowly than earlier thought. The current account deficit, which widened sharply in the second quarter, is expected to rise to 4.6 percent of GDP in 2002.

Considerable uncertainties remain, however, particularly with respect to developments in financial markets. First, as discussed above, equity markets could fall further, and the impact of such a decline on demand could be exacerbated by the relatively high level of household and corporate debt. Second, the projected recovery in investment could be delayed. There have been some signs of a pickup in investment—including an upturn in equipment and software spending in the second quarter—and lower interest rates and earlier investment incentives should help. However, excess capacity in some sectors and the general tightening of financial market and credit conditions pose downside risks. Finally, the possibility of an abrupt and disruptive adjustment in the U.S. dollar remains a concern, for both the United States and the rest of the world (Chapter II). The extent of these risks will depend importantly on whether the recent rise in productivity growth, which remains broadly intact despite recent data revisions, can be sustained. If productivity growth remains solid, this will provide support to profits (as was the case in previous recoveries—Figure 1.6) and consumption (through higher real wages), and will reduce the risk of an abrupt adjustment in the dollar. If not, there would be a considerably greater possibility of a slower and weaker pickup in demand, and a correspondingly weaker recovery.

Given the less favorable outlook, and relatively subdued inflation, the Federal Reserve has kept its target for the federal funds rate unchanged, but noted in August that the risks were weighted mainly toward conditions that might generate economic weakness. In view of the heightened uncertainties surrounding the outlook, the Federal Reserve has room to wait to withdraw stimulus until the recovery is more clearly established, and if incoming data were to weaken further, additional interest rate cuts would need to be considered. On the fiscal side, the combination of tax cuts, additional expenditures after the September 11 attacks, and the automatic stabilizers have played an important role in supporting demand. But this has taken a substantial toll on the fiscal position, with the FY2002 budget now expected to show a deficit of 1¾ percent of GDP,

[6]See “Is Wealth Increasingly Driving Consumption?” in Chapter II of the April 2002 *World Economic Outlook*.

rather than the 3 percent of GDP surplus anticipated a year ago. Of more concern, the medium-term outlook has also weakened considerably. Given the forthcoming fiscal pressures from the aging population—albeit less than in many other industrial countries—and the desirability of strengthening domestic savings, it will be important to reestablish a framework that sets the clear goal of balancing the budget (excluding Social Security) over the business cycle. With the budget already anticipating tight—and probably unrealistic—restraint on nondefense discretionary expenditures, reaching this goal will likely require some increase in revenues over the medium term. This should be accompanied by steps to safeguard the longer-term health of the Medicare and Social Security systems. Continued efforts are also required to improve corporate governance, building on the reforms under way—including by ensuring that the new oversight board develops needed reforms to accounting rules and that these and other reform measures are effectively enforced.

In Canada, the economy has rebounded faster than in any other G-7 country, underpinned by the near completion of the inventory correction, robust consumer spending, and the recent rebound in investment. The strength of the Canadian economy, especially in relation to the United States, reflects a number of factors, including a more moderate capital overhang, less dependence on the IT sector, the relatively depreciated value of the Canadian dollar, and the impact of the U.S. housing boom on the resource sector. Economic indicators continue to point to strong growth in the period ahead although, as in the United States, demand growth will be affected by the recent decline in equity markets. While fiscal policy has provided moderate support to activity, the federal budget remains in significant surplus. General government debt has fallen significantly in recent years, but is still close to 60 percent of GDP; correspondingly, the authorities remain appropriately committed to a balanced budget and further debt reduction over the medium term. Given the strength of the recovery, the Bank of Canada raised interest rates by 75 basis points through July, but paused in September, partly reflecting the weakening recovery in the United States. Looking forward, the pace of monetary tightening will need to continue to balance the currently strong domestic demand conditions in Canada against uncertain prospects for external demand, particularly from the United States, and the impact of financial market developments.

Japan: Are Growth Prospects Picking Up at Last?

Activity appears to have bottomed out in Japan after the third, and most severe, recession in the last decade. A modest rebound is projected for the remainder of this year and in 2003, although it remains subject to downside risks. The fundamental issue in Japan, however, continues to be how to achieve more rapid underlying rates of output growth, and break the decade-long pattern of anemic performance interspersed with recession. This cannot be achieved by macroeconomic policies alone, but requires decisive action to deal with long-standing structural impediments. Such action is most important in the banking sector, where a vicious circle needs to be broken in which large unrecognized nonperforming loans make banks unwilling to lend, hurting financial intermediation and activity, and thereby creating new nonperforming loans to replace those being written off.

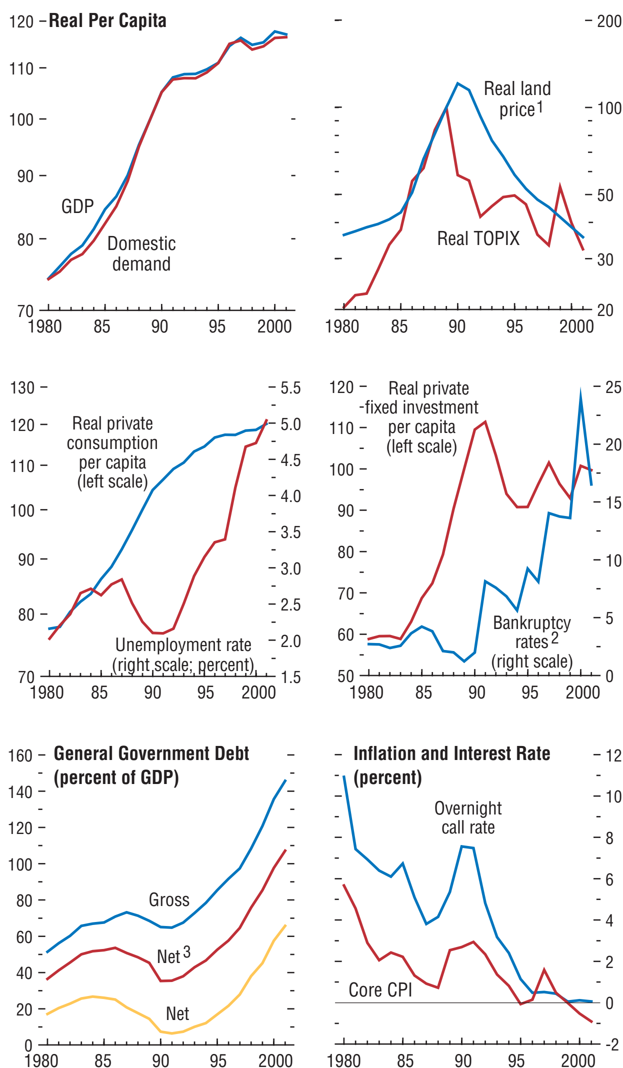
Activity appears to have stabilized in early 2002. The revised national income accounts indicate that activity accelerated modestly over the first half of this year, underpinned by net exports, while private domestic demand remained relatively weak.[7] More recent indicators suggest that business investment is likely to begin to recover

[7]A major overhaul of the methodology of the Japanese national accounts was introduced in August. Revisions of the data back to early 2001 using the new methodology indicate a smoother path for activity that is also more consistent with higher frequency data.

Figure 1.7. Japan: Costs of Muddling Through

(Logarithmic scale and index 1989 = 100 unless otherwise indicated)

Since the bursting of the asset price bubble in the early 1990s, the Japanese government has failed to put into place bold structural initiatives, at considerable long-term cost.



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

[1]Average of all areas for urban land prices in six big cities.
[2]Business failures: amount of liability in trillions of yen.
[3]Excluding social security.

by late 2002, although retail sales remain sluggish. High levels of slack remain, and deflation of about 1 percent a year persists, magnifying real debt burdens. Wealth destruction continues, with equity prices down since the start of the year and land prices continuing to fall, putting additional pressure on bank balance sheets.

Real GDP is projected to fall by ½ percent in 2002 (on an annual basis) before staging modest positive growth of about 1 percent in 2003. This anticipates a gradual recovery in private domestic demand, with private consumption growing somewhat in the second half of 2002 and business investment recovering late in the year. The contribution from net exports, however, is expected to weaken as rising domestic demand boosts imports and the appreciation of the yen erodes competitiveness. Higher private spending is partly offset by fiscal consolidation, with government investment declining in the latter part of 2002 as spending associated with past fiscal stimulus packages wanes, while the 2003 structural fiscal deficit is projected to fall by about 1 percent of GDP, although some of this decline may be offset by tax cuts that are likely to be announced soon.

While the economy could recover more rapidly, particularly if global activity picks up more quickly than currently expected, downside risks predominate. The recent appreciation of the yen highlights the susceptibility of the recovery to external influences, including further appreciation or weaker global recovery. A further fall in equity prices could also affect activity by eroding confidence and dealing a further blow to the difficult financial position of the banks, already weakened by slow growth and falling asset prices.

Over the last decade, the authorities have adopted a gradualist approach to reform, rather than taking decisive action to solve long-standing structural weaknesses exposed by the bursting of the asset price bubble in the early 1990s. This approach has come at a considerable cost to the Japanese economy in terms of activity, wealth destruction, and unemployment (Figure 1.7). Countercyclical macroeconomic policies have been unable to ignite self-sustaining growth or avoid deflation becoming entrenched, despite

stimulus measures that helped to increase net debt excluding social security to over 100 percent of GDP, and gross debt to 140 percent of GDP, and reduced short-term interest rates to zero.

In a break with the past, in 2001 the government of newly elected prime minister Koizumi presented a broad strategy to address Japan's fundamental economic problems. This strategy encompassed banking reform, fiscal consolidation, and corporate restructuring and deregulation, and the government is expected to announce another economic package that will provide further details of its reform proposals in coming weeks. Existing initiatives include recently completed special inspections of the accuracy of classification of major bank loans to particularly weak large corporations; accelerating major banks' disposal of the worst nonperforming loans; encouraging a reduction of banks' equity holdings; setting procedures for formal and informal rehabilitation of distressed companies; a ¥30 trillion (6 percent of GDP) limit on central government bond issuance in this fiscal year; and establishing broad goals for medium-term fiscal consolidation. While these are welcome steps, additional initiatives appear necessary to address the structural impediments confronting the Japanese economy and hence to significantly improve medium-term growth prospects, so as to achieve the following:

- *Improve banks' financial health and profitability* through full recognition of the quality of all bank loans; recapitalize viable banks, possibly using public funds, but subject to strong conditionality; promote the exit of nonviable banks; and scale down the role of government financial institutions. Forcefully tackling the underlying problems faced by the banks is a prerequisite for the planned removal of the blanket guarantee on demand deposits next April.
- *Accelerate corporate restructuring* by giving banks stronger time-bound incentives to agree realistic restructuring plans with viable firms and to carry out the rapid and complete disposal of the assets of nonviable ones.
- *Increase the credibility of the medium-term fiscal consolidation strategy* by setting a medium-term debt target and broad objectives for major budget categories, to help maintain investor confidence in an environment of high and rapidly rising debt.

Turning to the short-term macroeconomic stance, bolder monetary stimulus should be used to support the emerging recovery; given the difficult underlying fiscal position, however, consolidation should be initiated unless bold structural policies are undertaken. Specifically,

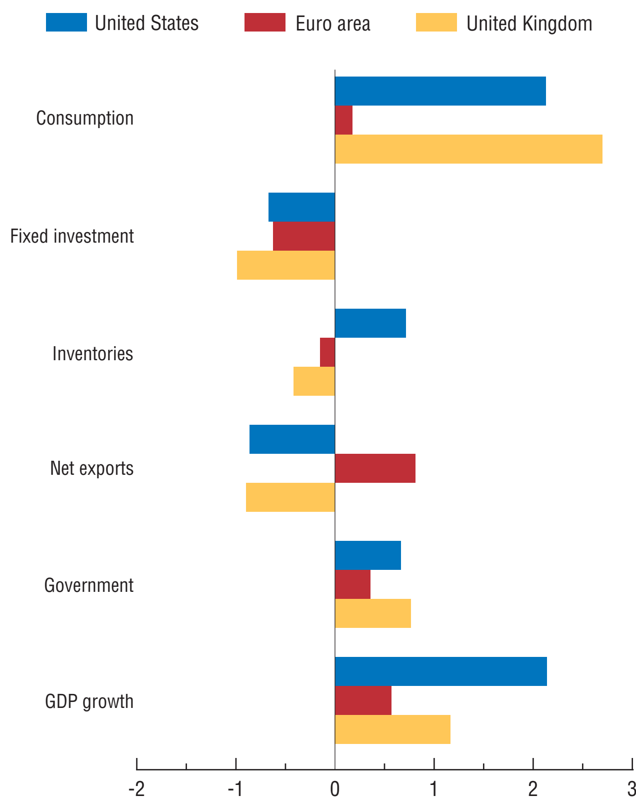
- *A more aggressive monetary stimulus is needed to support economic activity*, comprising a public commitment to end deflation in no more than 12–18 months, backed by further quantitative easing. The recent appreciation of the yen bolsters the case for further easing, as it will negatively affect activity and prices if sustained. Although there is a possibility that aggressive quantitative easing could result in excessive yen weakness, the regional impact should likely be manageable given the movement toward flexible exchange rates and healthier reserve and external debt positions. Regional effects would be further mitigated if quantitative easing were combined with the initiatives needed to revive Japan's medium-term growth; and
- *In the absence of appropriate restructuring initiatives, the focus of fiscal policy should move toward the initiation of gradual consolidation to stabilize the debt ratio in the medium term.* Given the unsustainable fiscal situation—net debt excluding social security is projected to rise to over 120 percent of GDP by the end of fiscal year 2002/03—it is critical that the authorities clarify their medium-term consolidation strategy. That said, if appropriate structural policies are followed, which could engender a negative short-run impact on activity, steps should be taken to attain a neutral fiscal stance in the short term.

Western Europe: A Tepid Recovery So Far

Recovery in the euro area appears to be lagging behind that of other regions, especially North America and emerging markets in Asia.

Figure 1.8. United States, Euro Area, and United Kingdom: Contribution to Change in GDP Growth[1]

Recent GDP growth in the United States and the United Kingdom has been driven largely by private consumption, government spending, and in the United States, the inventory correction, while the much weaker growth in the euro area stems mainly from net exports.



Source: Haver Analytics.
[1]GDP growth rate in the year to 2002:Q2.

Reflecting this, the modest pickup in growth since late 2001 has been led by the external sector, with exports gradually rising but imports falling further (Figure 1.8). But, as reflected in the weakness of imports, domestic demand remains sluggish across much of the region in early 2002, with private consumption still subdued and area-wide investment spending yet to recover from its fall in 2001. Recent indicators of activity and confidence—including retail sales, second quarter GDP, and the key IFO index of business sentiment in Germany—have generally disappointed, suggesting that the regional recovery will be more muted than earlier expected. Nevertheless, several factors should support some strengthening of growth later in 2002 and in 2003. The inventory cycle, which has yet to turn substantially in Europe, should provide a boost to activity later this year. Support should also come from a recovery in consumption, underpinned by recent increases in earnings growth, falling inflation, and the surprisingly robust labor market performance over recent years. And investment spending should strengthen as corporate earnings (which have held up better than in the United States) and capacity utilization pick up. Overall, GDP growth in the euro area is now expected to be 0.9 percent in 2002 and 2.3 percent in 2003, both about ½ percent lower than the projections in the April *World Economic Outlook.*

Questions remain about the resilience and dynamism of the expected recovery, however. The robustness of export-led growth could come under pressure if external demand disappoints or the euro continues to strengthen. Furthermore, while equity market capitalization is much lower in Europe than in the United States and equities are not as widely held by households, euro area stock markets have fallen even more sharply than those in the United States since 2000. This may have a dampening effect on confidence and demand, and add to balance sheet pressures on insurance companies and other financial institutions. Prospects for industrial production and domestic demand in Germany appear particularly uncertain, and further weak-

nesses there would have important implications for Europe as a whole. The severe floods during the summer of 2002 are estimated to have had a negligible net impact on area-wide activity. In Germany and Austria, any initial adverse effects on output will probably be more than offset later in 2002 and in 2003 by increased spending arising from flood relief and reconstruction efforts.

Substantial variations in economic performance persist across the region, reflecting differences in the impact of recent global shocks—for example, from higher oil prices and weaker international trade—together with differences in fiscal pressures and underlying structural conditions. Among the larger economies, domestic demand has been particularly weak in Germany and Italy, while France has been somewhat more resilient, helped by labor market reforms that have boosted employment over recent years. This variation in economic performance may also partly reflect differential movements in house prices, which have been rising in France but steadily declining in Germany. In addition, ongoing restructuring of the banking system in Germany may have contributed to slower credit growth. Elsewhere, recent growth has been relatively slow in Austria, Belgium, the Netherlands, and Portugal, while stronger economic performance is evident in Greece, Ireland, and Spain.

Inflation has been close to or above the 2 percent ceiling of the European Central Bank (ECB) during much of the economic slowdown, and core inflation (excluding energy, food, alcohol, and tobacco) has remained at about 2½ percent since the beginning of 2002. Concerns have been heightened by a gradual upward trend in wage growth, which, while partly a catch-up from weak growth in earlier years, has been accompanied by falling productivity and hence a sharp rise in unit labor costs. Inflation is expected to diminish in the period ahead, however, as the impact of temporary factors fades (including past increases in oil and fresh food prices, and the euro changeover), as productivity stages a cyclical rebound, and if the recent strengthening in the euro is sustained. The sizable output gap in the euro area should also help contain core inflation. Earlier in the year, with core inflation edging up and growth expected to recover from around midyear on, the ECB appropriately put interest rates on hold. In recent months, however, the euro's appreciation has led to an implicit tightening of monetary conditions, there are signs of core inflation starting to come down, and, as discussed above, the recovery has appeared increasingly hesitant. Hence, with risks to the outlook now more weighted to the downside and little room for maneuver on fiscal policy (see below), if monetary easing is not warranted now, a bias in that direction is.

On the fiscal front, the euro area's structural deficit is projected to begin narrowing again this year, although policy requirements differ significantly among member states—largely reflecting the failure of the largest countries to match the consolidation efforts of most smaller countries during the period of relatively strong growth in the late 1990s. Germany is expected to be close to the 3 percent limit of the Stability and Growth Pact in 2002 (a limit that Portugal may again exceed this year), implying that significant efforts will be needed in the coming years to bring the deficit down to close to balance. Following revised budget estimates and recent tax decisions in France, the fiscal position now appears much more difficult. And Italy will also need to make substantially firmer efforts to meet the commitment of fiscal balance, to be achieved in 2005 (rather than 2003, as envisaged earlier). More generally, most euro area economies face the need for further strengthening of fiscal positions over the medium term, especially to provide scope for reductions in high tax burdens and to meet public pension and health care obligations, which are projected to rise significantly over the next 10 to 20 years. Credible steps by the three largest countries toward achieving underlying fiscal balance would permit an easier monetary policy.

These fiscal challenges, and the broader need to improve the euro area's growth potential, highlight the need for further structural reforms throughout the region. Some important steps have been taken over recent years—for example,

with countries providing greater scope for the use of part-time, temporary, and contractual employees, and some also lowering tax wedges on lower-paid workers and allowing greater flexibility in work arrangements. Such measures, supported by overall wage moderation, contributed to the pickup in employment growth and reduction in unemployment in the second half of the 1990s, including the absorption into employment of many females and younger workers (see Box 1.3). But these efforts need to be intensified and broadened to promote growth in employment and potential output, which would help in meeting the challenges ahead from population aging. While area-wide unemployment has come down substantially, it remains high compared with other advanced economies; and labor force participation rates—especially of people aged over 55—are very low relative to the United States and other countries. Support also needs to come from further product market and financial sector reforms—both areas now all the more important given the scope for increased area-wide integration and efficiency gains since the introduction of the euro.

Turning to other European economies, growth in the United Kingdom slowed sharply in the final quarter of 2001, but rebounded in the second quarter of this year. Private consumption has remained relatively robust, especially in comparison with the large euro area economies, and has been supported by firm labor markets, increased household borrowing, and rapidly rising house prices—up about 20 percent in the year to August. The manufacturing sector has shown signs of improvement following a severe contraction in output and fixed investment since 2000. Looking ahead, growth is expected to pick up in the second half of 2002 and reach about 2½ percent in 2003. This recovery should be helped by the recent weakening of sterling (especially against the euro) and stronger demand for exports. With inflation below target (2 percent in July), weak equity prices, and risks to the global recovery, the Monetary Policy Committee's unchanged interest rate stance is appropriate. Some firming in monetary policy may be needed when the projected recovery is clearly established, particularly if house prices continue to rise rapidly. This monetary stance will need to be supported by ongoing fiscal prudence as recovery proceeds, with fiscal policy—which includes a major expansion of public spending over the coming years—continuing to be anchored to a sound medium-term framework.

Elsewhere, growth in Denmark, Norway, and Sweden appears to be picking up steadily, and is expected to reach about 1½ percent in 2002 and 2–2½ percent in 2003. These improvements should be supported by further strengthening in private consumption, which, helped by generally firm labor market conditions and earnings growth, has been relatively robust during the slowdown; and by a pickup in exports—including, in Sweden, a rebound in the high tech sector. Manufacturing activity and investment still appear weak, however, and are expected to lag the overall recovery. With inflation pressures still of some concern and growth picking up, monetary policy was tightened in Sweden in early 2002. Further monetary policy adjustments should wait until the recovery is firmly embedded, especially in view of the recent currency appreciation. With inflation remaining very low, the authorities in Switzerland have lowered policy interest rates to help ease safe-haven-related appreciation pressures on the Swiss franc. The Swiss economy is expected to stagnate in 2002, but growth is projected to rebound to about 2 percent in 2003.

Latin America: Heightened Economic and Financial Uncertainties

In contrast with signs of strengthening in most other regions, economic and financial conditions in Latin America deteriorated in the first half of 2002 and remain fragile. Regional output contracted by 2½ percent in the first quarter (compared with the final quarter of 2001), and is expected to fall in 2002 as a whole (Table 1.6). Financial indicators for the region have come under particular pressure: bond spreads widened significantly in the first half of 2002—including sharp increases in Brazil, Ecuador, and

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**	**0.6**	**–0.6**	**3.0**	**8.1**	**6.4**	**8.6**	**9.3**	**–2.4**	**–2.8**	**–1.9**	**–1.6**
Mercosur[3]	**2.9**	**0.1**	**–2.6**	**2.4**	**5.0**	**4.9**	**11.4**	**13.5**	**–3.8**	**–3.5**	**–1.3**	**–0.1**
Argentina	–0.8	–4.4	–16.0	1.0	–0.9	–1.1	29.0	48.0	–3.1	–1.6	10.8	15.4
Brazil	4.4	1.5	1.5	3.0	7.0	6.8	6.5	4.3	–4.2	–4.6	–3.8	–3.6
Chile	4.4	2.8	2.2	4.2	3.8	3.6	2.1	2.8	–1.4	–1.9	–1.6	–2.0
Uruguay	–1.4	–3.1	–11.1	–4.5	4.8	4.4	24.2	49.9	–2.6	–2.5	1.6	1.5
Andean region	**2.9**	**2.0**	**–0.4**	**2.4**	**16.1**	**10.6**	**10.2**	**10.4**	**4.8**	**0.2**	**0.2**	**0.4**
Colombia	2.7	1.4	1.2	2.0	9.2	8.0	5.7	5.0	0.5	–2.2	–2.4	–2.4
Ecuador	2.3	5.6	3.5	3.5	96.2	37.7	12.7	8.9	5.3	–3.4	–8.6	–6.6
Peru	3.1	0.2	3.5	3.0	3.8	2.0	0.4	2.0	–2.9	–2.0	–2.0	–2.3
Venezuela	3.2	2.8	–6.2	2.2	16.2	12.5	22.7	25.2	10.8	3.2	5.7	6.4
Central America and Caribbean	**6.0**	**0.2**	**1.7**	**3.9**	**8.7**	**6.5**	**4.8**	**4.0**	**–3.5**	**–3.2**	**–3.1**	**–3.4**
Dominican Republic	7.2	2.8	3.5	5.3	7.7	8.9	4.8	4.5	–5.2	–3.9	–3.9	–3.8
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	1.5	4.0	9.5	6.4	4.8	3.7	–3.1	–2.9	–2.8	–3.2

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Includes Argentina, Brazil, Paraguay, and Uruguay, together with Bolivia and Chile (associate members of Mercosur).

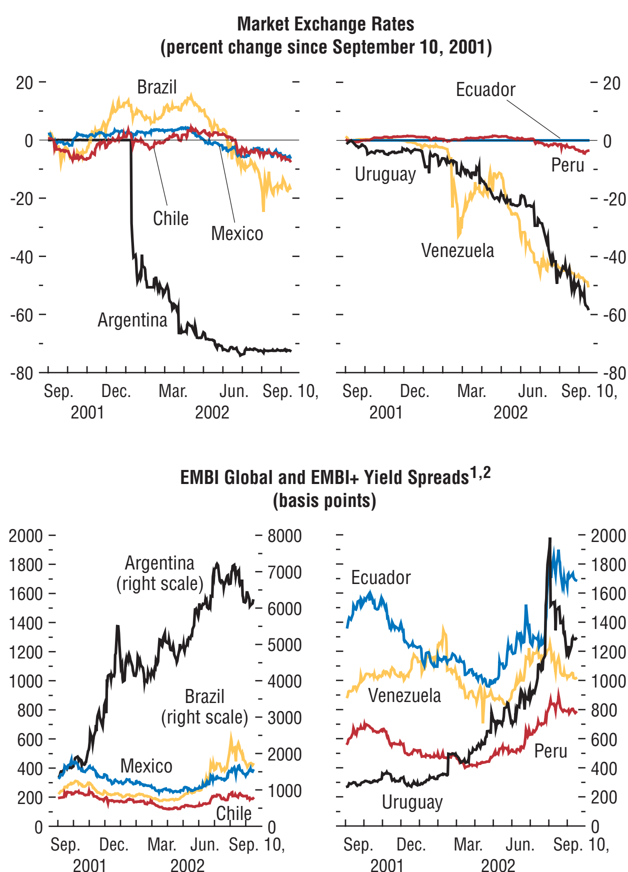
Venezuela, together with further deterioration in Argentina and Uruguay; most currencies weakened, with the Brazilian *real* falling to an all-time low and the Venezuelan bolivar also depreciating significantly; and debt markets remained largely closed to all but investment-grade issuers—that is, Chile and Mexico (Figure 1.9). The latter two countries continue to resist the region's difficulties reasonably well, helped by sound policy management, relatively low public debt (Chile), and strong links to the United States (Mexico).

Much of the output decline in Latin America during the first few months of 2002 was accounted for by the crisis in Argentina and its spillover effects on some neighboring countries, especially Uruguay and Paraguay. More broadly, though, while direct contagion from Argentina still appears limited, this crisis has provided investors with a "wake-up call" to underlying vulnerabilities that persist in the region. In particular, the recent upsurge in difficulties being experienced by many regional economies stems from interactions between domestic political uncertainties and economic weaknesses, including high debt levels, large external financing requirements, and—in some cases—fragile banking systems. Furthermore, the deterioration in financial market sentiment toward Brazil—with by far the largest external financing requirement in the region—may have exacerbated the problems being faced by other Latin American economies. Looking ahead, the improvement in global growth should provide some support for regional activity over the coming year. But short-term risks still appear to be predominantly on the downside, and any turnaround in confidence and prospects will be heavily contingent on the abatement of current political, economic, and financial market uncertainties.

Argentina is experiencing an economic contraction of unprecedented magnitude in its economic history, with the cumulative fall in output in the four years to the end of 2002 expected to be over 20 percent—about twice that experienced in the Great Depression of the 1930s. GDP fell 6 percent in the first quarter (over the previous quarter), with consumption and especially investment contracting sharply, and unemployment has increased to about 25 percent. While the trade and current account balances have improved, this reflects the collapse of imports; exports have also fallen, largely because of a cutoff in trade finance. Inflation picked up significantly during the first part of 2002 and,

Figure 1.9. Selected Western Hemisphere Countries: Exchange Rates and EMBI Yield Spreads

There has been a marked weakening in exchange rates and rise in bond spreads for most Latin American countries over recent months.



Sources: Bloomberg Financial Markets, LP; and J.P. Morgan Chase.
[1]EMBI Global: Chile and Uruguay.
[2]EMBI+: Argentina, Brazil, Ecuador, Mexico, Peru, and Venezuela.

while monthly inflation rates have recently moderated, this in part reflects temporary factors, including the continuing freeze on public service prices. Rapid progress is needed in four key areas: finalizing a fiscal framework that, to the extent possible, balances medium-term debt sustainability requirements and current cyclical considerations; developing a comprehensive strategy to address the very difficult financial condition of the banking sector, and applying this transparently and uniformly; establishing a sustainable monetary anchor for the authorities' economic program; and reinforcing the independence of the central bank.

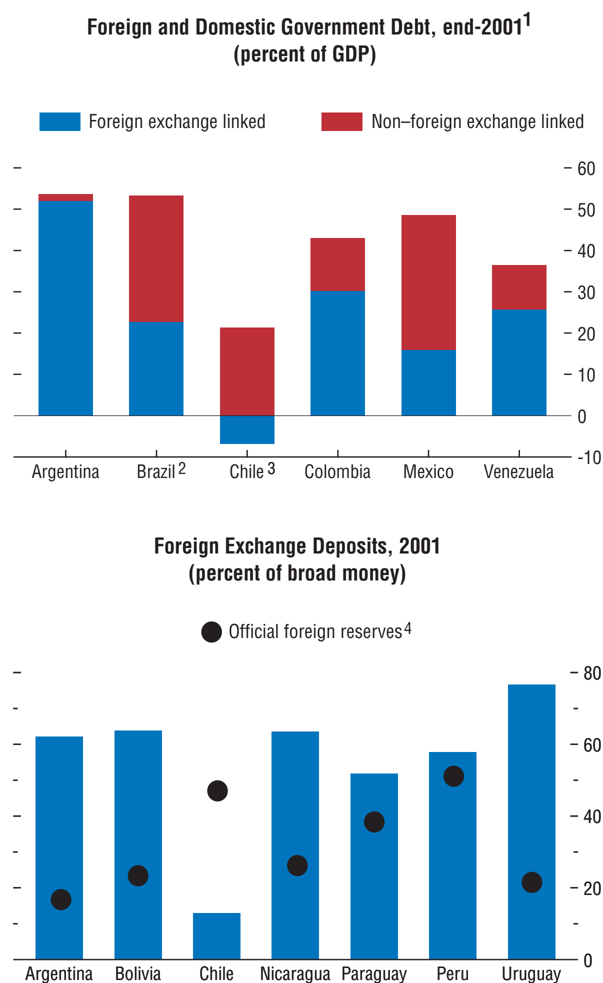
Some countries neighboring Argentina—notably Uruguay, but also Paraguay and Bolivia—have also been affected by the Argentine crisis through trade, tourism, and financial channels (to varying degrees among the countries concerned). Banks in Uruguay have suffered a particularly severe run on dollar deposits, with heavy withdrawals by Argentine deposit holders then spreading to domestic depositors, and this led to a temporary suspension of banking operations in late July. Paraguay and Bolivia have experienced similar, if lesser, pressures, although deposit withdrawals in Bolivia were driven mostly by uncertainty surrounding the general elections. Seeking to limit the drain on reserves, the Uruguayan authorities allowed the peso to float as of June 20, and further support has come from an augmentation of Uruguay's stand-by credit arrangement with the IMF. Indicating an improvement in sentiment, there was a significant slowing in the outflow of deposits during August, especially on the part of domestic deposit holders. Nevertheless, a continuing vulnerability in Uruguay and some other regional economies—already highlighted by the problems in Argentina—is the high level of dollarization of the banking system (Figure 1.10). As a result, the authorities have only limited scope to use monetary policy to respond to current pressures, and banks are facing significant balance sheet problems as exchange rates weaken. In such circumstances, policy attention needs to focus on strengthening the banking system, in part through a more rig-

orous supervisory framework, as well as on tackling underlying sources of risk—especially by improving fiscal performance.

Having resisted direct contagion from the crisis in Argentina reasonably well, Brazil faced a sharp deterioration in financial market sentiment in the second quarter, notwithstanding the sound macroeconomic policies pursued since the 1998 crisis (Box 1.4). The decline in market confidence—reflected in a sharp fall in the Brazilian *real* and widening of bond spreads—appeared to be driven largely by uncertainties about the prospective policy stance following the October presidential elections. This situation has raised particular concerns, given the high level of Brazil's public debt, the scale of its gross financing requirements, and its important role in emerging debt markets. Responding to these concerns, the IMF has agreed with the Brazilian authorities on a new $30 billion stand-by arrangement, to be disbursed mainly in 2003. The floor on net international reserves has been lowered by $10 billion. The new program envisages the maintenance of a primary surplus target of no less than 3¾ percent of GDP during 2003, to be revisited each quarter, and the inclusion of no less than that target in Brazil's budgetary guidelines law for 2004 and 2005. Accompanying this agreement have been commitments by the major presidential candidates to follow prudent macroeconomic policies, and expressions of intent from foreign banks to sustain their general level of business in Brazil, including trade lines. Greater stability appears to have returned to financial markets in recent weeks, including a significant fall in bond spreads, although they remain very high. These developments have helped to improve confidence and reduce uncertainty, and should thereby support the continuation of the authorities' policy strategy directed toward strengthening macroeconomic stability and growth. But important vulnerabilities remain—including with respect to the debt amortization and rollover schedule in the months ahead. Over the medium term, the policy goal should be to reduce the country's debt burden through the maintenance of high

Figure 1.10. Selected Western Hemisphere Countries: Public Debt and Foreign Exchange Deposits

The significant dollarization of public debt and private bank deposits in most Latin American countries acts as a constraint on the use of easier monetary and exchange rate policies to ease the region's economic difficulties.



Sources: National authorities; IMF, *International Financial Statistics;* and IMF staff estimates.

[1]Unless noted otherwise, data refer to gross stocks of government debt, including that of public enterprises, but excluding central bank liabilities.

[2]Includes also central bank liabilities (monetary base) net of liquid foreign exchange assets.

[3]Consolidated debt of the Chilean government, central bank, and state-owned enterprises, net of official reserves and deposits in the financial system. Figures do not include recognition bonds related to pension system conversion.

[4]Percent of broad money; estimated using central bank's Gross International Reserves.

Box 1.4. Brazil: The Quest to Restore Market Confidence

Following more than two decades of macroeconomic instability in Brazil, the *real* plan in 1994—centered on the introduction of a new currency, the *real,* and the adoption of a crawling peg policy vis-à-vis the dollar—proved a turning point for macroeconomic policies. In the four years that followed, inflation was brought down to 5 percent and GDP growth averaged 4 percent; at the same time, considerable progress was made in structural reform, notably in the areas of large scale privatization, demonopolization and deregulation of key sectors, external liberalization, and financial reform. However, the *real* plan was less successful in addressing structural fiscal problems. After an initial tightening, the consolidated public sector—encompassing the central government, the social security system, the central bank, the states and municipalities, and the public enterprises (all levels of government)—posted an average primary deficit of 0.4 percent of GDP between 1996 and 1998, while net domestic public debt rose from 21 percent of GDP in 1994 to 30 percent of GDP in 1997. Partly for this reason, and also because of a sharp appreciation of the exchange rate as stabilization took hold, the current account deficit widened to 4 percent of GDP by 1997.

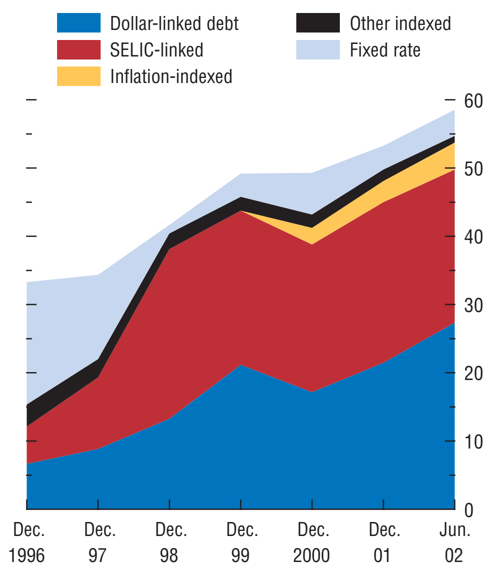
These underlying vulnerabilities were exposed by the Asian crisis in 1997 and even more so by the Russia and LTCM crisis of 1998, as capital flows to Latin America dropped precipitously. In response to growing pressures on the *real*, the authorities chose to defend the crawling peg regime by raising interest rates, substituting substantial dollar-linked and overnight interest rate–linked debt for fixed-rate debt, and tightening fiscal policy, supported, from December 1998, by an $18 billion stand-by arrangement with the IMF. The issuance of indexed debt allowed the authorities to avoid "locking in" high interest rates on long-term fixed-rate domestic debt, but at a cost of increased vulnerability to subsequent shocks to interest rates and the exchange rate. While financial pressures initially abated, they quickly reemerged, partly reflecting concerns that the projected fiscal stabilization could not be achieved, and, following an initial widening of the exchange rate band, the *real* was floated on January 15, 1999. This, together with subsequent increases in interest rates, stemmed capital outflows, and the currency stabilized quickly, albeit at a much more depreciated level. After an initial spike in prices, inflation fell back to 6 percent by the end of 2000, aided by the successful introduction and implementation of an inflation-targeting framework. Real GDP growth resumed at 4.4 percent in 2000, after near-stagnation in 1998 and 1999.

In the aftermath of the floating of the *real*, Brazil tightened fiscal policy, posting a primary surplus of 3.2 percent of GDP in 1999 and 3.5 percent in 2000, implying a fiscal adjustment of nearly 4 percentage points of GDP. Brazil also implemented fiscal institutional reforms that substantially strengthened the management of its public finances. The centerpiece of the institutional strengthening effort was the enactment in May 2000 of a Fiscal Responsibility Law, which set out, for all levels of government, fiscal rules aimed at ensuring medium-term fiscal sustainability. In addition, the Budget Guidelines Law sets medium-term fiscal targets as indicative guidelines for the annual budget law. Subnational finances have also been strengthened through the conclusion by 1999, and subsequent continued enforcement, of debt restructuring arrangements between the National Treasury and the states and over 180 municipalities.

Nonetheless, despite the large increase in the primary surplus, the public debt continued to grow rapidly, for several reasons. First, the high interest rates used to defend the currency in 1998 resulted in a sharp increase in interest payments. In addition, the devaluation of 1999 sharply increased the *real* value of dollar-linked public debt that had been issued as part of the defense of the crawling peg policy. Finally, about 11 percentage points of the increase in the debt ratio was due to the recognition of the so-called "skeletons," or implicit public sector liabilities, which were gradually made explicit. Overall, net public debt (domestic and external) rose from 35 per-

Note: The main author of this box is Andrew Berg. The box covers developments up to September 13, 2002.

Brazilian Net Public Debt and its Composition
(Percent of GDP)



Source: Brazilian Central Bank.

cent of GDP in 1997 to 50 percent by the end of 2000.[1] Moreover, public debt remained highly indexed, with 45 percent linked to the SELIC overnight interest rate and a further 35 percent linked to the U.S. dollar by end-2000 (see the figure).

In 2001, Brazil experienced a series of domestic and external shocks, including a domestic energy crisis, spillovers from developments in Argentina, and slower growth in the global economy. Output growth slowed, the *real* weakened substantially in real terms, and spreads on Brazilian sovereign bonds widened along with those of emerging market indices in general. In response, the authorities tightened fiscal policy, supported by a $15 billion stand-by arrangement with the IMF. The authorities indicated that they did not intend to draw under the program unless conditions in local and external markets deteriorated. In the weeks immediately following the events of September 11, the *real* depreciated and spreads increased further, in part owing to investors' concern about the ability of Brazil to confront large external and domestic financing requirements during a period of global instability, and the authorities purchased $5 billion under the recently negotiated stand-by arrangement with the IMF. By early 2002 the *real* and bond prices had rebounded to roughly mid-2001 levels, and there was some evidence of a recovery in real GDP growth as the energy crisis waned. Most of the recently purchased IMF resources were repaid ahead of schedule in April 2002. However, given the weakening of the *real* over the course of the year, net public debt continued to rise, reaching 53 percent of GDP by the end of 2001.

The respite proved relatively short-lived, and from the second quarter of 2002 the macroeconomic situation has deteriorated sharply. Although macroeconomic policies have remained on track—with primary surplus targets exceeded despite lower than expected GDP growth—sovereign spreads doubled from 750 basis points to 1500 basis points between end-March and end-June and the *real* weakened by 18 percent to 2.8 reais per dollar. The reasons for this deterioration are varied. Perhaps most fundamentally, market participants began to focus their attention on the political uncertainties associated with the October presidential election and what this implied for the existing policy framework. In this context, the surprisingly large losses suffered by major international banks in Argentina were leading them to reassess and in some cases reduce sharply their exposure to Brazil. At the same time, the external environment worsened as global risk appetite fell, industrial stock markets dropped sharply, and doubts about the direction of the global economy resurfaced.

In response, on June 13 the authorities announced a further tightening of fiscal policy—raising the primary surplus target from 3½ to 3¾ percent of GDP—as well as their intent to purchase as much as $10 billion from the previ-

[1]Net debt is defined as total debt less the value of various government assets, such as government bank deposits.

Box 1.4 *(concluded)*

ously approved IMF package following the completion of the Third Review under the program on June 18. Upon completion of the review, the net international reserves floor was lowered from $20 billion to $15 billion, allowing the authorities more leeway to sell their foreign exchange reserves in the market and buy back their external debt. Notwithstanding these measures, the situation deteriorated further in July and early August. First, markets grew increasingly nervous about the outcome of the election and what that might imply for the sustainability of Brazil's public finances, especially following polls in early July. Meanwhile, the weaker *real* continued to increase the value of dollar-indexed debt as a share of GDP, with net public debt rising to 58 percent of GDP at the end of June. Reflecting—and at the same time magnifying—these concerns, international credit lines continued to be cut and private borrowers found it increasingly difficult to roll over international credits. By August 6, spreads had risen to above 20 percentage points while the *real* had weakened to 3.11 reais per dollar (down 24 percent from end-May).

On August 7, the Brazilian authorities reached an agreement with the IMF on a new stand-by arrangement that commits US$30 billion of additional financing by the IMF, 80 percent of which is to be disbursed during 2003. To ensure fiscal sustainability over the medium term, the new program envisages the maintenance of a primary surplus target of no less than 3¾ percent of GDP during 2003, and the inclusion of no less than that level of primary surplus target in the budgetary guidelines.[2] At the same time, the arrangement gives the authorities more room to intervene in the foreign exchange market, with the net international reserve floor stipulated under the previous stand-by arrangement with Brazil reduced by US$10 billion to US $5 billion immediately upon Executive Board approval of the program, which came on September 6.

The new program is designed to provide a bridge to the new administration, which will take office on January 1, 2003, and to support a policy strategy that will underpin macroeconomic stability. Under plausible macroeconomic assumptions, predicated on continuing improvement in market sentiment over time, the minimum consolidated primary surplus of 3¾ percent of GDP is consistent with a gradual reduction of the net debt ratio over the medium term. The program envisages quarterly reviews of the primary surplus target in light of macroeconomic developments. While initial market reaction to the package was positive, the *real* and sovereign spreads gave up their gains in the following days, partly reflecting a mixed reaction from the main opposition candidates to the announced program and new poll results. Corporations continued to experience difficulties rolling over trade credit lines from foreign banks. To help mitigate this issue, the national development bank (BNDES) has set up a program to provide credit lines to exporters, and the central bank has begun auctioning foreign exchange to domestic banks involved in export financing, for them to on-lend to Brazilian exporters. Meanwhile, foreign banks have, after meetings with the authorities in recent weeks, expressed their intent to sustain their general level of business in Brazil, including trade lines. These developments, in addition to commitments by the major presidential candidates to follow prudent macroeconomic policies, among other factors, have led to greater stability in financial markets in recent weeks. Bond spreads have fallen sharply from their July/August peaks to levels not seen since mid-July; at the time the *World Economic Outlook* went to press the exchange rate had not made up as much ground. Markets remain focused both on short-run concerns about the need to roll over maturing government debt and the availability of external finance and longer-run questions regarding the public debt burden. To assuage these concerns, it is critical to provide confidence that an appropriate policy framework will remain in place after the elections; in this respect, the assurances already given by the major presidential candidates that they will maintain an adequate primary surplus and honor contracts are key ingredients.

[2]The 2003 budget law for the central government and federally owned enterprises has been submitted to congress in August 2002, in line with the projection of the program.

primary surpluses, accompanied by structural reforms directed at reducing fiscal rigidities, which should help reduce the real interest rate, and strengthening and broadening sources of economic growth, including through greater openness to foreign trade.

Many other countries in Latin America—including Ecuador, Peru, and Venezuela—have also experienced a sharp rise in risk perceptions since the first quarter. As in Brazil, this deterioration appears to reflect the interactions among increased regional (and to some extent global) uncertainties, domestic political tensions, and underlying economic vulnerabilities that stem in most cases from the level and composition (by currency and maturity) of public debt. However, policy weaknesses, including substantial fiscal slippages and lack of progress with structural reforms, have also played an important role. In Ecuador, for example, the economic benefits arising from dollarization in early 2000 and from strong oil prices risk being undermined by delays in controlling public spending, due in part to large public sector wage increases, and in reforming public enterprises and the social security system. These developments have put upward pressure on the real exchange rate and widened the current account deficit. In Venezuela, a contraction in economic activity is expected this year as a result of cuts in oil output and the impact of prevailing uncertainties on the non-oil sector. Notwithstanding relatively high oil export prices, the fiscal deficit is expected to remain large at 3.7 percent of GDP in 2002, putting severe strains on sources of domestic and international finance. Further efforts to strengthen revenue and restrain spending are urgently required. Also needed is a program to address financial sector weaknesses, especially as deposit withdrawals and the decline in economic activity have increased the fragility of the banking system. Risk perceptions regarding Peru have also risen as a result of increased pressures on the government to relax macroeconomic policies in the run-up to regional elections in November.

In all of these countries, fiscal adjustment—involving expenditure restraint and improvements in revenues—is the core policy requirement for reducing economic vulnerabilities. This needs to be supported by firm monetary policies and wide-ranging structural reforms, including measures to address banking sector weaknesses and to liberalize external trade. Such mutually reinforcing policies are needed to restore investor confidence, lower interest rates, attract external financing, and reinvigorate growth.

Elsewhere in the region, Mexico and Chile have not escaped the region's difficulties entirely. The Mexican peso has weakened since the start of the year (although this may not be entirely unwelcome, given its earlier appreciation); Chile has been hit by a reduction of its exports to Argentina and some Chilean firms have also suffered losses in that country; and both countries' bond spreads have risen somewhat (although they remain low compared with other regional economies). Overall, though, these countries appear in relatively good shape to withstand current pressures and to resume stronger growth rates later in 2002 and in 2003, supported by the gradual firming of activity in the United States (of particular importance to Mexico) and in other advanced economies. Underpinning these countries' comparative resilience have been their strong records of policy performance, reflected in their investment-grade ratings and, in Chile, the low level of public debt. Given the substantial risks still present in the outlook, maintaining a firm and credible policy stance remains essential to limit the impact of the difficulties elsewhere in Latin America. Mexico's substantial external financing needs still leave it exposed to changes in investor sentiment, and recent tax reforms have not succeeded in raising non-oil revenues as intended. Key measures to reduce the associated risks include implementation of the authorities' medium-term program of fiscal and structural reform directed at reducing external vulnerabilities, strengthening productivity growth, and improving international competitiveness. In addition, with inflation having picked up recently, a firm monetary stance will need to be maintained to keep the inflation target within reach. The widening of the Argentina crisis could weaken

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 Asia[3]	**7.0**	**5.0**	**5.9**	**6.1**	**1.8**	**2.5**	**2.0**	**3.1**	**2.8**	**3.0**	**2.6**	**2.1**
Newly industrialized Asian economies	**8.5**	**0.8**	**4.7**	**4.9**	**1.1**	**1.9**	**1.1**	**2.2**	**4.4**	**6.0**	**5.7**	**5.5**
Hong Kong SAR	10.4	0.2	1.5	3.4	–3.7	–1.6	–3.0	–0.5	5.4	7.3	9.2	9.7
Korea	9.3	3.0	6.3	5.9	2.3	4.1	2.7	3.3	2.7	2.0	1.5	0.9
Singapore	10.3	–2.0	3.6	4.2	1.1	1.0	—	1.0	16.7	20.4	21.7	22.3
Taiwan Province of China	5.9	–1.9	3.3	4.0	1.3	—	0.4	1.6	2.9	6.7	5.8	5.9
ASEAN-4	**5.1**	**2.6**	**3.6**	**4.2**	**3.0**	**6.6**	**6.2**	**5.5**	**7.8**	**5.9**	**3.8**	**2.1**
Indonesia	4.8	3.3	3.5	4.5	3.8	11.5	11.9	8.7	5.3	4.7	2.7	2.0
Malaysia	8.3	0.5	3.5	5.3	1.6	1.4	1.8	2.5	9.4	8.2	6.9	6.4
Philippines	4.4	3.2	4.0	3.8	4.3	6.1	4.0	5.0	11.3	6.3	3.3	–3.3
Thailand	4.6	1.8	3.5	3.5	1.6	1.7	0.7	1.9	7.6	5.4	3.5	2.4
South Asia[4]	5.3	4.0	4.8	5.5	4.0	3.8	4.5	5.1	–1.2	–0.1	0.1	–0.1
Bangladesh	5.6	4.7	4.0	4.0	2.3	1.9	4.8	6.2	–1.3	–0.8	—	–0.3
India	5.4	4.1	5.0	5.7	4.0	3.8	4.5	5.1	–0.9	—	0.1	—
Pakistan	4.3	3.6	4.6	5.0	4.4	3.1	3.4	4.0	–1.9	0.3	1.3	0.1
Formerly centrally planned economies[5]	**7.9**	**7.2**	**7.4**	**7.2**	**0.4**	**0.7**	**–0.3**	**1.6**	**1.9**	**1.5**	**1.4**	**0.8**
China	8.0	7.3	7.5	7.2	0.4	0.7	–0.4	1.5	1.9	1.5	1.5	1.0
Vietnam	5.5	5.0	5.3	6.5	–1.7	0.1	4.1	3.8	2.1	2.2	–2.5	–4.0

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Includes developing Asia, newly industrialized Asian economies, and Mongolia.
[4]Includes Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka.
[5]Includes Cambodia, China, Lao People's Dem. Rep., Mongolia, and Vietnam.

the pickup in growth expected in Chile next year. Given its generally stronger debt position and financial sector, however, Chile should continue to outperform other countries in the region.

Emerging Markets in Asia: Consolidating the Recovery

In emerging markets in Asia, activity has picked up markedly since the beginning of the year, with industrial production and exports rebounding in response to the global upturn and the improvement in the IT sector. With second quarter data continuing to exceed expectations, and signs of a broadening pickup in domestic demand—aided by supporting macroeconomic policies—regional GDP growth is projected to increase to 6 percent in 2002 and to remain at that level in 2003 (Table 1.7). However, the outlook remains highly dependent on external developments, including the possibility of a slower-than-expected recovery in the United States and Europe, and a loss of momentum in the IT sector. Asia is also relatively vulnerable to higher oil prices, were the security situation in the Middle East to deteriorate (see Appendix 1.1).

The impact of the recent turmoil in financial markets has so far been moderate. While equity markets have fallen back, the decline has been less than in other emerging markets. Most countries retain access to international capital markets, and contagion from Latin America has been limited. While spreads in the Philippines have risen somewhat, this appears primarily due to concerns about the fiscal position, and they remain significantly below their levels in late 2001. Except in China, Hong Kong SAR, and Malaysia, regional currencies have risen against the U.S. dollar since late March, as the latter fell back against the euro and yen. But trade-weighted exchange rates have generally depreciated moderately (except in Indonesia and Korea), suggesting that fears that movements in the U.S. dollar could adversely affect competi-

tiveness or lead to deflationary pressures are as yet misplaced.

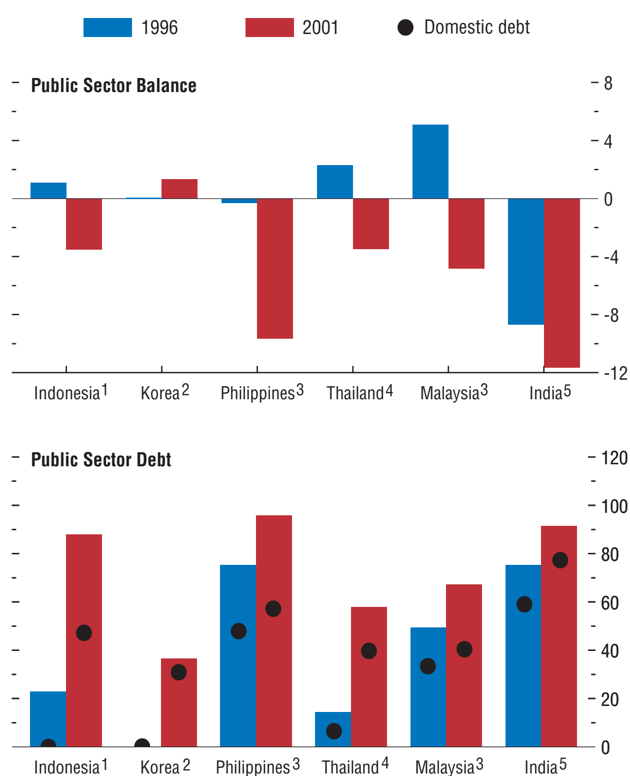
Assuming the recovery continues to unfold as expected, the focus of policies will need to shift increasingly to addressing medium-term challenges. These include the following.

- *Creating the conditions for a sustainable strengthening of domestic demand,* which remains below precrisis levels in some countries (in part reflecting structural problems). Stronger domestic demand is needed both to underpin balanced growth and to help resolve global imbalances (see the first essay in Chapter II).
- *Strengthening resilience to shocks.* Higher public sector debt—in many cases the legacy of the 1997/98 crisis—has increased macroeconomic vulnerabilities in a number of countries (Figure 1.11). Dependence on semiconductors—whose prices are highly volatile and linked to the industrial country cycle (Figure 1.12)—has also risen in many cases, even allowing for the relatively high import content of electronics production. Correspondingly, these countries will need to manage greater variability in output and the external current account, putting an increasing premium on maintaining adequate room for policy maneuver.
- *Ensuring that economies are flexible and dynamic* enough to manage—and indeed take advantage of—the substantial changes in intraregional comparative advantage in prospect, including as a result of China's rapid growth and entry into the World Trade Organization (WTO). In the longer run, successful completion of China's own bank and corporate reforms will be of critical importance for both China and the region.

While the policy priorities needed to meet these challenges vary across countries, there are a number of common themes. These include pressing ahead with the outstanding structural reform agenda, especially in banks and corporates; designing and implementing medium-term plans to ensure fiscal sustainability; and ensuring that exchange rate regimes are managed appropriately flexibly, without reversion to the de facto soft pegs seen in earlier years.

Figure 1.11. Asia: Deteriorating Fiscal Positions
(Percent of GDP)

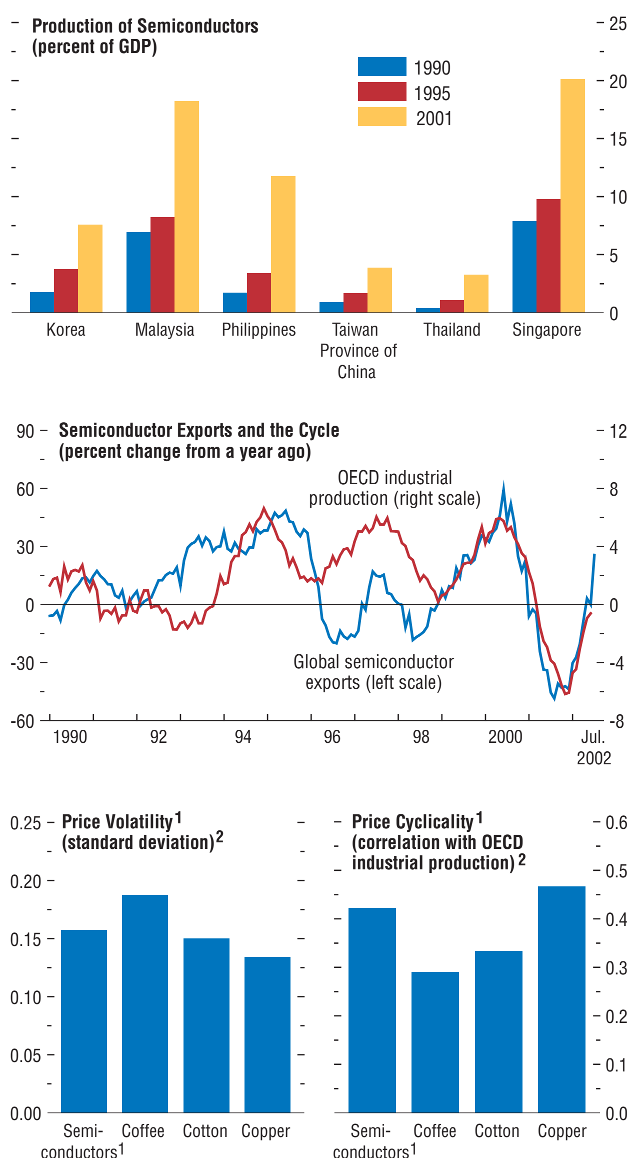
Fiscal positions in most countries have deteriorated significantly since the mid-1990s, accompanied by a sharp rise in public sector debt, mostly domestic currency–denominated.



Sources: National authorities; and IMF staff estimates.
[1]End-March 1997 (prior to 2000, fiscal years covered April–March).
[2]Consolidated central government balance. Owing to lack of data, public sector debt for 2001 refers to calendar year 2000.
[3]Calendar years.
[4]Fiscal years 1995/96 and 2000/01.
[5]Fiscal years 1996/97 and 2001/02.

Figure 1.12. Has Asia Become a Commodity Producer?

Over the past decade, production of semiconductors has increased sharply in many Asian countries. Since semiconductors—like primary commodities—have highly volatile prices and react strongly to the industrial country cycle, this has increased vulnerability to external shocks.



Sources: Reed Electronic Research (2001); OECD Direct; Semiconductor Industry Association; and IMF staff estimates.
[1]For semiconductors, refers to volatility and cyclicality of export value in U.S. dollars, given the lack of price data.
[2]All series detrended using bandpass filter.

Among the newly industrialized economies (NIEs) and ASEAN-4 countries (Indonesia, Malaysia, the Philippines, and Thailand), the expansion is so far best established in Korea, driven by buoyant domestic demand (in part underpinned by strong consumer lending) and also, more recently, by exports. With house prices rising rapidly, and inflation expected to rise in 2002 and 2003, interest rates were raised in May. The appreciation of the won will help moderate inflationary pressures, which, together with heightened external uncertainties, suggests that further interest rate increases may not be needed in the short run. Elsewhere, while final domestic demand appears to be picking up, the recovery is still dependent on exports and a turnaround in the inventory cycle; with inflation subdued and downside risks to global demand, monetary policies should remain accommodative for the time being. Given rising debt burdens, fiscal policies will need to shift increasingly from providing countercyclical support to consolidation, including in Indonesia, the Philippines, and also Hong Kong SAR, where a sizable structural deficit has emerged. Progress in structural reform varies, being more advanced in Korea (although there remains a need to strengthen insolvency procedures) and Malaysia. A more substantial agenda remains in other regional economies, including corporate debt restructuring and asset recovery (Indonesia); resolving the debt overhang and reviving bank intermediation (Thailand); and resolving banking sector fragility and accelerating implementation of power reforms (the Philippines).

In China, GDP growth has continued to exceed expectations, buoyed by strong public investment and export growth. Import growth has also picked up significantly, providing support to the recovery elsewhere in the region. Aided by continued strong inflows of foreign direct investment, the balance of payments has strengthened markedly, with reserves rising by $31 billion in the first half of the year. With moderate deflation reemerging at end-2001, monetary policy was eased in February and has since remained on hold. On the fiscal side, there

is scope to achieve a moderate budgetary consolidation, especially given the difficult fiscal outlook, including high off-balance-sheet fiscal liabilities. Over the medium term, both growth and fiscal sustainability depend importantly on structural reforms, especially making further progress toward developing a sound and commercially oriented banking system, and completing the restructuring of state enterprises. Such reforms are all the more important following China's entry into the WTO. With the economy facing a period of major structural change, a gradual move toward more flexible exchange rate management would facilitate adjustment—especially given the strength of the balance of payments and the weakening of the U.S. dollar—supported by further development of foreign exchange market infrastructure.

In India, a cyclical recovery is now under way, although agriculture has been negatively affected by a poor monsoon and the regional security situation and higher oil prices are sources of risk. Inflation remains moderate and the external position is comfortable. However, trend growth has declined since the mid-1990s as the benefits of earlier structural reform have faded. With the fiscal deficit among the highest in the world, fiscal consolidation has become urgent, and pending fiscal responsibility legislation offers an opportunity to set out a clear and explicit medium-term fiscal consolidation path. Recent efforts to strengthen state finances are welcome, but the FY2002/03 budget envisages only modest deficit reduction, and even this may be difficult to achieve given relatively optimistic revenue projections. On the structural side, significant progress has been made in privatization, more market-based pricing of petroleum products, and interest rate liberalization. However, a large unfinished agenda remains, including further opening up to trade and foreign investment (Box 1.5), removing restrictions on agricultural and industrial activity; and strengthening the financial system.

Elsewhere on the subcontinent, Pakistan has continued to make progress toward macroeconomic stability, reflected in rising GDP growth and a strengthened external position, although the deterioration in the regional security situation is again a risk. The proposed FY2002/03 budget will help arrest adverse debt dynamics and shift expenditure toward human development. Higher military expenditures as a result of regional tensions have complicated the outlook, however, and enforcing higher tax collection will require strong political resolve. Fiscal reform—linked to financial and public enterprise restructuring—is also critical in Bangladesh, where expansionary macroeconomic policies and loss of structural reform momentum have increased the risks to the outlook. In both countries, continued efforts to strengthen governance are also a priority.

In Australia and New Zealand, GDP growth in 2001 was among the highest in industrial countries, underpinned by supportive macroeconomic policies, highly competitive exchange rates, higher housing wealth, and rising long-term migration (New Zealand). With demand remaining robust in the first quarter of 2002, the RBA and RBNZ began to withdraw earlier monetary easing, although both central banks have held interest rates steady in recent months as the global outlook has weakened. Fiscal positions in both countries remain sound, although each faces rising pressures from aging populations. In Australia, additional measures may be required to finance major structural reforms that are needed over the medium term, while ensuring the objective of balancing the budget on average over the business cycle. In New Zealand, where productivity growth has disappointed in recent years, the authorities' focus on innovation and skill development is appropriate, and should be accompanied by additional efforts to reduce disincentives to work, save, and invest.

European Union Candidates: Surprisingly Resilient, but Some Policy Pressures

Growth among the EU candidates in central and eastern Europe and the Baltic region has, in general, been relatively well sustained during the global slowdown. For most of these countries,

Box 1.5. Where Is India in Terms of Trade Liberalization?

There is an acute awareness in India that more needs to be done to reap the full benefits of globalization so as to realize India's great economic potential. As Governor Jalan of the Reserve Bank of India has said: "*. . . Despite all the talk, we are nowhere even close to being globalized in terms of any commonly used indicator of globalization. In fact, we are still one of the least globalized among major countries—however we look at it . . .* "[1] This box focuses primarily on India's integration with the world through trade rather than through capital account opening, reflecting the relative priorities in India's own reform process.

For most of India's postindependence period, trade policies were largely geared toward self-reliance through import substitution. Quantitative import restrictions and other nontariff barriers were pervasive and import tariffs were extremely high, resulting in a strong antiexport bias. In a major departure from this approach, India began a process of trade liberalization in the early 1990s as part of the wide-ranging reforms implemented in response to a major balance of payments crisis. In addition to trade liberalization, the reform program included gradual liberalization of the capital account and foreign investment regime. These policies resulted in strong trade and growth performance.

Since 1997, however, the pace of tariff reform has slowed. While the statutory peak rate was gradually reduced, higher duties continued to apply to a number of items, the rates on certain tariff lines were increased, and additional surcharges were introduced. As a result, the average tariff rate remained broadly unchanged at over 30 percent during 1997 to 2001. The remaining quantitative import restrictions were removed in two steps during 2000 and 2001 but, in some cases, new nontariff barriers were imposed. Export and import growth rates slowed and the share of trade in GDP remained flat. However, a sharp expansion of services exports—especially software, communications, and management services—mitigated the slowdown in goods exports, reflecting the fact that the service industry has been relatively free of regulatory barriers.

Notwithstanding the reforms of the 1990s, India remains in the group of countries with the most restrictive trade regimes. India's average tariff remains one of the highest in the world, and the tariff shows substantial escalation in some sectors. A range of nontariff barriers continues to be in use, including some import bans, import restrictions through state trading monopolies, and stringent standards or certification requirements. India has also become one of the major users of antidumping measures, with some 250 actions initiated during 1995–2001. Overall, measured by the IMF's trade restrictiveness index, India stands at 8 (on a scale of 1 to 10) compared with 5 for China and 4–5 for other countries in east Asia.

Furthermore, effective protection in India and the antiexport bias may have been increased by the way trade has been liberalized, with tariffs on inputs and intermediate goods lowered at a faster pace than tariffs on outputs. Trade development has also been restrained by various domestic impediments to investment and growth. These include a relatively restrictive foreign investment regime; the policy of reserving the production of a large number of goods exclusively for small-scale industries; the poor quality of public infrastructure, such as transportation and power; the slow pace of industrial restructuring, reflecting weak bankruptcy laws and regulations that severely limit labor market flexibility; and transaction costs associated with administrative hurdles.

Reflecting these restraints, India is still lagging behind the rest of Asia in terms of opening up to international trade. Between 1980 and 2000, India's trade openness increased by about 50 percent while that of China surged by 150 percent. A similar pattern emerges in terms of shares of world trade.[2] While India's share of world merchandise exports increased from 0.5 percent to less than 0.7 percent over the last 20 years, China's share more than tripled to almost 4 percent (see the figure). Foreign direct investment inflows to India also remain very

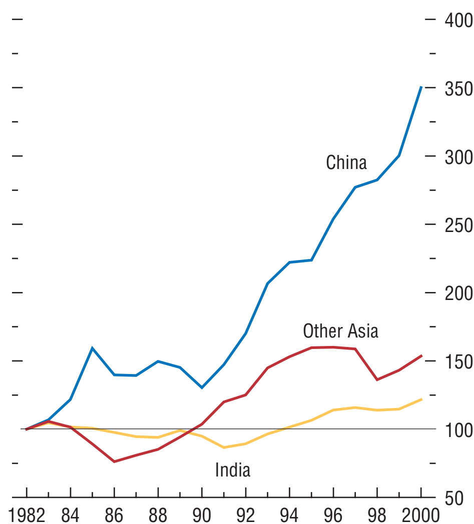
Note: The main author of this box is Jean-Pierre Chauffour. For a more comprehensive discussion of this issue, see Subramanian, Tamirisa, and Bhavnani, forthcoming.

[1]Address at the Thirty Sixth Convocation of the Indian Statistical Institute by Reserve Bank of India Governor Bimal Jalan, Kolkata, January 15, 2002.

[2]China's rising export share in world markets is overstated, however, because a significant portion of China's exports reflects processing trade.

Index of Share of World Trade

(1982 = 100)



Sources: IMF, *International Financial Statistics;* and IMF staff estimates.

low in comparison to some other emerging countries. It should be noted, however, that thanks to India's competitive edge in the information technology sector, India's trade performance looks more favorable when trade in services is included.

The fact that India lags in global integration is confirmed by trade gravity models, which explain bilateral trade in terms of countries' characteristics such as economic mass, distance apart, geographical contiguity, common language, and free trade agreements. According to one set of estimates, India's merchandise trade between 1995 and 1999 was, on average, about 36 percent below its "expected" level.[3] This represents an improvement since the early 1990s, however, when undertrading is estimated to have been about 50 percent. When policy variables are included, gravity model estimates suggest that India's relatively restrictive policies account for about 25 percent of the shortfall in its trade openness compared with other developing countries over 1995–99, with the remainder attributable to India's relatively low per capita income, geographic factors, and restrictions imposed by other countries.

The authorities announced their intentions to advance liberalization with the export and import (EXIM) policy for 2002–07. This aims to identify potential markets and new areas of comparative advantage to raise India's share of world exports to 1 percent by 2007. Key elements include establishing new private sector–run special economic zones, making labor markets more flexible, significantly reducing the number of goods reserved for the small-scale sector, reducing red tape, and upgrading export infrastructure. At a microeconomic level, strategic sectors were identified for special focus, with the three "E"s—electronics, electrical, and engineering goods—figuring prominently in the list of items with the greatest export potential.

To achieve the authorities' objective for trade integration, however, more efforts are needed to eliminate the antiexport bias. Priorities should include significantly reducing and simplifying the tariff structure—for example, to bring the average tariff rate down to or below the "Asian level" of 12 percent—and removing the remaining nontariff and administrative barriers on imports and exports. Additional support would come from liberalizing the foreign investment regime and allowing the exchange rate to respond more flexibly to structural changes in the economy. As an indication of the potential impact of such reforms, estimates from the gravity model noted above suggest that if India unilaterally liberalized its trade and balance of payments regime, its average bilateral trade flow would increase by about 44 percent. More broadly, the array of domestic reforms needed to unshackle Indian industry and improve its global competitiveness would receive further support from reductions in industrial countries' trade barriers, which, as in other developing and emerging markets, impede India from fully exploiting its areas of comparative advantage.

[3]This estimate is based on the model discussed in Chapter III of this *World Economic Outlook.* Other gravity model estimates of undertrading are even larger: Subramanian, Tamirisa, and Bhavnani (forthcoming) find that India's merchandise trade during 1995 to 1998 was about 70 to 80 percent less than expected given its income and geography.

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
EU candidates	**4.9**	**—**	**3.0**	**4.1**	**24.7**	**21.2**	**16.8**	**11.9**	**–5.1**	**–2.6**	**–3.4**	**–3.5**
Turkey	7.4	–7.4	3.9	5.0	54.9	54.4	47.1	28.6	–4.9	2.3	–0.8	–1.0
Accession candidates	3.8	3.0	2.7	3.7	13.1	9.8	6.2	5.7	–5.3	–4.3	–4.5	–4.4
Baltics	**5.5**	**6.2**	**4.6**	**5.2**	**2.2**	**2.7**	**2.3**	**2.8**	**–6.2**	**–6.7**	**–6.9**	**–6.6**
Estonia	7.1	5.0	4.5	5.0	4.0	5.8	3.7	3.0	–5.8	–6.1	–6.9	–7.4
Latvia	6.8	7.6	5.0	6.0	2.6	2.5	3.0	3.0	–6.9	–10.0	–8.5	–7.5
Lithuania	3.8	5.9	4.4	4.8	1.0	1.3	1.1	2.5	–6.0	–4.8	–5.9	–5.7
Central Europe	**3.9**	**2.2**	**2.1**	**3.3**	**8.9**	**6.2**	**3.2**	**3.5**	**–5.2**	**–3.9**	**–4.1**	**–4.2**
Czech Republic	3.3	3.3	2.7	3.2	3.9	4.7	2.7	3.0	–5.3	–4.6	–5.2	–4.6
Hungary	5.2	3.8	3.5	4.0	9.8	9.2	5.5	5.2	–2.8	–2.2	–3.8	–3.7
Poland	4.0	1.0	1.0	3.0	10.1	5.5	2.1	2.3	–6.3	–4.0	–3.6	–4.2
Slovak Republic	2.2	3.3	4.0	3.7	12.0	7.3	4.2	7.1	–3.6	–8.6	–8.5	–7.2
Slovenia	4.6	3.0	2.5	3.2	8.9	8.4	7.7	5.5	–3.4	–0.4	–0.8	–0.6
Southern and South Eastern Europe	**2.9**	**4.8**	**4.0**	**4.9**	**32.9**	**25.0**	**18.1**	**14.1**	**–5.1**	**–5.7**	**–5.3**	**–4.9**
Bulgaria	5.4	4.0	4.0	5.0	10.4	7.5	6.4	4.3	–5.6	–6.1	–5.6	–5.5
Cyprus	5.1	4.0	2.5	4.0	4.1	2.0	2.5	2.2	–5.2	–4.4	–5.5	–3.6
Malta	5.2	–1.0	2.0	4.9	2.4	2.9	2.0	2.0	–14.9	–5.0	–5.7	–4.4
Romania	1.8	5.3	4.3	4.9	45.7	34.5	24.2	19.1	–3.9	–5.9	–5.1	–4.9

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

growth rates of at least 2½ to 4½ percent are expected in 2002, roughly the same on average as in 2001 (if Turkey is excluded) and with further strengthening projected for 2003 as the global economy improves (Table 1.8). Conditions and prospects differ among individual countries, however: the Polish economy is still relatively weak, although recently released indicators of economic activity have been more encouraging than in previous months; the Czech Republic was severely hit by the recent floods, as were other countries in the region to a lesser degree; and Turkey remains vulnerable to changes in financial market sentiment (see below). Moreover, the region as a whole has not escaped the impact of global financial market developments, with equity prices having fallen significantly—by 50 percent or more in most cases—since 2000. Over the same period, several countries—including the Czech Republic, Hungary, and Poland—have also experienced substantial effective exchange rate appreciations, although this has been partly reversed in Poland over recent months as a result of lower interest rates and an increase in policy uncertainties. While the central European and Baltic countries' access to international finance continues to be strong, and bond spreads are low compared with other emerging markets, most of these economies remain vulnerable to a change in market sentiment as a result of their persistently high current account deficits.

Regional activity has been supported by strong inflows of foreign direct investment (FDI), providing the major source of external financing and helping sustain domestic demand. Such inflows no doubt reflect the benefits of generally stable and credible macroeconomic policies, together with market-friendly business climates. More specifically, much FDI has been attracted by these countries' relatively low-cost production bases and their increasing access to the EU market—especially given expectations of EU accession beginning within the next few years. Indeed, over the past decade countries in central Europe and the Baltics have been substantially more successful than other transition economies in building up FDI—a tendency that appears closely related, probably as both cause and effect, to their relative progress with enterprise reforms (Figure 1.13). In addition, domes-

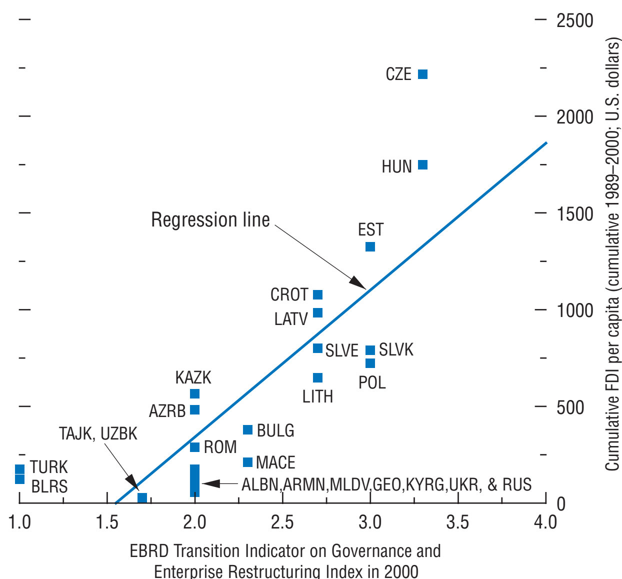
tic demand has been boosted in most countries by robust wage growth, falling inflation, and—in some cases—sizable fiscal stimulus packages. Export growth—although slowing somewhat since 2000—has also been surprisingly well sustained despite the EU slowdown and widespread exchange rate appreciations, with most countries continuing to gain market share (Figure 1.14).

While the policies needed to sustain and strengthen growth differ around the region, depending on current cyclical conditions and areas of prospective pressure, fiscal restraint—with supportive structural reforms—remains a priority in most countries. Over the short term, this would contribute to a better balance between macroeconomic policies; and, over the medium to long term, it would help accommodate ongoing spending pressures associated with EU and NATO accession, as well as rising public pension obligations. In Poland, the public expenditure restraint shown in the 2002 budget represents an important step toward reining in the growing fiscal imbalance. Fiscal consolidation—including through structural measures to better target social transfers and improve the overall quality of spending—needs to continue in the period ahead to limit the buildup of public debt. Such restraint should also provide scope for further easing of monetary policy to support recovery. In this regard, the significant monetary easing over the past year, including the further reduction in the main policy interest rate on August 28, has been appropriate given the weak state of the economy, the strength of the zloty, and the undershooting of the inflation target.

The cyclical position in Hungary has remained stronger than in Poland, with growth of about 3½ percent expected in 2002 and 4 percent in 2003. In this context, fiscal stimulus as large as that in the works in 2002—following substantial stimulus in 2001—does not appear necessary. Such stimulus, which reflects considerable public sector wage increases, could put at risk the inflation target, leading to further increases in interest rates (which the central bank has already begun to raise), and complicate the task of keeping the external current

Figure 1.13. Foreign Direct Investment and Enterprise Restructuring in Transition Economies

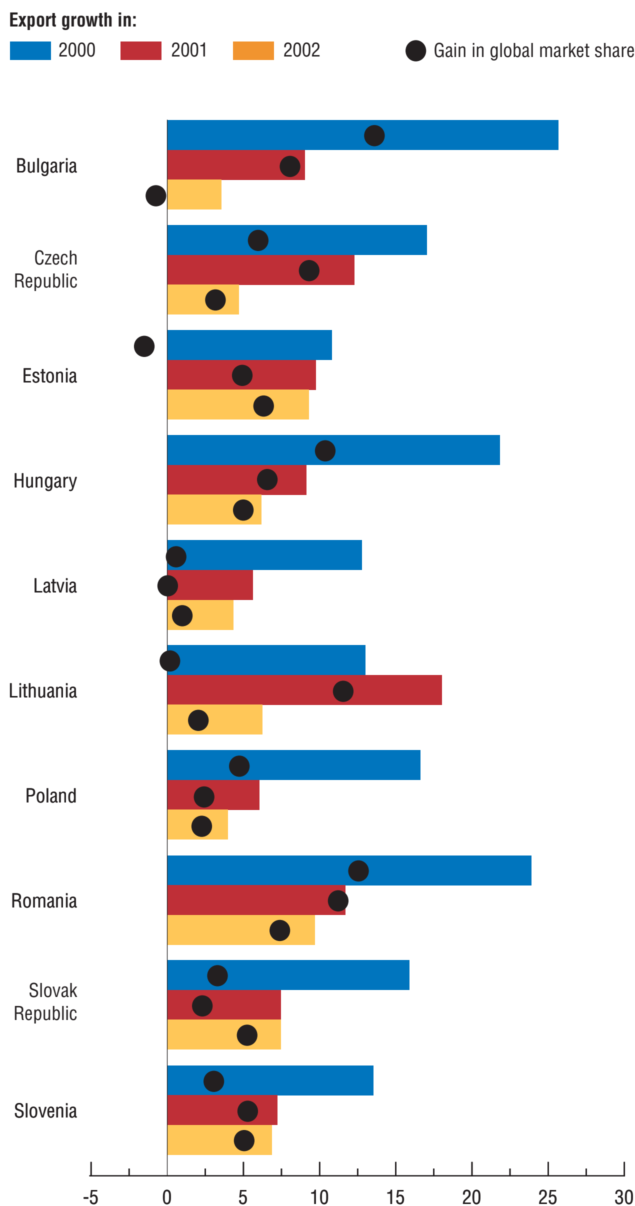
FDI among transition economies is positively related to progress with enterprise restructuring.



Sources: European Bank for Reconstruction and Development (2000); and IMF staff estimates.

Figure 1.14. Selected European Union Accession Countries: Exports and Market Share Growth
(Percent)

Although export growth has slowed since 2000, most EU accession countries have continued to experience firm export performance along with gains in market share during the current global slowdown.



account deficit within prudent limits. These pressures would be eased through determined efforts to hold down expenditures and move toward significant medium-term consolidation.

The same policy priority applies to the new government in the Czech Republic, where the fiscal deficit appears set to increase substantially in 2002. Part of this increase is likely to arise from reconstruction spending following the recent floods—where the government estimates overall damage to be 2½–4 percent of GDP. However, since the bulk of this spending is likely to take place after this year, the increase in the deficit is largely attributable to higher spending unrelated to the floods. Such an expansion appears unwarranted, given the economy's recent resilience and the expected acceleration in growth in 2003, and medium-term fiscal pressures arising from costs associated with EU accession, bank restructuring, and growing future imbalances in the pension system. On the monetary side, the sizable appreciation of the exchange rate has contributed to an undershooting of the inflation target and allowed the central bank to lower interest rates, which have recently been below those in the euro area. With growth picking up in the Slovak Republic, concerns also center on recent fiscal slippages and on the high current account deficit. Responding to these developments, the central bank increased interest rates at the end of April; nevertheless, the currency depreciated significantly. Further interest rate increases could be needed if external pressures do not abate and no fiscal adjustment occurs.

Turning to southeastern Europe, macroeconomic developments in Bulgaria and Romania are largely on track. With further support coming from the projected recovery in western Europe, these countries are expected to continue growing by 4–5 percent this year and next. External deficits remain rather high, however, and so both countries will need to maintain a firm fiscal stance coupled with ongoing efforts to restructure their economies and boost external competitiveness. In Bulgaria, priorities include lowering public subsidies, moving forward with the privatization program, increasing labor market

flexibility, and improving the business environment. High inflation remains a key concern in Romania, and needs to be tackled both through sound macroeconomic policies and by wage restraint—including in the government sector and state-owned enterprises. After posting strong output growth in 2000 and 2001, the Cypriot economy is experiencing a slowdown, driven by a decline in tourism arrivals. Nevertheless, underlying economic fundamentals remain solid.

While slowing somewhat from 2001, solid growth is expected to continue in the Baltic countries over 2002 and 2003, driven by robust domestic demand and accompanied by generally low inflation. Ongoing fiscal restraint and economic adjustment is particularly important in these countries, given their hard exchange rate pegs and persistently high current account deficits. While financed largely from FDI inflows, these external deficits nevertheless represent a potential source of vulnerability. In this regard, Estonia's strong policy record would be further enhanced if the public revenues from stronger-than-expected growth were saved rather than spent, especially in view of possible increases in budgetary tension in future years. With Latvia's current account deficit remaining very high, the government that takes office following the October parliamentary elections will need to formulate a 2003 budget that targets further reduction of the fiscal deficit. And favorable economic and policy developments in Lithuania would receive further support from structural reforms directed at reforming the tax system, strengthening the financial sector, and improving the country's external competitiveness.

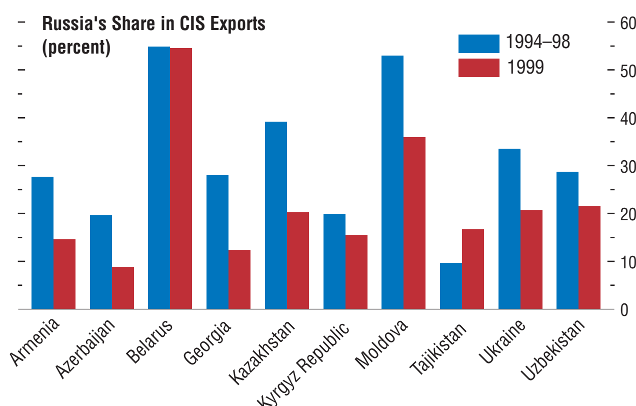
Economic and financial conditions in Turkey improved significantly in the first few months of 2002, with industrial production and tourism receipts picking up, inflation declining—helped by a relatively stable exchange rate—and the fiscal position remaining on track. In May to July, however, financial sentiment deteriorated significantly, reflected in weakening of the exchange rate and stock prices and widening bond spreads. This deterioration stemmed mainly from political uncertainties regarding the viability of the government coalition, but also from the more generalized weakening in international financial markets. Given the persistently high level of interest rates and the need to roll over large volumes of short-term domestic debt, much of which is foreign exchange–linked or floating rate, a key requirement is to provide clear reassurances to markets about Turkey's political, economic, and financial stability, including through continued strong implementation of the program strategy. In late July, parliament set a date for general elections, and passed several laws needed to meet the Copenhagen criteria for EU accession. Political stability following these elections will be particularly important in improving market conditions and bringing interest rates down to sustainable levels. Macroeconomic policies should continue to be directed toward a public sector primary surplus target of 6½ percent of GDP and a sustainable reduction in inflation, including through ongoing preparations for the eventual introduction of a formal inflation targeting framework. Significant progress has been made on bank reform, which has been skillfully handled, with the bank audit and recapitalization exercise now completed. Structural reform priorities in the period ahead include further improvements in bank supervision; determined efforts to move ahead with privatization; further measures to strengthen the business climate; and improvements in public financial management.

Commonwealth of Independent States (CIS): Persistent Dichotomy Between Advanced and Less Advanced Reformers

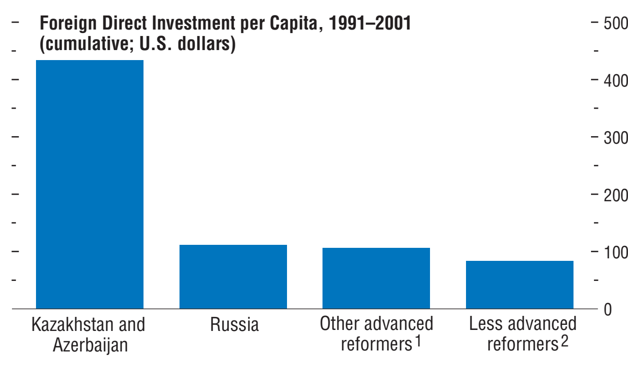
The impact of the global slowdown on CIS countries has been relatively mild. This region's resilience has been aided by strong domestic demand in Russia—the region's largest economy, with substantial (although possibly declining) linkages to the rest of the CIS (Figure 1.15)—and in Ukraine. During 2002, however, notwithstanding strengthening external demand, GDP growth across the region is expected to moderate, reflecting two main factors (Table 1.9). First,

Figure 1.15. Developments in Exports, FDI, and Demand for Money in the Commonwealth of Independent States (CIS)

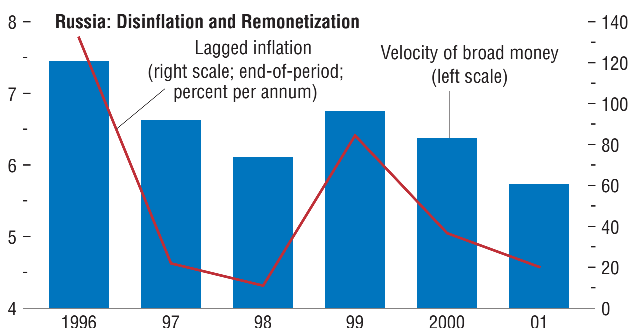
Russia absorbs a large share of exports from other CIS countries, although this share appears to be declining.



Foreign investment appears strongly biased toward natural resource extraction, especially oil.



Progress with disinflation has contributed to an increase in the demand for money in Russia.



Sources: IMF, *Direction of Trade Statistics;* and IMF staff estimates.
[1]Armenia, Georgia, Kyrgyz Republic, Moldova, and Ukraine.
[2]Belarus, Tajikistan, and Uzbekistan.

growth in Russia and, to a lesser extent, Kazakhstan has slowed as a result of lower oil revenues, reflecting the lagged impact of weaker prices observed in late 2001 and early 2002. In Russia, the resulting fall in earnings of the energy sector may lead to cuts in investment spilling over to other sectors and countries (notably Ukraine, which has a substantial metal working industry), although the recent firming in oil prices should help to mute these effects. Second, agricultural growth—which was very high in 2001 owing to recovery from drought in 2000 and, in Ukraine, structural reforms—is projected to return to more normal levels. In general, however, with the exception of some less advanced reformers, GDP growth is expected to remain relatively well sustained. To date, contagion from the deteriorating situation in Latin America has been limited, largely reflecting the lack of trade linkages with this region together with the very limited global financial integration of most CIS countries.

Looking forward to 2003, GDP growth is expected to remain solid, supported by continued—if weaker—global recovery and the firming of oil prices. Within this, however, there is a persistent dichotomy across the region. In Russia and other more advanced reformers, domestic demand is expected to remain supportive of economic activity, mainly owing to strong private consumption and earlier progress made with reforms. By contrast, growth in the less advanced reformers is generally expected to lag behind, reflecting macroeconomic instability, lack of corporate restructuring (Belarus), and the unfavorable investment climate. Growth may remain relatively strong in Tajikistan, however, owing to strong growth in agriculture and satisfactory performance in the industrial sector. Beyond the pace of the global recovery, the key uncertainty in the outlook relates to developments in commodity prices, given the importance of the oil sector in Russia, and excessive dependence on a few commodities elsewhere (especially Uzbekistan and Tajikistan). The war in Afghanistan has had mixed effects: some countries are benefiting from reconstruction or leasing and airport fees (Kyrgyz Republic), but in others higher per-

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	**8.4**	**6.3**	**4.6**	**4.9**	**25.0**	**19.9**	**14.6**	**10.7**	**13.2**	**7.5**	**4.9**	**4.3**
Russia	9.0	5.0	4.4	4.9	20.8	20.7	15.8	11.0	17.5	10.3	7.0	6.3
Excluding Russia	7.0	8.9	5.2	4.9	34.9	18.0	11.9	10.1	1.6	–1.2	–1.7	–2.3
More advanced reformers	**6.8**	**9.6**	**5.8**	**5.6**	**19.7**	**9.4**	**5.1**	**7.3**	**2.1**	**–1.0**	**–1.8**	**–3.0**
Armenia	6.0	9.6	7.5	6.0	–0.8	3.2	2.8	2.8	–14.1	–7.2	–8.6	–8.2
Azerbaijan	11.1	9.0	7.9	7.3	1.8	1.5	2.4	3.3	–2.4	–1.3	–17.7	–30.4
Georgia	1.9	4.5	3.5	4.0	4.0	4.7	5.9	5.0	–5.4	–6.7	–6.2	–8.0
Kazakhstan	9.8	13.2	8.0	7.0	13.3	8.3	5.8	6.2	3.2	–6.9	–3.6	–2.5
Kyrgyz Republic	5.4	5.3	4.4	3.8	18.7	7.0	4.1	4.5	–7.5	–3.3	–3.8	–5.4
Moldova	2.1	6.1	4.8	5.0	31.3	9.8	6.6	8.4	–8.4	–7.4	–7.3	–7.7
Ukraine	5.9	9.1	4.8	5.0	28.2	12.0	5.1	9.1	4.7	3.7	2.6	1.7
Less advanced reformers[3]	**5.1**	**4.6**	**3.4**	**3.6**	**89.4**	**45.1**	**32.6**	**17.8**	**–0.6**	**–1.8**	**–1.4**	**–0.2**
Belarus	5.8	4.1	3.5	3.8	168.9	61.3	43.1	22.5	–2.5	–2.2	–1.4	0.5
Tajikistan	8.3	10.2	7.0	6.0	32.9	38.6	10.7	7.6	–6.5	–7.0	–4.2	–4.6
Uzbekistan	3.8	4.5	2.7	3.0	25.0	27.2	23.2	13.5	1.6	–1.0	–1.1	–0.7
Memorandum												
Net energy exporters[4]	9.3	6.1	4.7	5.0	19.6	19.2	14.7	10.5	16.1	8.9	5.8	5.2
Net energy importers[5]	5.2	7.0	4.2	4.4	45.2	22.1	14.2	11.6	1.0	0.6	0.2	—
Highly indebted countries[6]	4.1	6.5	5.0	4.7	13.0	9.3	5.7	5.3	–8.3	–6.4	–6.3	–7.1

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year as is the practice in some countries.
[2]Percent of GDP.
[3]Updated data for Turkmenistan not available.
[4]Includes Azerbaijan, Kazakhstan, Russia, and Turkmenistan.
[5]Includes Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Tajikistan, Ukraine, and Uzbekistan.
[6]Armenia, Georgia, Kyrgyz Republic, Moldova, and Tajikistan.

ceived risks may have reduced foreign lending and investment (Tajikistan).

On the external side, the regional current account surplus is projected to decline in both 2002 and 2003. This is mainly because of a lower surplus in Russia, driven by strong domestic demand and a real appreciation of the ruble; and in Azerbaijan, where oil sector investment is projected to rise sharply. Elsewhere, changes are more moderate, although the current account surplus in Ukraine is also expected to decline as a result of the slower growth in Russia, solid domestic demand and real exchange rate appreciation. Large deficits are expected to persist in many countries, particularly among the region's poorest economies, where the level of external debt remains a serious threat to fiscal and external sustainability (Georgia, Kyrgyz Republic, Moldova, and Tajikistan). While continued domestic adjustment and structural reforms will be required in these cases, the international community should provide more help through specific technical and financial assistance, including grants and, in some cases, debt relief. In that respect, the international financial institutions have recently proposed a specific initiative (the CIS-7 initiative). This aims to strengthen policy design and implementation, foster regional cooperation, heighten donors' awareness of the region's difficulties, and improve coordination among donors in the seven low-income CIS countries (the four listed above plus Armenia, Azerbaijan, and Uzbekistan).

While inflation has continued to decline across the region, aided by progress in fiscal consolidation, it remains an area of concern in Russia and a number of the less advanced reformers. In Russia, the main source of monetary expansion has come from the strength of the external position—mainly the current account surplus—which, given the desire to

avoid an overly rapid appreciation of the ruble, has put upward pressure on liquidity in the absence of full sterilization. With the current account surplus projected to decline in 2002, monetary growth should moderate somewhat, but the central bank will need to stand ready to absorb liquidity as necessary to contain inflationary pressures. To facilitate this, it will be important to limit the extent of any fiscal relaxation in the 2003 budget. Among the less advanced reformers, inflation is primarily generated by continued state interventions in the economy (such as subsidies to public enterprises)—often off-budget—thereby boosting credit and money supply growth. In many countries in the region, the inflationary impact of rapidly increasing monetary aggregates has been moderated by higher money demand (remonetization), accompanied by a reduction in barter transactions. While this trend is both welcome and likely to continue for a while, the corresponding rapid increase in credit expansion—which raises questions about credit quality and risk—will need to be carefully monitored.

The main medium-term challenge for CIS countries remains to accelerate the reform process, particularly in the areas of institution building and governance. Key measures should include effective enforcement of legislation establishing basic market institutions; the liberalization of factor and goods markets; enterprise restructuring; and strengthening the financial sector. Over the past three years, Russia has made significant progress in critical areas of reform such as the tax system—which was made simpler and more transparent; fiscal management—including relations with decentralized entities; pension reform; labor law; agricultural land law; and administrative barriers to business. In other CIS countries, progress has generally been slower and implementation uneven, reflecting the opposition of powerful vested interests. While the solution to these problems lies largely in the countries themselves, it is to be hoped that accelerated reforms in Russia will—given its central role in the region—spur more rapid progress elsewhere (as the prospect of integration to the European Union has for EU candidates).

Beyond this, countries in the region face a number of specific challenges. In particular, many countries remain heavily dependent on primary commodities, increasing vulnerability to external shocks and complicating macroeconomic management, particularly on the fiscal side. More specifically, significant uncertainty over revenues has led some countries to establish stabilization funds (for example, in Kazakhstan) in an attempt to insulate public expenditure from swings in revenues, or to formulate contingent expenditure plans (Kazakhstan and Russia) so as to preserve fiscal discipline in case of a shortfall in revenues. However, the efficient operation of stabilization funds may pose problems, notably in terms of transparency, while cutting expenditure plans if the economy experiences an adverse shock to the terms of trade may be difficult. Economic diversification therefore remains a priority, and would be facilitated by acceleration of reforms to improve the business climate and help correct the current bias of foreign direct investment towards exhaustible-resource extraction (Figure 1.15). Greater integration in the world economy, notably through WTO accession, would also contribute to reducing reliance on Russia as the main engine of growth.

Africa: Establishing the Conditions to Grow out of Poverty

GDP growth in Africa is projected to decline by 0.4 percentage points to 3.1 percent in 2002, equivalent to per capita income growth of about 0.5 percent (Table 1.10). While Africa will benefit from the expected strengthening of global activity, this may be offset by a combination of internal and external factors, including developments in commodity prices—still the driving force of economic performance in most countries of the region. In oil-exporting economies, growth prospects have been weakened by lower oil revenues, reflecting the lagged effect of earlier price declines and, in some cases, produc-

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**	**3.5**	**3.1**	**4.2**	**14.3**	**13.1**	**9.6**	**9.5**	**1.2**	**0.3**	**–1.7**	**–1.6**
Maghreb	**2.4**	**4.4**	**3.2**	**4.0**	**1.3**	**2.6**	**3.3**	**2.7**	**7.3**	**7.0**	**3.5**	**3.7**
Algeria	2.5	2.8	2.1	2.9	0.3	4.2	4.0	3.0	16.9	12.4	8.1	8.9
Morocco	1.0	6.5	4.4	4.1	1.9	0.6	2.1	2.1	–1.4	4.9	1.3	0.5
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-Sahara[3]	**3.1**	**3.8**	**3.3**	**4.8**	**24.9**	**21.6**	**13.3**	**14.2**	**–1.0**	**–3.0**	**–5.6**	**–5.4**
Cameroon	4.2	5.3	4.4	4.7	0.8	2.8	4.0	3.0	–1.7	–2.2	–3.8	–4.3
Côte d'Ivoire	–2.3	0.1	3.0	4.5	2.5	4.4	3.0	3.0	–2.8	–2.3	1.0	–0.8
Ghana	3.7	4.2	4.5	5.0	25.2	32.9	14.6	10.8	–8.4	–4.0	–6.2	–5.9
Kenya	–0.1	1.2	1.4	2.8	10.0	5.8	2.0	4.7	–2.7	–3.0	–4.6	–5.9
Nigeria	4.3	2.8	–2.3	3.7	6.9	18.9	15.9	13.2	11.9	6.0	–5.4	–1.5
Tanzania	5.1	5.6	5.8	6.0	6.2	5.2	4.4	3.9	–1.6	–1.6	–4.9	–4.6
Uganda	5.0	5.6	5.7	6.5	6.3	4.6	–1.8	1.0	–12.1	–11.3	–12.4	–13.1
South Africa	**3.4**	**2.2**	**2.5**	**3.0**	**5.4**	**5.7**	**7.9**	**6.0**	**–0.4**	**–0.1**	**0.8**	**0.6**
Memorandum												
Oil importers	2.9	3.6	3.3	4.4	13.8	11.7	8.0	8.8	–3.0	–2.2	–3.2	–3.4
Oil exporters	3.3	3.4	2.2	3.4	16.3	18.0	15.4	12.0	13.0	7.1	2.3	3.2

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

tion cuts due to lower OPEC production quotas (Nigeria). Recent increases in oil prices will help to offset these effects, but will clearly weaken prospects among oil importers, which include many of the poorest countries. The protracted weakness in cotton and coffee prices will also continue to bear down on the performance of many countries in 2002. Country-specific factors have also played a role, including the spreading impact of drought and the resulting sharp decline in agricultural output in a number of countries in southern Africa, putting millions on the brink of starvation; continued conflicts and political instability, including in Liberia, Sudan, and Zimbabwe; and, in Morocco, a return to lower growth rates following the sharp, post-drought recovery in 2001. GDP growth is projected to pick up to 4.2 percent in 2003, aided by rising non-oil commodity prices (especially coffee, cotton, metals), and stronger external demand as the global recovery gains momentum. As noted above, however, the WEO projections for African growth have in the past been consistently optimistic, and much will depend on further improvements in political stability as well as the absence of natural disasters.

On the external side, the regional current account deficit is expected to increase to 1.7 percent of GDP in 2002. This is mainly due to a decline in the surpluses of energy producers (particularly Nigeria and Algeria), offset in part by the emergence of a current account surplus in South Africa as a result of higher prices for gold and other metals and stronger external demand. In sub-Saharan Africa, with the notable exception of Côte d'Ivoire (where exports are being boosted by a sharp increase in cocoa prices), current account deficits remain relatively large, due to weak non-oil commodity prices and high oil prices by historical standards, and still high external debt-servicing costs. Over time, the latter should be reduced through the Heavily Indebted Poor Countries (HIPC) Initiative: through July 2002, some 22 (out of 26 eligible) African countries had begun to receive nominal debt service relief totaling $32.2 billion, which, on average, will halve the net present value of their debt. Recent commitments to increase international aid flows and raise the

proportion provided as grants will also contribute to relaxing financing constraints.

Since the mid-1990s, African countries have made substantial progress toward macroeconomic stability, with CPI inflation expected to fall to single-digit levels in 2002 for the first time ever, and remain there in 2003. To a considerable extent, this has reflected increasing fiscal discipline across the region: excluding Nigeria, central government deficits in sub-Saharan Africa have been more than halved since the mid-1990s. Where fiscal discipline has improved, fiscal policy has been able to accommodate a larger availability of financing and to increase spending on behalf of the poor. Progress has been particularly notable in long-lasting high-inflation cases such as the Democratic Republic of Congo, because of the monetary and fiscal tightening that accompanied the decision to float the currency and lift exchange controls, and Ghana, as a result of fiscal discipline and greater central bank independence. However, inflationary pressures remain a serious concern in a number of countries, in particular Angola, Nigeria, Zambia, and Zimbabwe, generally reflecting excessive fiscal expansion, accompanied by rapid money supply growth.

Africa continues to face an enormous range of political and economic problems. Civil unrest, political instability and armed conflicts still threaten macroeconomic stability and longer-term growth prospects in a significant number of countries; natural disasters regularly damage subsistence crops; and the HIV/AIDS pandemic—as well as other infectious diseases—has seriously affected prospects across the continent, particularly in southern Africa (including a significant reduction in life expectancy, notably in Botswana and Zimbabwe). These are accompanied by a variety of other problems, including low levels of investment and savings and limited direct investment inflows (Box 1.6); poor infrastructure, including public utilities and the health and education sectors; pervasive market distortions (especially in agriculture); underdeveloped legal and regulatory frameworks; and weak governance. These problems are often self-reinforcing: for instance, low life expectancy reduces the returns from education, and political instability and governance problems can magnify the impact of natural disasters (as appears to be the case, for example, in the famine in southern Africa).

Given the gains made in establishing macroeconomic stability in a growing number of African economies, the pressing need now is to address these underlying problems, and improve the overall environment for investment and growth. As stressed in the New Partnership for Africa's Development (NEPAD) put forward by African leaders in late 2001, the solutions are multidimensional in nature. However, one key element is to make further progress in strengthening the economic infrastructure—including basic market institutions such as the protection of property rights and, more generally, the rule of law, democratic accountability, the fight against corruption, and bureaucratic quality. A growing number of studies have found that these factors play a central role in explaining growth differences across countries.[8] Economic performance and human development are positively related to the quality of institutions (Figure 1.16, top two panels). The relationship between human development and institutional quality remains positive and significant even after taking into account the effect of GDP per capita on human development (as illustrated by the bottom panel of Figure 1.16).

Against this background, the emphasis placed in the NEPAD on developing economic infrastructure and institutions is particularly welcome. While much remains to be done, a number of countries have made important progress in key areas such as governance (for example, Botswana and Tanzania); economic liberalization (for example, Mozambique, Senegal,

[8]See Hall and Jones (1999).

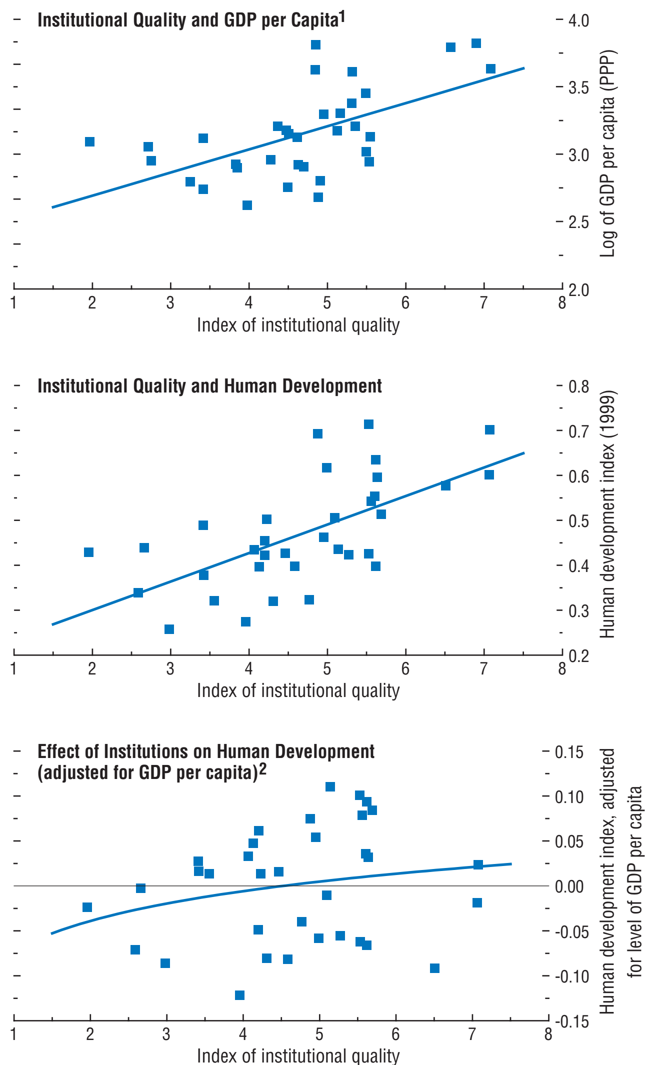
and Uganda); and fiscal management, including tax collection, public expenditure management, civil service reform, and priority given to poverty reduction (for example, Burkina Faso, Mozambique, and Mali). For its part, the international community is beginning to support these efforts through additional financial and technical assistance, including increased aid commitments announced in Monterrey and the G-8 Africa Action Plan announced last June. However, these efforts need to be accompanied by faster and more aggressive trade liberalization, which—as discussed in Chapter II—would particularly benefit sub-Saharan Africa.

Looking more specifically at the region's largest economies, economic activity in South Africa has held up well in the face of the global downturn, and higher gold prices and external demand should stimulate stronger growth later this year and in 2003. The short-term outlook for inflation, however, is being affected by the sharp depreciation of the rand in 2001 and the target of 3–6 percent inflation in 2002 is likely to be missed. Inflationary pressures should, nevertheless, ease considerably toward the end of the year in response to the recovery in the value of the rand and four consecutive 100 basis point hikes in the repurchase rate by the central bank. Monetary and fiscal policies should remain firmly committed to maintaining macroeconomic stability, and inflation is expected to fall back into its targeted range in 2003. Modest current account surpluses are expected for 2002 and 2003.

As Nigeria cuts back oil production in line with its OPEC quota, GDP is projected to contract by 2.3 percent in 2002. Political uncertainties have lowered prospects for improving macroeconomic stability and promoting reforms in the near future, and Nigerian debt prices have recently fallen sharply as a result of heightened uncertainties regarding the status of debt payments. Excessive government expenditure and monetary expansion continue to feed inflation, and—along with the drop in exports—are leading to an unsustainable increase in the current account deficit and a sizable decline in

Figure 1.16. Impact of Institutional Quality in Africa

Institutional quality is positively related to human development, even after taking into account its positive contribution to GDP per capita.



Sources: World Bank, *African Indicators;* Political Risk Services Group, *International Country Risk Guide (ICRG);* and UNDP, *Human Development Report.*

[1]The institutional quality index combines equally weighted ratings of government stability, democratic accountability, bureaucratic quality, law and order, and corruption. The sample consists of 34 African countries.

[2]The adjusted, or "unexplained" part of the human development index (HDI) is the residual from a log-linear regression of HDI on GDP per capita.

Box 1.6. Foreign Direct Investment in Africa

The stock of foreign direct investment (FDI) in Africa increased almost fivefold, to just under $150 billion, between 1980 and 2000. Despite this increase, however, Africa's share of global FDI has declined substantially, even compared with other developing country regions (see the table). Most FDI has been directed toward the primary sector, with the nine oil-exporting countries accounting for about 75 percent of FDI inflows during the 1990s. Privatization of state-owned enterprises has also provided an important source of foreign investment for a number of countries, including South Africa—by far the largest economy in the region.

A number of smaller countries, however, have been able to attract sizable FDI flows—representing a substantial share of their GDP and gross capital formation—outside the energy sector. Reflecting this, the 34 least developed countries approximately doubled their share in FDI inflows to Africa over the 1990s. This box considers briefly the experiences and prospects of seven small, non-oil-producing countries—Botswana, Lesotho, Namibia, Mauritius, Mozambique, Swaziland, and Uganda—all of which received relatively large flows of FDI in the 1990s (and, in some cases, the 1980s). It discusses in particular the four influences that may have been largely responsible for channeling FDI flows to Africa: the availability of natural resources; recent economic and structural reforms; host country policies that actively target export-oriented foreign investment; and specific locational advantages.

Natural Resources

It is in mining of high-value minerals and petroleum that Africa is particularly prominent as a host to FDI and where great potential for future FDI exists. While many countries are abundant in some type of natural resources, only some—including Botswana and Namibia—have been successful in obtaining *diversified* FDI. In both these countries, macroeconomic stability within the framework of a stable democratic political system has allowed access to relatively large FDI inflows. Also important in attracting FDI are their good governance and low levels of corruption, investment in human and physical capital, and the protection of property and contractual rights.

Economic Reforms

A few countries, including Mozambique and Uganda, were shunned by investors in the past but have recently attracted significant investor interest in response to their implementation of far-reaching economic and structural reforms. After witnessing economic decline in the context of political instability, civil strife, and ill-conceived policies over a long period since independence, in both Mozambique and Uganda the progression toward political stability and the pursuit of market-oriented economic reform has allowed private sector activity to become increasingly important in fueling economic expansion. A reduced role for the state, including through a rapid acceleration in the privatization of state-owned assets, the prioritizing of government spending to improve the quality and availability of physical and human capital, and the removal of impediments to foreign investment have yielded results in terms of larger access to global capital flows. Significant foreign participation in each country's privatization program has been backed by deliberate government efforts to reassure investors about the safety of their investment—including by signing international agreements governing investment protection and by eliminating discrimination between domestic and foreign investors. Attention has also been given to investment that would boost exports; for example, the Industrial Free Zones that came into effect in Mozambique in 1998 require a minimum export content of 85 percent. In this context, preferential access to the European Union and other markets under the Cotonou Agreement and the Generalized System of Preferences has provided further incentives for investment location.

Note: The main authors of this box are Anupam Basu and Krishna Srinivasan. For a fuller discussion of this topic, see Basu and Srinivasan (2002).

Foreign Direct Investment Inward Stock by Host Region, 1980–2000, Share of Global Stock

	1980	1985	1990	1995	1999	2000
Developed countries[1]	58.2	60.1	73.5	69.3	63.5	65.8
Developing countries[2]	41.8	39.9	26.3	29.4	34.5	32.2
Africa	5.3	3.8	2.6	2.6	2.7	2.3
Latin America and the Caribbean	8.1	8.9	6.2	6.9	10.0	9.6
Developing Europe	—	—	0.1	0.1	0.2	0.2
Asia	28.1	27.0	17.4	19.8	21.5	20.0
The Pacific	0.2	0.1	0.1	0.1	0.1	0.1
Central and Eastern Europe	—	—	0.2	1.2	2.0	2.0

Source: World Investment Report (WIR).
[1]For expositional purposes, excludes South Africa; WIR includes South Africa in the list of developed countries.
[2]For expositional purposes, includes South Africa; WIR includes South Africa in the list of developed countries.

Policies targeting export-oriented foreign investment

Mauritius has been particularly successful in targeting and attracting export-oriented FDI. An investment-friendly climate has been underpinned by political stability, macroeconomic discipline, and the availability of bilingual and cheap labor, with further support provided by public investment in education and infrastructure. An important role has also been played by the creation of export-processing zones: these now account for over two-thirds of merchandise exports—especially textiles and clothing, almost all of which are destined for the European Union or the United States.

Locational advantages

The imposition of global sanctions on South Africa had positive effects on some other countries in the region, including Lesotho and Swaziland, which served as the conduit of trade between South Africa and a number of third countries. Multinational firms that wished to evade the sanctions located their subsidiaries in Lesotho or in neighboring Swaziland to produce goods that were primarily exported to South Africa. In addition to very specific locational advantages, these two countries enjoyed (partly through their relationship with South Africa) political stability, the adoption of reasonably sound macroeconomic policies, and the presence of a cheap, productive, and skilled labor force; to a smaller extent, the provision of tax incentives also influenced investment location decisions. More recently, however, the pace of new FDI has declined, although reinvestment of earnings by foreign subsidiaries in these countries has continued.

Conclusions

While Africa is undoubtedly rich in natural resources, a critical mass of mutually reinforcing measures clearly needs to be in place before the region can secure a larger share in global FDI flows. Progress toward conflict resolution is essential, because political stability is an important determinant of investment location. Political stability, however, is a necessary but not sufficient condition to ensure access to large FDI flows; a favorable economic environment is also crucial. Even countries well positioned to attract FDI as a result of their natural resources or locational advantages have sought to strengthen investment prospects by implementing sound macroeconomic policies and far-reaching structural reforms. Moreover, among countries without these natural endowments, a number have been successful in attracting FDI by establishing a policy environment conducive to investment. For example, privatization of state assets has generally been a key element in economic liberalization and a catalyst for increased foreign investment. Export processing zones and tax incentives could help to attract FDI inflows, but the potential benefits arising from these approaches need to be weighed against risks of eroding the tax base and encouraging rent-seeking activities and corruption. Hence, broad-based liberalization and adjustment remains the preferred approach to strengthening the investment climate and securing greater access to global FDI flows.

international reserves. In response to the deterioration in the macroeconomic situation and to protect international reserves, the Central Bank of Nigeria introduced a more market-based foreign exchange regime in July, centered on an auction mechanism for selling the government's oil receipts. As a result, the differential between the official and parallel market exchange rates has narrowed considerably. While a positive step, the priorities for policymakers should be to restore macroeconomic stability, implying a significant fiscal adjustment, and to unify the exchange rate and strengthen banking sector supervision.

The outlook for Algeria remains affected by civil unrest, political violence, and very high unemployment, especially among youth. Real growth, expected to remain weak at about 2.1 percent this year, is supported by domestic demand, including investment, but is negatively influenced by the reduction in Algeria's OPEC quota, which came into effect on January 1, 2002. Moderately expansionary fiscal policy, combined with lower hydrocarbon revenue under current price and output assumptions, is expected to lead to smaller current account surpluses. Inflation, which increased sharply in 2001, is expected to slow down somewhat this year. With investment concentrated in oil and gas production capacities, oil market developments remain a key source of vulnerability, underlining the need to press ahead with efforts to diversify the economy.

Middle East: Growing Divergences This Year; Better Prospects for 2003

Conditions and prospects in the Middle East are being shaped by a combination of global and local influences—notably the general economic slowdown and oil market developments; the difficult regional security situation; and country-specific policy pressures. The impact and relative importance of these various forces vary widely among the countries concerned, however. Among the region's oil exporters, growth in Saudi Arabia and Kuwait has weakened quite sharply over the past two years, partly as a result of lower oil GDP (arising from production quotas and the lagged impact of oil price declines) and of the global slowdown more generally (Table 1.11). In contrast, reflecting recent progress with diversification, Iran has been better able to offset weaker activity in its oil sector through growth in non-oil activities, and robust growth of 5 to 6 percent looks set to continue. Elsewhere, security concerns, which are affecting the entire region, are the main reason for the substantial weakening in growth in Israel and the West Bank and Gaza. And, in Egypt, the further slowing in business activity and output in 2002 is a result of the sharp decline in tourism after September 11 and difficulties in the domestic policy framework, complicated to some extent by the political and security situation in the region. The severe economic and financial vulnerabilities faced by Lebanon are primarily a result of policies that have led to persistent budget deficits and high levels of public debt. In Jordan, on the other hand, robust export performance and growth over recent years have been underpinned by the authorities' firm commitment to macroeconomic stability and structural reforms.

Looking ahead, GDP growth across the region is expected to pick up later in 2002 and in 2003—particularly if global output strengthens as projected, if oil prices remain relatively firm, and if there is an easing in security tensions. While recent increases in oil prices would normally be expected to have a positive impact on prospects for energy exporters, the associated possibility of military conflict clearly represents a downside risk for the region. Sustaining stronger growth rates will also be contingent on progress in addressing growing policy challenges. In Saudi Arabia, for example, lower oil prices earlier in the year led to a significant deterioration in the fiscal situation. Domestic debt is high, and the economy remains vulnerable to potential oil market fluctuations. As a result, expenditure restraint and increases in non-oil revenues should continue to be pursued, possibly even more vigorously. Rapid progress with the author-

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 East[3]	**5.7**	**4.2**	**3.5**	**4.6**	**9.8**	**8.0**	**9.4**	**9.2**	**11.8**	**7.6**	**4.4**	**3.2**
Oil exporters[4]	**6.2**	**4.6**	**3.9**	**4.9**	**12.6**	**10.0**	**11.7**	**11.2**	**16.0**	**10.5**	**6.2**	**4.7**
Saudi Arabia	4.9	1.2	0.7	3.3	–0.6	–0.8	—	1.1	7.6	7.8	2.1	0.2
Iran, Islamic Rep. of	5.7	4.8	5.8	5.5	12.6	11.4	15.0	15.0	13.4	4.8	3.2	2.5
Kuwait	3.8	–1.0	–1.0	1.7	1.7	2.5	2.5	2.5	38.8	31.9	29.0	27.8
Mashreq[5]	**4.2**	**3.2**	**2.4**	**3.6**	**1.8**	**1.9**	**2.7**	**3.3**	**–2.2**	**–2.2**	**–2.3**	**–2.6**
Egypt	5.1	3.3	2.0	3.7	2.8	2.4	2.5	3.4	–1.2	—	–0.2	0.1
Jordan	4.0	4.2	5.1	6.0	0.7	1.8	3.2	2.1	0.7	–0.1	–0.4	–1.7
Memorandum												
Israel	7.4	–0.9	–1.5	1.8	1.1	1.1	6.2	3.0	–1.7	–1.7	–1.9	–1.8

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Includes Bahrain, Egypt, Islamic Rep. of Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, United Arab Emirates, and Republic of Yemen.
[4]Includes Bahrain, Islamic Rep. of Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and United Arab Emirates.
[5]Includes Egypt, Jordan, Lebanon, and Syrian Arab Republic.

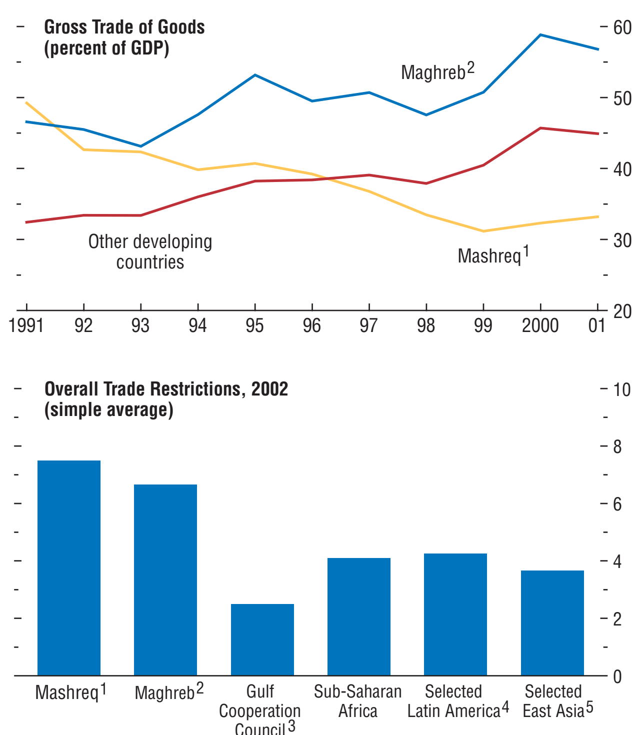
ities' reform program is also important—particularly through the restructuring and privatization of state-owned enterprises, expedited integration of the segmented labor market, and capital market development.

In Iran, macroeconomic policies should build on the successful unification of exchange rates and introduction of a managed float in March 2002, particularly by reducing fiscal and monetary pressures that have developed recently and by improving policy coordination. The recent surge in public spending growth—which has been driven in large part by the exchange rate unification (which led to implicit subsidies that previously arose through the exchange rate system being recognized explicitly in the public accounts) but also by increases in other outlays—should be reined in. Such restraint would help to reduce persistent double-digit inflation. Also important are ongoing structural reforms, including further trade and price liberalization, subsidy reforms, measures to strengthen the operations and supervision of the financial sector, and public enterprise restructuring and privatization.

In Egypt, economic prospects have strengthened following a recovery in tourism. The upturn would be more solid, however, with a better functioning exchange rate regime. Further flexibility in the official exchange rate would permit a reunification of the official and parallel currency markets, restoring much-needed liquidity to the former. Egypt's consolidated fiscal position has deteriorated from approximate balance in the late 1990s to a deficit of about 2½ percent of GDP, largely on account of the automatic stabilizers as growth slowed, but the limits to this flexibility have now been reached. The 2002/03 budget appropriately targets a reduced deficit, such a consolidation made all the more urgent by the large increases in public debt over recent years. With the move to greater exchange rate flexibility, monetary policies will need to take on a more central and transparent role as nominal anchor. In Jordan, the authorities' sound policy record would be reinforced by further fiscal consolidation, supported by implementation of their bold strategy on pension reforms and other structural measures. Lebanon faces extremely difficult debt dynamics, notwithstanding the reduction in the fiscal deficit from 25 percent of GDP in 2000 to a projected 17 percent of GDP in 2002. With gross public debt (including debt owed to the central bank and some other public institutions) over 170 percent of GDP, the immediate priority should be to tackle fiscal pressures

Figure 1.17. Middle East: Trade Restrictions

The Mashreq countries have relatively high trade restrictions and low levels of trade.



Sources: IMF, *Trade Policy Information Database (TPID);* and IMF staff estimates.
[1]Egypt, Jordan, Lebanon, and Syrian Arab Republic.
[2]Algeria, Morocco, and Tunisia.
[3]Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.
[4]Argentina, Brazil, Chile, and Mexico.
[5]Malaysia, Singapore, and Thailand.

by curtailing public spending and boosting revenues. Trade liberalization, together with privatization and other structural reforms, also needs to be part of the reform strategy to improve growth prospects.

In this regard, the economies of Egypt and several others in the region remain heavily protected by tariff and nontariff barriers, even after substantial tariff reductions in some cases (including Egypt) in the 1990s. Illustrating this, it is notable that the level of trade restrictiveness for most countries both in the Mashreq (including Egypt, Lebanon, and the Syrian Arab Republic) and in the Maghreb (especially Morocco and Tunisia) is much higher than in other developing countries (Figure 1.17). Moreover, gross trade in the Mashreq is particularly low, reflecting the impact of trade restrictions, real exchange rate appreciations during the 1990s, and political uncertainties.[9] This suggests there is substantial scope for increased regional and international trade integration to help support stronger growth (see Chapter III).

The increased political and economic uncertainties arising from security concerns have, as noted, led to significant downward revisions in growth projections for Israel in 2002 and 2003. These concerns have added to the pressures that were already apparent in 2001 as a result of the global slowdown and problems in the IT sector. With confidence declining, the sheqel has weakened substantially since the end of 2001—putting upward pressure on inflation, which is expected to rise to about 6 percent this year. In response to these currency and inflation pressures, the Bank of Israel has increased interest rates in several steps so far in 2002. A pickup in exports—supported by the lower sheqel and stronger global growth—should contribute to economic recovery in 2003, however, especially if regional tensions abate. The West Bank and Gaza has also been severely affected by the security situation, with

[9]See Blavy (2001).

real GDP expected to fall by about 20 percent in 2002. An easing of these tensions, together with international support to restore infrastructure and basic economic institutions, will be needed to lay the groundwork for a return to growth.

Appendix 1.1. Commodity Markets[10]

After bottoming out in late 2001, commodity prices recovered in the first months of this year, as prospects for global recovery improved. Prices generally stabilized in the second quarter, however, in the absence of further major surprises to the global growth outlook (Figure 1.18). In addition to global demand prospects, crude oil prices have been significantly influenced by political events in the Middle East and Venezuela, against the background of a relatively tight balance between world demand and supply. Non-oil commodity prices have broadly stabilized in the aggregate since April, although the picture for individual commodities varies.

Crude Oil

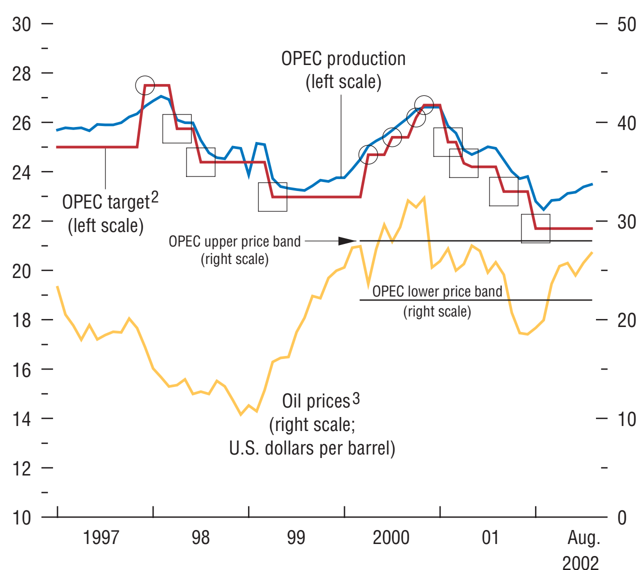
A combination of improved world growth prospects, cuts in OPEC production targets, and especially political uncertainty in the Middle East caused OPEC's reference oil prices to rise back within the $22–$28 target range early in the year (Figure 1.19). Nevertheless, prices have remained below the peaks reached in 2000. Prices increased sharply in the second half of August as regional security tensions increased, easing back somewhat in mid-September as these tensions appeared to partly abate. Recent price fluctuations have been driven mostly by developments in the Middle East and Venezuela, owing to their implications for supply disruptions. While Iraq's temporary suspension of exports has been lifted, unresolved issues remain with the United Nations regarding the pricing of oil exports and the details surrounding resumption of arms inspections. Global inventories of both crude oil and products have

Figure 1.18. Oil and Non-oil Price Indices
(1990 = 100)

Source: IMF staff estimates.
[1]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil.

[10]The main author of this appendix is Guy Meredith.

Figure 1.19. OPEC Target and Actual Production of Oil[1]
(Millions of barrels a day unless otherwise indicated)



Source: Bloomberg Financial Markets, LP.
[1]Excluding Iraq.
[2]Circles denote increases in OPEC target production and squares denote decreases in OPEC target production.
[3]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil.

fallen back to about the same level as last year, given recent drawdowns due to temporary cuts in supply from Iraq.

At its meeting in late June, OPEC announced it will leave oil production quotas unchanged for the third quarter. Nevertheless, actual production has edged up relative to target in recent months, as has occurred following past production cuts. Meanwhile, production restraint agreed to earlier by non-OPEC producers has weakened. Both Russia and Norway, the two largest non-OPEC producers, have announced plans to raise production in the third quarter. In early July, Russia sent its first oil shipment to the United States, following talks between Presidents Bush and Putin that could lead the United States to broaden its supply base and Russia to increase energy exports.

OPEC is to review output quotas at its meeting in Osaka on September 19 (just after the *World Economic Outlook* goes to press). Crude oil futures currently imply a substantial decline in spot prices in coming quarters, back toward the WEO baseline assumption, consistent with an expected easing in the tight supply situation and, most recently, indications of a possible reduction in political tensions following Iraq's decision to allow arms inspections to resume. Meanwhile, the volatility of future oil prices implied by options markets has declined since late last year, suggesting that perceived uncertainty about future market conditions has fallen (Figure 1.20). As discussed earlier in this chapter, however, the possibility of further sharp increases in oil prices arising from a deterioration in the Middle East security situation remains an important downside risk to the global outlook. In this regard, some indicators of the impact of changes in oil prices on regional output and trade balances are provided in Table 1.12.

Nonfuel Commodities

Conditions in markets for agricultural commodities have been more balanced than during 2001, when weak demand and expanding supply put severe downward pressure on many prices.

Table 1.12. The Impact of a $5 a Barrel, Permanent Increase in Oil Prices After a Year
(Percent of GDP)

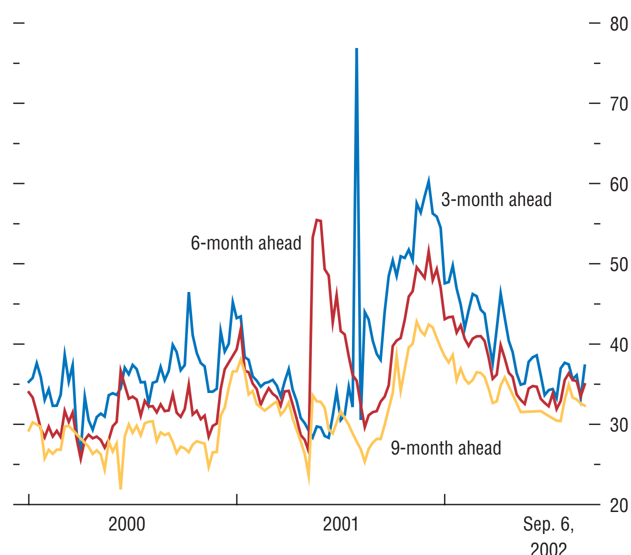
	Real GDP	Trade Balance
World GDP	**–0.3**	**—**
Industrial Countries	**–0.3**	**–0.2**
United States	–0.4	–0.1
Euro area	–0.4	–0.1
Japan	–0.2	–0.2
Other	–0.2	0.2
Developing countries	**–0.2**	**0.2**
Of which:		
Latin America	–0.1	—
Asia	–0.4	–0.5
Emerging Europe and Africa	0.1	0.2

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

Although demand has generally not picked up as much as had been expected, there has been some drawdown of inventories, partly due to the effects of adverse weather on production. The scope for significant price increases in the near term, however, is limited by continued high inventory levels and excess capacity. Passage of the U.S. Farm Bill, which both increases price support and expands support to new crops, is another factor dampening the prospect for higher agricultural prices. Proposals to reform agricultural subsidies in the European Union have been introduced, but passage remains uncertain, and the near-term effect on support levels would be modest. As discussed in the next section, the projected El Niño in 2002–03 could also affect commodity markets, although the expected intensity is modest relative to the last event in 1997–98.

Grain prices edged up during the first half of 2002, largely due to adverse weather conditions in the United States, Canada, and Australia and consequent declines in global stocks. In the near term, however, further price increases are limited by increased competition from other producers such as Argentina and Brazil, while the European Union may reinstate export subsidies. *Vegetable oils and meals* prices have shown a more pronounced recovery than other agricultural commodities, largely reflecting a reversal of extremely depressed levels in 2000–01. Palm and

Figure 1.20. NYMEX Oil: Implied Volatilities from Options Prices
(Standard deviation expressed in percent)



Source: Bloomberg Financial Markets, LP.

coconut oil prices have increased owing to small crops in major producer countries and reduced inventories; palm oil prices have also been affected by large purchases in India and Pakistan to guard against possible supply disruptions stemming from political conflict.

Beef prices have eased in recent months, as drought conditions in parts of the United States and Australia have led to increased slaughter rates, and owing to strong competition from pork and poultry. World *sugar* prices are expected to decline in 2002 owing to large crops in Brazil and China. *Coffee* prices continue to slide, in spite of Brazil's announced intention to retain some production to contain the fall in prices in the face of large anticipated production increases. Coffee growers worldwide are expected to increase their production for the coming crop year by 10 percent. *Cocoa bean* prices have reached a four-year high, in the face of declining supply; production in Côte d'Ivoire, the world's largest producer, dropped by about 14 percent during the 2001 crop year.

Within industrial inputs, *timber* prices remained strong in the first half of 2002, largely owing to a trade dispute between the United States and Canada and also reflecting strong U.S. housing starts. Prices eased back in July and August as inventories were drawn down. *Cotton* production estimates for the current year have increased, as favorable crop conditions have raised yields above historical averages. Reduced planting areas in South America in reaction to low world prices, however, will offset some of the effect of increased yields on production. World stocks of raw cotton will fall in the period ahead if global economic recovery leads to increased demand for cotton yarn and textiles, and weather conditions return to average.

Metal prices generally followed global cyclical developments through the first half of the year, picking up in the first quarter as growth prospects improved, and then stabilizing in the second quarter. Stocks of key metals, such as copper and aluminum, generally remain at comfortable levels, and the supply situation is relatively stable. Looking ahead, the main factor driving metal prices is likely to be evolving prospects for global industrial production.

Semiconductor Markets

Signs of a robust recovery in semiconductor markets earlier in 2002 have faded in recent months. Continuing difficulties among large telecommunications companies, notably WorldCom and Qwest, have dampened demand prospects in this sector. At the same time, retail sales of electronics products, including computers and cellular phones, have remained sluggish. Shipments of semiconductors have picked up only modestly from last year's depressed levels. Memory chip prices have fallen back after a short-lived rebound early in the year, and both Intel and AMD have introduced major price cuts for microprocessors (Figure 1.21). The outlook for memory chip prices is clouded by the announcement by U.S. authorities of an antitrust investigation among producers, but the introduction of double-data-rate (DDR) technology could spur new demand.

Exceptions to the generally subdued picture involve increased defense spending in the IT sector, expanding demand in parts of Asia (particularly Taiwan Province of China and China), and stronger demand for flat-screen monitors. But the outlook for the market as a whole remains clouded by the weak financial position of many companies and overcapacity in the telecommunications sector, both of which will limit IT investment in the period ahead. There are, as yet, few signs of a major replacement cycle in personal computers, as users do not appear to have a compelling need for new hardware or operating systems. Uncertainties about the prospects for the proposed industry standard on "digital rights management" (DRM) schemes for personal computers may also be a factor limiting upgrade demand.

El Niño and Commodity Prices

Climatic conditions have an important effect on commodity markets, most directly by altering

production conditions. Less visibly, weather patterns also influence other aspects of the world economy, for instance by stimulating building construction, including in areas where the weather is atypically good, or disrupting transportation links as a result of floods and storms.

One of the most widely watched global weather indicators is the El Niño Southern Oscillation (ENSO) phenomenon. ENSO refers to a reversal of the typical water temperature and air pressure systems in the South Pacific, having far-reaching effects on global weather. ENSO events have been systematically tracked since the late 1800s, and tend to recur at a frequency of roughly four to five years. The intensity of the phenomenon varies, with particularly large events having occurred in 1981–82 and 1997–98. Based on available indicators, another ENSO event is expected in the fall of 2002, although it is not projected to be as strong as in 1997–98 (Figure 1.22).

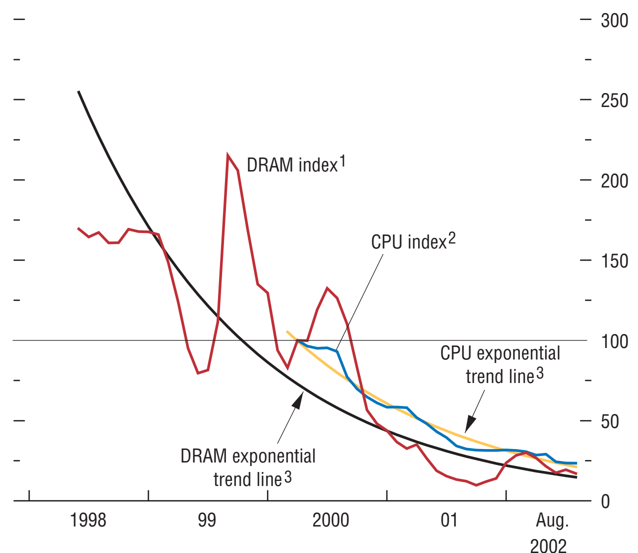
The effects of ENSO on the world economy have been of particular interest since the widespread impact of the major 1981–82 event. In part because of this experience, there is a perception that ENSO is likely to have damaging effects on commodity production and world output more generally. Conceptually, however, the effects of ENSO are less clear-cut. Certain types of commodity production can actually be stimulated by the associated change in weather patterns, as can some activities unrelated to commodities, such as building construction, both as result of rebuilding and (in some countries) more favorable weather for the construction industry.[11] There is also a tendency for fewer tropical storms in the Atlantic to be observed during ENSO events, causing less disruption to activity on the U.S. east coast.[12]

[11]Rebuilding may, however, be more difficult in poorer countries with less resources.

[12]The U.S. National Oceanographic and Atmospheric Agency (NOAA) discusses the effect of ENSO on the U.S. economy in "The Economic Implications of an El Niño," available via the Internet: www.noaanews.noaa.gov/magazine/stories/mag24.htm.

Figure 1.21. Comparison of the Semiconductor Indices, CPU, and DRAM Indices

(April 2000 = 100)



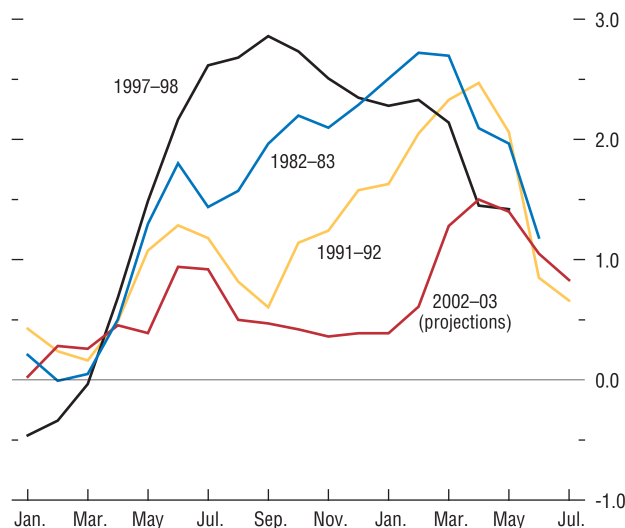
Sources: Bloomberg Financial Markets, LP; Thomson Financial's DataStream; and IMF staff calculations.

[1]DRAM index is the DataStream quoted price for a SDRAM Module 100Mhz 128Megabytes (16X8Megabyte), indexed to April 2000 and spliced with a more complete index in January of 2001, which comprises varying types of DDR and SDRAM.

[2]CPU index is constructed from Intel Celeron Processors weighted by their "clock speed" and length of time on market.

[3]Trend lines are calculated by using a least squares best fit approach to the Log 10 of the indices and using the results as exponents to the factor of 10.

Figure 1.22. Recent and Projected ENSO Effects
(SST anomalies from seasonal averages in degrees Kelvin)



Source: National Oceanic Atmospheric Administrations (NOAA).

In a recent study of the effect of ENSO on commodity prices, Brunner (2000) found that nonfuel commodity prices tend to rise in response to ENSO events. But the impact on world GDP seems, if anything, to be (slightly) positive, while there is a negligible impact on consumer price inflation. This section extends Brunner's analysis to include more recent data and consider alternative definitions of economic activity. It appears that his conclusions are robust: whether measured by GDP or industrial production, world output tends to rise in response to ENSO events, notwithstanding the positive impact on commodity prices. Overall consumer prices are largely unaffected by ENSO activity. One implication is that although an ENSO recurrence in 2002–03 could have serious effects on individual countries, notably on the Pacific coast of Latin America, it would not, in itself, present a downside risk to global recovery or an upside risk to inflation.

To analyze the impact of ENSO, vector autoregressions (VARs) were performed using a four-variable system consisting of deviations in a measure of ENSO (either surface water temperature or air pressure) from "normal" levels; growth in real commodity prices (the IMF's index of nonfuel commodity prices deflated by G-7 consumer prices); growth in real activity (either G-7 GDP or world industrial production); and inflation in a broad price index (G-7 consumer prices). Quarterly data from 1961 to 2001 were used. Preliminary testing indicated that four lags on each variable captured the main interactions in the system, so this common lag structure was imposed in the equations.

The statistical significance of the lagged impact of ENSO on the other variables is reflected in likelihood ratio statistics. Of the two measures of ENSO, preliminary results indicated that ocean surface temperature had a stronger effect on the system as a whole than did atmospheric pressure. The marginal significance of this measure of ENSO on both the overall system and the individual equations is as follows. The results are similar regardless of whether real

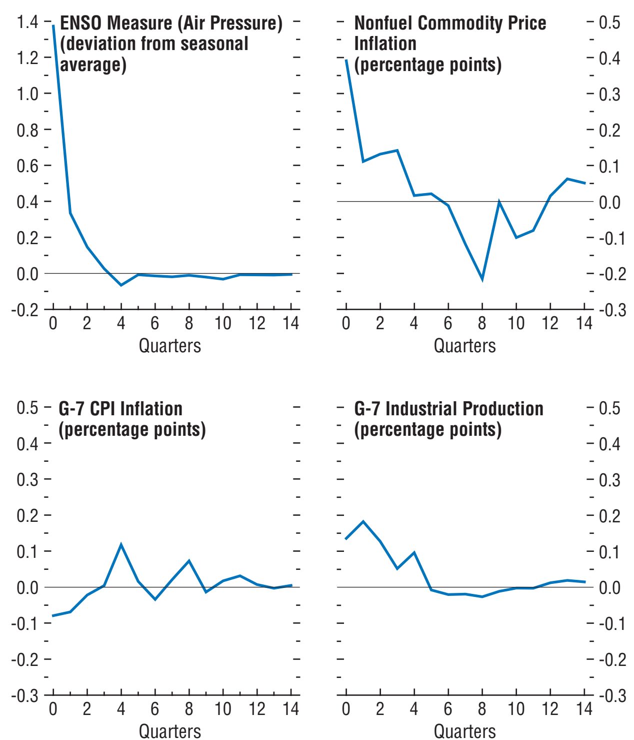
activity is measured by GDP or industrial production. ENSO plays a significant role in influencing the economic variables as a group, but with the effect falling almost entirely on nonfuel commodity prices as opposed to real activity or CPI inflation.

The time path of the impact of an ENSO shock on the endogenous variables is indicated by impulse response functions. These are illustrated in Figure 1.23 for 16 quarters following a temporary shock to the ENSO variable (here measured as atmospheric pressure, with industrial production as the activity variable). It is apparent that the ENSO effect itself dies out relatively quickly—about three quarters following an innovation. The initial impact is to raise non-oil commodity price inflation for several quarters, with the effect eventually reversing sign, as expected in the case of a temporary shock. Industrial production also rises in response to an ENSO shock, although the effect is minor. A similar pattern is evident when GDP is used as the activity variable. Finally, G-7 consumer prices are almost unaffected by ENSO, falling slightly on impact and rising slightly over time.

The overall picture provided by the significance tests and impulse responses, then, is that ENSO does have a significant positive impact on commodity prices. At the same time, the effect on global activity is, if anything, positive (though insignificant in statistical terms). However, this is subject to two important caveats (beyond the usual concerns about drawing inferences from relatively short historical samples). First, as already noted, the impact on some individual countries could be much greater; Ecuador and Peru, for instance, have experienced significant negative shocks from recent ENSO events.

Second, the analysis does not take account of the broader impact of climatic changes on economic wealth, as opposed to the current flow of production (GDP). Because measured output does not include capital losses from storm damage, forest fires, and other natural phenomena related to ENSO, it should not be concluded

Figure 1.23. Impulse Response Functions for an ENSO Shock



Sources: National Oceanic Atmospheric Administrations (NOAA); and IMF staff calculations.

that ENSO is a "good thing" from the point of view of global welfare.

References

Ark, Bart van, Robert Inklaar, and Robert H. McGuckin, 2002, "Changing Gear; Productivity, ICT, and Service Industries: Europe and the United States," paper presented at Brookings Seminar on Productivity Measurement in the Service Industry, Washington, D.C, May 22.

Baily, Martin Neil, 2002, "The U.S. Outlook: Capital Spending and Productivity Growth," paper presented at the Institute for International Economics Conference, "Global Economic Prospects," Washington D.C., April. Available via the Internet: www.iie.com/papers/baily0402.pdf.

Basu, Anupam, and Krishna Srinivasan, 2002, "Foreign Direct Investment in Africa—Some Case Studies," IMF Working Paper 02/61 (Washington: International Monetary Fund).

Blavy, Rodolphe, 2001, "Trade in the Mashreq: An Empirical Examination," IMF Working Paper 01/163 (Washington: International Monetary Fund).

Breuer, Peter, 2002, "How Does the Volatility Risk Premium Affect the Informational Content of Currency Options?" forthcoming IMF Working Paper (Washington: International Monetary Fund).

Brunner, Allan D., 2000, "El Niño and World Primary Commodity Prices: Warm Water or Hot Air?" IMF Working Paper 00/203 (Washington: International Monetary Fund).

Campa, José Manuel, and Linda S. Goldberg, 2002, "Exchange Rate Pass-Through into Import Prices: A Macro or Micro Phenomenon?" NBER Working Paper No. 8934 (Cambridge, Massachusetts: National Bureau of Economic Research).

European Commission, 2000, *Employment in Europe 2000* (Brussels: European Commission).

Gordon, Robert J., 1996, "Problems in the Measurement and Performance of Service-Sector Productivity in the United States," NBER Working Paper No. 5519 (Cambridge, Massachusetts: National Bureau of Economic Research).

Gust, Christopher, and Jaime Marquez, 2002, "International Comparisons of Productivity Growth: The Role of Information Technology and Regulatory Practices," International Finance Discussion Paper No. 727 (Washington: Federal Reserve Board).

Hall, Robert E., and Charles I. Jones, 1999, "Why Do Some Countries Produce So Much More Output per Worker Than Others?" *Quarterly Journal of Economics,* Vol. 114 (February), pp. 83–116.

International Monetary Fund, 2000, "The Impact of Higher Oil Prices on the Global Economy." Available on the Internet: www.imf.org/external/pubs/ft/oil/2000/index.htm.

Kumar, Manmohan, and Maitland MacFarlan, forthcoming, "Reversal of Fortunes—Temporary or Permanent? A Comparison of U.S. and European Productivity Growth," IMF Working Paper (Washington: International Monetary Fund).

Meredith, Guy, and Yue Ma, 2002, "The Forward Premium Puzzle Revisited," IMF Working Paper 02/28 (Washington: International Monetary Fund).

Nordhaus, William D., 2001, "Productivity Growth and the New Economy," NBER Working Paper No. 8096 (Cambridge, Massachusetts: National Bureau of Economic Research).

Organization for Economic Cooperation and Development, 2002, *Economic Outlook* (Paris: OECD).

Oliner, Stephen D., and Daniel E. Sichel, 2002, "Information Technology and Productivity: Where Are We Now and Where Are We Going?" Finance and Economics Discussion Paper No. 2002–29 (Washington: Federal Reserve Board). Available via the Internet: www.federalreserve.gov/Pubs/FEDS/2002/200229/200229pap.pdf.

Subramanian, Arvind, Natalia Tamirisa, and Rikhil Bhavnani, forthcoming, "Are Developing Countries Integrated in the Global Economy?" IMF Working Paper (Washington: International Monetary Fund).