CHAPTER I ECONOMIC PROSPECTS AND POLICY ISSUES

The global economic expansion has remained broadly on track, evolving largely as expected when the last *World Economic Outlook* was published in September 2004. After averaging about 6 percent in late 2003 and early 2004, global growth moderated, accompanied by a significant slowdown in industrial production and global trade, reflecting both a return to a more sustainable pace of expansion and the adverse impact of higher oil prices (Figures 1.1 and 1.2 and Table 1.1). Most recent data suggest that this slowdown has begun to bottom out, and forward-looking indicators appear consistent with solid expansion in 2005, although rising oil prices are an increasing risk. Despite the appalling human cost and physical destruction of the December 2004 tsunami and the substantial budget and balance of payments implications for some affected countries (Box 1.1, "The Indian Ocean Tsunami: Impact on South Asian Economies"), the impact on growth is expected to be modest.

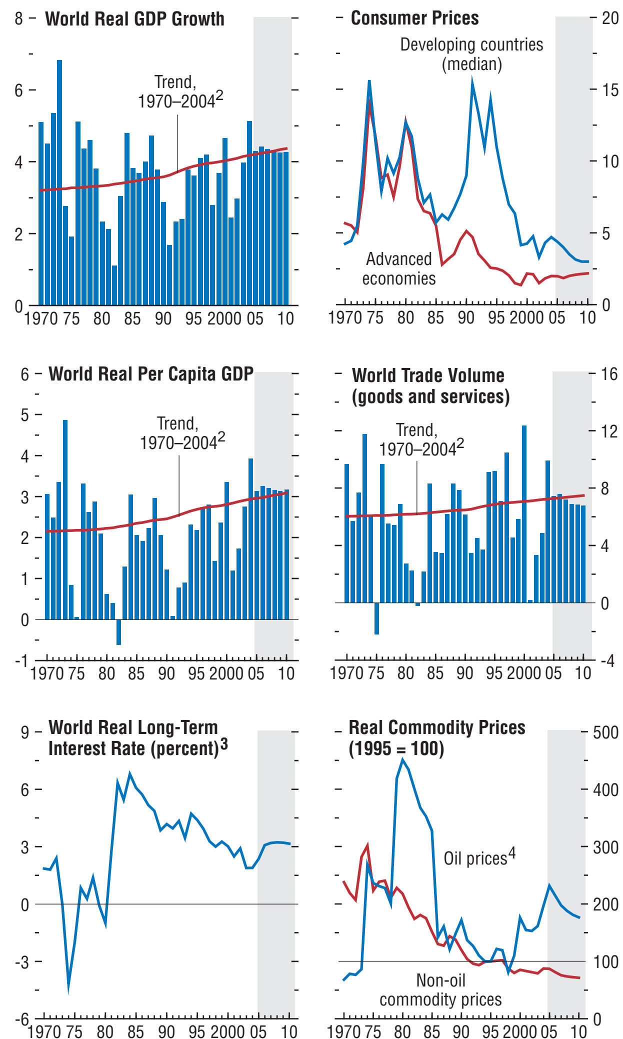
This overall picture, however, hides growing divergences across regions. In particular:

- *The expansion has become less balanced.* Growth has been stronger than expected in the United States, where the "soft spot" proved more moderate than previously thought; in China, where activity remains buoyant despite tightening measures; and in most emerging market and developing countries. In contrast, growth in Europe and Japan has been disappointing, reflecting—to different extents—faltering exports and weak final domestic demand (and, in Japan, revisions to the national accounts methodology).
- *Global current account imbalances have widened.* The U.S. current account deficit is estimated at a record 5.7 percent of GDP in 2004, with the effects of the depreciation of the U.S. dollar to date offset by continued strong domestic demand relative to its trading partners and

Figure 1.1. Global Indicators[1]

(Annual percent change unless otherwise noted)

Global growth is expected to moderate in 2005, but stay above trend, while inflation remains subdued.



[1]Shaded areas indicate IMF staff projections. Aggregates are computed on the basis of purchasing-power-parity (PPP) weights unless otherwise noted.

[2]Average growth rates for individual countries, aggregated using PPP weights; the aggregates shift over time in favor of faster growing countries, giving the line an upward trend.

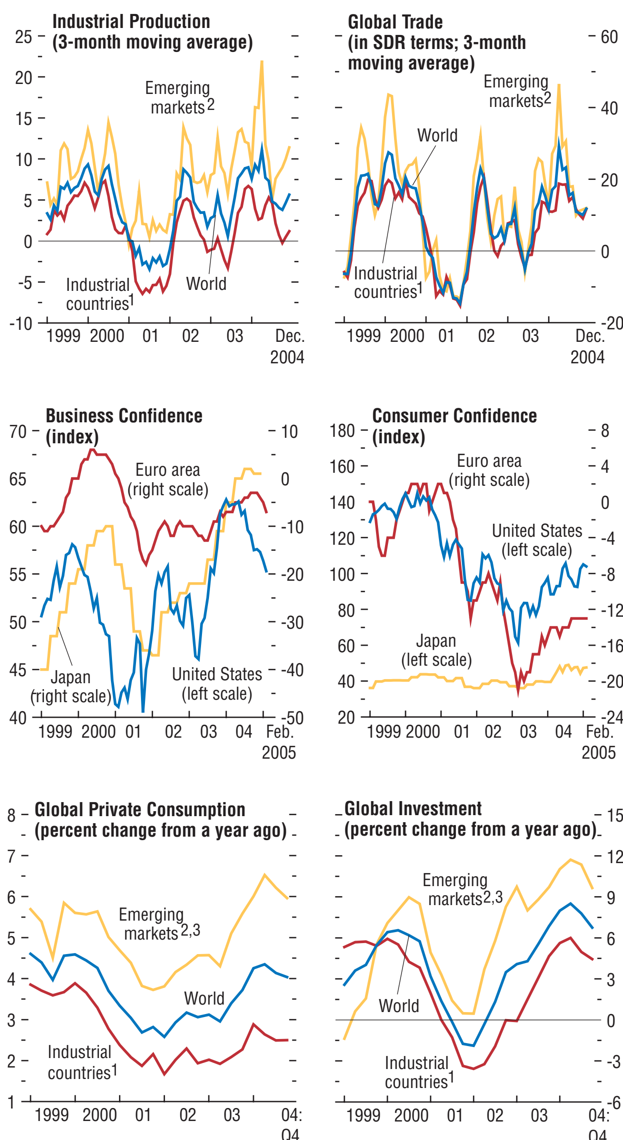
[3]GDP-weighted average of the 10-year (or nearest maturity) government bond yields less inflation rates for the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada. Excluding Italy prior to 1972.

[4]Simple average of spot prices of U.K. Brent, Dubai Fateh, and West Texas Intermediate crude oil.

Figure 1.2. Current and Forward-Looking Indicators

(Percent change from previous quarter at annual rate unless otherwise noted)

Industrial production and trade growth slowed during 2004, but business and consumer confidence remain generally solid.



Sources: Business confidence for the United States, the Institute for Supply Management; 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, Cabinet Office. All others, Haver Analytics.

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

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

[3]Data for China, India, Pakistan, and Russia are interpolated.

higher oil prices. This is matched by current account surpluses in emerging Asia, Japan, the oil-producing countries in the Middle East and the Commonwealth of Independent States (CIS), and—to a much lesser extent—the euro area. In emerging Asia and the oil-producing countries, external reserves have also continued to rise sharply, with a significant portion believed to be held in U.S. dollars.

- *Partly reflecting these developments, the U.S. dollar has depreciated further,* matched by appreciations of industrial and emerging market currencies, including several in emerging Asia (Figure 1.3). Since early September, the U.S. dollar has fallen some 6 percent in trade-weighted terms—mostly in late 2004, with major currencies remaining relatively range bound so far in 2005—and by a cumulative 17 percentage points from its February 2002 peak. To date, adjustment has been orderly, and—with options market data suggesting that implied volatility remains moderate—markets appear sanguine that this will continue to be the case.

Despite moderating global growth, oil prices have remained high and volatile. After rising sharply through mid-October, oil prices subsequently fell back sharply, but have recently rebounded to new nominal highs, driven by continued strong demand, uncertainties about Organization of the Petroleum Exporting Countries (OPEC) production plans, and falling non-OPEC supply, all exacerbated by a very low level of excess capacity (Appendix 1.1, "Recent Developments in Commodity Markets"). As of early April the spot oil price stood at $52.96 a barrel;[1] futures markets project prices to average about $54 a barrel in the remainder of 2005, falling back somewhat in 2006 and beyond. With excess capacity expected to remain low—and mainly in the form of heavy crude, for which refining capacity is limited—oil prices are likely

[1]The oil price used in the *World Economic Outlook* is the simple average of the spot prices of U.K. Brent, Dubai, and West Texas Intermediate crudes (respectively, $53.46 a barrel, $49.56 a barrel, and $55.85 a barrel on April 6, 2005).

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

			Current Projections		Difference from September 2004 Projections	
	2003	2004	2005	2006	2004	2005
World output	**4.0**	**5.1**	**4.3**	**4.4**	**0.2**	**—**
Advanced economies	2.0	3.4	2.6	3.0	–0.2	–0.3
United States	3.0	4.4	3.6	3.6	0.1	0.1
Euro area	0.5	2.0	1.6	2.3	–0.2	–0.6
Germany	–0.1	1.7	0.8	1.9	–0.4	–1.0
France	0.5	2.3	2.0	2.2	–0.3	–0.3
Italy	0.3	1.2	1.2	2.0	–0.2	–0.7
Spain	2.5	2.7	2.8	3.0	0.1	–0.2
Japan	1.4	2.6	0.8	1.9	–1.8	–1.5
United Kingdom	2.2	3.1	2.6	2.6	–0.3	0.2
Canada	2.0	2.8	2.8	3.0	–0.1	–0.4
Other advanced economies	2.5	4.4	3.4	3.9	0.1	–0.1
Newly industrialized Asian economies	3.1	5.5	4.0	4.8	0.1	–0.1
Other emerging market and developing countries	6.4	7.2	6.3	6.0	0.6	0.4
Africa	4.6	5.1	5.0	5.4	0.6	–0.5
Sub-Sahara	4.2	5.1	5.2	5.6	0.6	–0.6
Central and eastern Europe	4.6	6.1	4.5	4.5	0.6	–0.3
Commonwealth of Independent States	7.9	8.2	6.5	6.0	0.1	—
Russia	7.3	7.1	6.0	5.5	–0.2	–0.6
Excluding Russia	9.1	10.5	7.7	7.0	0.8	1.2
Developing Asia	8.1	8.2	7.4	7.1	0.6	0.6
China	9.3	9.5	8.5	8.0	0.5	1.0
India	7.5	7.3	6.7	6.4	1.0	—
ASEAN-4[1]	5.4	5.8	5.4	5.8	0.4	—
Middle East	5.8	5.5	5.0	4.9	0.5	0.3
Western Hemisphere	2.2	5.7	4.1	3.7	1.1	0.5
Brazil	0.5	5.2	3.7	3.5	1.2	0.2
Mexico	1.6	4.4	3.7	3.3	0.3	0.5
Memorandum						
European Union	1.2	2.5	2.1	2.5	–0.1	–0.4
World growth based on market exchange rates	2.7	4.0	3.2	3.4	–0.4	–0.3
World trade volume (goods and services)	**4.9**	**9.9**	**7.4**	**7.6**	**1.0**	**0.1**
Imports						
Advanced economies	3.6	8.5	6.5	6.3	0.8	0.9
Other emerging market and developing countries	8.9	15.5	12.0	11.0	2.7	—
Exports						
Advanced economies	2.8	8.1	5.9	6.8	—	–0.4
Other emerging market and developing countries	10.7	13.8	9.9	9.7	3.0	–0.4
Commodity prices (U.S. dollars)						
Oil[2]	15.8	30.7	23.2	–5.9	1.8	23.2
Nonfuel (average based on world commodity export weights)	7.1	18.8	3.8	–5.1	2.0	7.8
Consumer prices						
Advanced economies	1.8	2.0	2.0	1.9	–0.1	–0.1
Other emerging market and developing countries	6.0	5.7	5.5	4.6	–0.2	0.1
London interbank offered rate (percent)[3]						
On U.S. dollar deposits	1.2	1.8	3.3	4.1	0.2	—
On euro deposits	2.3	2.1	2.3	2.9	—	–0.5
On Japanese yen deposits	0.1	0.1	0.1	0.4	—	–0.2

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during January 31–February 28, 2005. See Statistical Appendix for details and groups and methodologies.

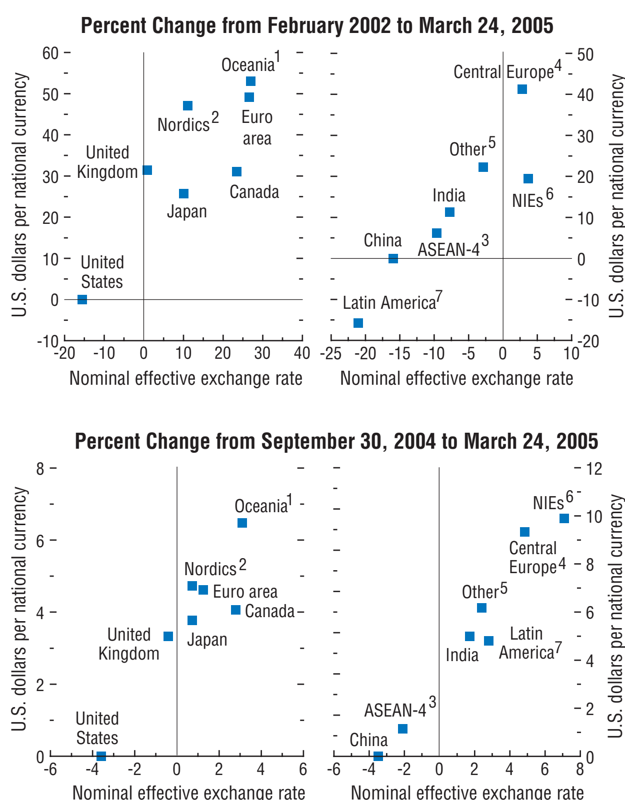
[1]Includes Indonesia, Malaysia, the Philippines, and Thailand.

[2]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 $37.76 in 2004; the assumed price is $46.50 in 2005, and $43.75 in 2006.

[3]Six-month rate for the United States and Japan. Three-month rate for the euro.

Figure 1.3. Global Exchange Rate Developments

The U.S. dollar has depreciated since September 2004, accompanied by moderate appreciation of most industrial and emerging market currencies.



Sources: Bloomberg Financial Markets, LP; and IMF staff calculations.
[1]Australia and New Zealand.
[2]Denmark, Norway, and Sweden.
[3]Indonesia, Malaysia, the Philippines, and Thailand.
[4]Czech Republic, Hungary, and Poland.
[5]Russia, South Africa, and Turkey.
[6]Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.
[7]Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

to remain volatile, with options market data suggesting some upside risk. In contrast, prices of nonfuel commodities have leveled off since mid-2004, with rising beverage and metals prices offset by falling prices of some food and agricultural raw materials, most notably cotton. The semiconductor market has also weakened markedly, owing to large inventories and substantial excess capacity; while forward indicators are mixed, most analysts project a significant slowdown in semiconductor sales in 2005.

Inflation and inflationary pressures remain relatively subdued, with few signs to date of significant second-round effects from higher oil prices (Figure 1.4). With monetary tightening cycles under way in most cyclically advanced countries, and inflationary expectations generally well grounded, inflation is expected to remain moderate in the near future. However, inflationary pressures will gradually increase as the expansion proceeds, and two potential upside risks bear close monitoring. First—consistent with the strong pickup in corporate profits—unit labor costs in most industrial countries have fallen significantly. While this may partly reflect structural factors—such as rising competition from emerging markets in Asia and Europe—there is potential for a significant rebound as labor market conditions tighten, especially if labor productivity growth were to weaken. Second, monetary policy in a number of emerging markets—notably in Asia and the CIS—is increasingly complicated by strong external inflows. While the impact on domestic liquidity can be temporarily offset through sterilization, in the absence of greater upward exchange rate flexibility, inflationary pressures will eventually rise.

The recovery has continued to be supported by favorable financial market conditions, with policy rates in most countries still close to zero in real terms, although there has been some tightening in conditions recently as U.S. long-term interest rates have risen and corporate and emerging market spreads have widened (Figures 1.5 and 1.6). Nevertheless, equity markets across the globe remain robust; long-run interest rates still appear well below equilibrium levels; and

spreads are close to historical lows; private capital inflows to emerging markets have also been strong (Table 1.2). These developments partly reflect improved fundamentals, including well-grounded inflationary expectations, strengthening corporate balance sheets, and reduced external vulnerabilities in emerging markets. However, the highly accommodative monetary conditions across the globe, accompanied by a continuing search for yield, and—in the case of low long-run interest rates—an ample supply of investable funds have also played an important role (see Box 1.2, "What Are the Risks from Low U.S. Long-Term Interest Rates?"). Correspondingly, as stressed in the IMF's April 2005 *Global Financial Stability Report*, financial conditions could tighten markedly, particularly in the event of unexpected shocks.

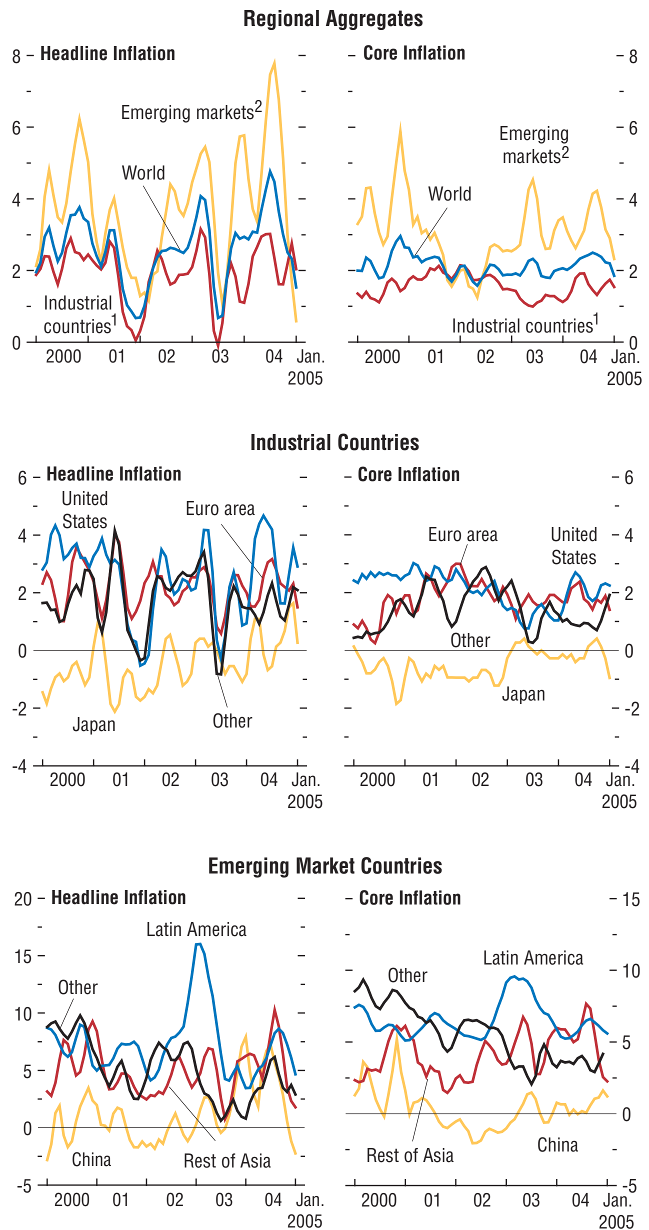
Looking forward, global GDP growth is projected to moderate to 4.3 percent in 2005, 0.8 percentage point slower than in 2004, and to remain at about that level during 2006. Underlying this, the slowdown during 2004 is expected to bottom out in early 2005, with global growth increasing marginally thereafter, aided by a gradual recovery in the euro area and Japan, as well as strengthening activity in much of emerging Asia (Figure 1.7). The expansion will continue to be underpinned by accommodative macroeconomic policies, albeit to a lesser extent than in 2004 (Figure 1.8); improving corporate balance sheets; supportive financial market conditions; a gradual rise in employment; and continued strong growth in China. Looking across the major countries and regions:

- Among *industrial countries*, the U.S. economy has continued to grow at or above trend, driven by strong domestic demand. With most forward-looking indicators remaining solid, the expansion is set to continue in 2005, although—with household savings close to zero—a retrenchment in private consumption remains a risk, particularly if house price increases were to slow. In contrast, growth in most other industrial countries has fallen short of expectations. In the euro area, GDP growth slowed markedly in the second half of

Figure 1.4. Global Inflation

(Annualized percent change of three-month moving average over previous three-month average)

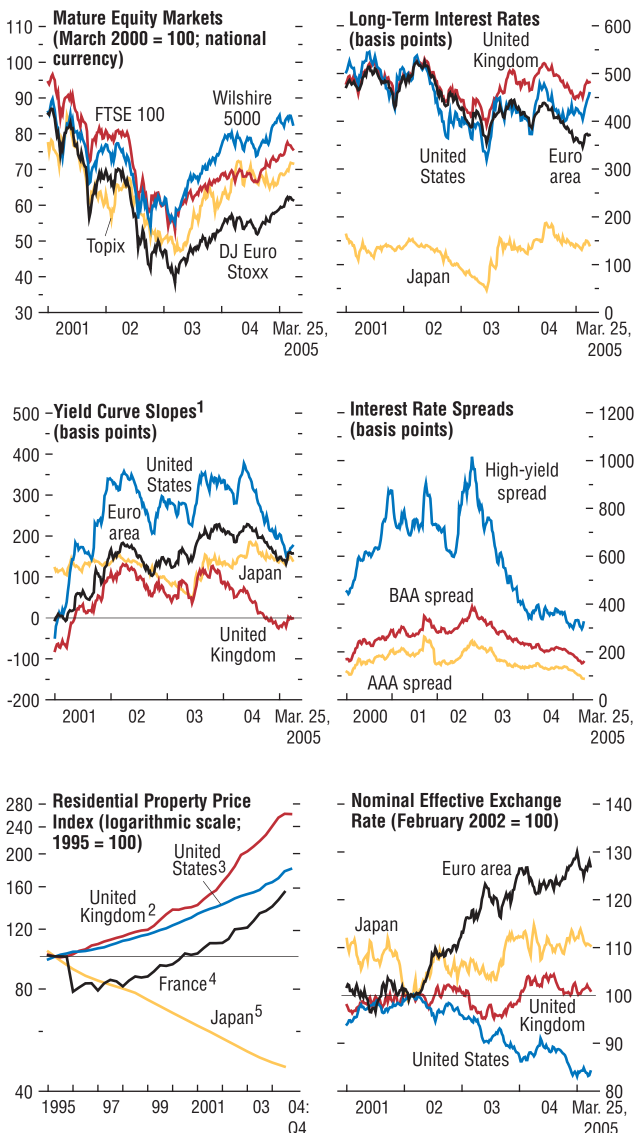
Headline inflation has fallen back following the mid-2004 spike owing to higher oil prices; so far, there is little sign of substantial second-round effects on core inflation.



Sources: Haver Analytics; and IMF staff calculations.
[1]Canada, Denmark, euro area, Japan, Norway, Sweden, United Kingdom, and United States.
[2]Brazil, Chile, China, India, Indonesia, Hungary, Korea, Mexico, Poland, South Africa, and Taiwan Province of China.

Figure 1.5. Developments in Mature Financial Markets

Financial market conditions remain unusually benign, with long-term interest rates and spreads at exceptionally low levels.



Sources: Bloomberg Financial Markets, LP; Office of Federal Housing Enterprise Oversight; Japan Real Estate Institute; Halifax; National Institute for Statistics and Economic Studies; and IMF staff calculations.

[1]Ten-year government bond minus three-month treasury bill rate.

[2]Halifax housing index as measured by the value of all houses.

[3]House price index as measured by the value of single-family homes in the United States as a whole, in various regions of the country, and in the individual states and the District of Columbia.

[4]Housing price index: all homes.

[5]Urban land price index: average of all categories in six large city areas.

2004, as the contribution of net exports turned sharply negative. While some tentative signs of renewed growth are emerging, confidence indicators have generally eased and the upturn in 2005 is expected to be significantly weaker than earlier thought. Growth in Japan has stalled since the second quarter of 2004, as exports, investment, and consumption faltered; however, recent data generally suggest activity is picking up, and strong corporate profits and solid consumer and business confidence should support a renewed expansion during 2005, albeit at a weaker pace. In both the euro area and Japan, further sharp currency appreciation is an important risk.

- In *emerging markets*, GDP growth in 2004 exceeded expectations in almost all regions, and continued—albeit generally slower—growth is projected during 2005, consistent with global developments. In emerging Asia, China's economic momentum remains very strong, notwithstanding tightening measures by the authorities, and investment remains unsustainably high; growth in India also remains quite robust. While strong growth in these countries will support activity elsewhere in the region, much continues to depend on extraregional developments—particularly the extent of the correction in the information technology (IT) markets, which has contributed to a marked slowdown in growth in some Asian countries during 2004. Activity in Latin America has continued to exceed expectations, aided by high commodity prices, improving external confidence, progress with structural reforms, and in some cases a continued rebound from earlier crisis-induced slowdowns. Fiscal management has been less procyclical than in past upswings, and most countries in the region have taken advantage of favorable financial market conditions to improve debt structure and prefinance 2005 obligations, although high levels of public debt and financial dollarization remain key sources of vulnerability. In the Middle East, GDP growth is projected to slow moderately as oil output plateaus owing to limited excess

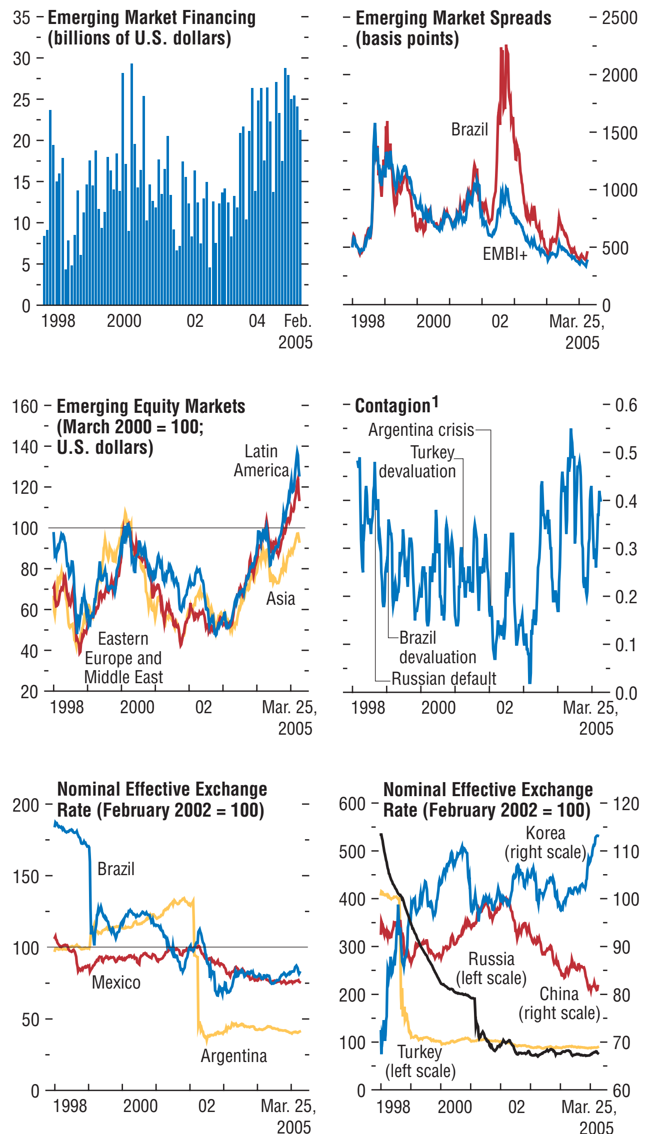
capacity. The prospect of continued high oil prices offers an important opportunity to address fiscal weaknesses and accelerate the reforms needed to reduce unemployment in the face of rapidly growing labor forces. In Turkey, the economy continues to grow strongly and the inflation target has been met, but high public debt and the large current account deficit underscore the need for continued fiscal prudence and reform. Growth in transition economies remains strong, aided by buoyant commodity prices, although the recent deterioration in the investment climate in Russia is a concern. European Union (EU) accession countries continue to grow solidly, with the key vulnerabilities being large fiscal and external deficits, particularly in Hungary.

- Among the *poorest countries*, GDP growth in sub-Saharan Africa rose to 5.1 percent in 2004, underpinned by generally prudent macroeconomic policies; buoyant commodity prices, although some countries have been hit hard by falling cotton prices; improved weather conditions, notably in Ethiopia; and debt relief under the Heavily Indebted Poor Countries (HIPC) initiative. In 2005, GDP growth is projected to remain robust, underpinned primarily by continued strong growth in oil-producing countries as new capacity comes on stream; however, much depends on improved political stability—the recent peace agreement in Sudan is a welcome step—and favorable weather conditions.[2] The ending of world textile trade quotas will also pose a major challenge for many poor countries in Africa, south Asia, and Central America (see Box 1.3, "The Ending of Global Textile Trade Quotas").

The balance of risks to the short-term outlook is tilted to the downside. On the one hand, the cyclical rebound could continue to be stronger than expected, especially given improving corporate and household balance sheets

Figure 1.6. Emerging Market Financial Conditions

Emerging market borrowing has surged, with spreads at historically low levels.



Sources: Bloomberg Financial Markets, LP; Capital Data; and IMF staff calculations.
[1]Average of 30-day rolling cross-correlation of emerging debt market spreads.

[2]Since 1990, sub-Saharan African GDP growth in the current year has been overestimated by an average of 0.7 percentage point in spring *World Economic Outlooks*, in part because such expectations were not in fact fulfilled.

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

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total										
Private capital flows, net[2]	198.4	84.8	89.1	60.8	60.9	75.8	149.5	196.6	175.1	193.9
Private direct investment, net	147.2	159.8	173.3	174.3	184.7	144.4	151.9	186.4	217.4	222.3
Private portfolio flows, net	60.4	42.5	69.1	20.5	−86.9	−90.0	−9.9	28.8	2.3	16.0
Other private capital flows, net	−9.2	−117.6	−153.3	−134.0	−36.9	21.4	7.5	−18.6	−44.6	−44.4
Official flows, net	27.7	53.5	18.2	−42.7	1.8	8.5	−58.1	−58.0	−65.0	−55.3
Change in reserves[3]	−105.2	−37.4	−93.5	−121.9	−115.1	−194.4	−369.3	−518.9	−523.4	−515.7
Memorandum										
Current account[4]	−83.5	−51.9	38.9	126.6	89.4	142.5	233.8	336.3	395.4	345.8
Africa										
Private capital flows, net[2]	14.3	10.8	11.5	−1.7	7.6	6.9	12.3	11.4	15.6	13.5
Private direct investment, net	7.9	6.6	9.0	8.0	23.0	14.8	14.6	15.4	16.7	16.6
Private portfolio flows, net	7.4	4.3	9.1	−1.8	−7.7	−0.9	0.4	3.9	2.7	3.1
Other private capital flows, net	−1.1	−0.1	−6.6	−7.9	−7.7	−7.0	−2.8	−8.0	−3.8	−6.2
Official flows, net	−4.5	2.9	1.1	−0.2	−2.6	3.8	2.8	−0.5	−1.4	0.7
Change in reserves[3]	−11.3	1.7	−2.8	−12.8	−11.9	−8.1	−19.2	−33.1	−34.3	−32.1
Central and eastern Europe										
Private capital flows, net[2]	20.2	27.2	36.7	39.1	12.2	55.3	52.0	60.6	65.8	57.7
Private direct investment, net	11.6	19.2	22.6	23.9	24.2	25.1	15.1	22.1	29.5	29.0
Private portfolio flows, net	5.4	−1.4	5.7	3.1	0.5	1.4	7.1	24.9	22.4	19.1
Other private capital flows, net	3.2	9.4	8.4	12.2	−12.4	28.7	29.8	13.6	13.9	9.6
Official flows, net	−3.3	0.3	−2.6	1.5	5.5	−7.6	−5.5	−6.9	−5.0	−3.3
Change in reserves[3]	−10.7	−9.5	−11.3	−2.9	7.4	−10.5	−11.4	−12.9	−6.9	−5.1
Commonwealth of Independent States[5]										
Private capital flows, net[2]	19.9	6.7	−6.4	−13.0	−1.8	−9.5	16.4	2.9	−6.4	2.7
Private direct investment,net	5.9	5.3	4.2	2.4	4.6	3.9	5.3	7.7	8.6	9.4
Private portfolio flows, net	17.6	7.7	−3.1	−6.1	−9.2	−8.2	−4.8	−1.1	−10.8	−2.8
Other private capital flows, net	−3.7	−6.3	−7.5	−9.4	2.8	−5.3	15.9	−3.7	−4.3	−3.9
Official flows, net	8.6	10.0	0.1	−4.3	−4.5	−1.7	−5.2	−1.0	−5.4	−1.7
Change in reserves[3]	−4.3	7.5	−2.7	−17.2	−11.3	−11.8	−33.8	−55.5	−69.8	−70.7
Emerging Asia[6]										
Private capital flows, net[2,7]	36.5	−49.9	11.8	−2.0	10.7	23.9	56.1	130.1	108.9	115.0
Private direct investment, net	55.7	56.6	67.1	67.1	54.8	52.5	70.6	87.0	104.3	105.8
Private portfolio flows, net	6.8	8.7	55.8	20.0	−57.6	−62.0	2.5	25.8	11.2	9.1
Other private capital flows, net[7]	−26.0	−115.2	−111.1	−89.2	13.5	33.3	−17.0	17.3	−6.6	0.2
Official flows, net	22.7	15.4	−0.2	1.0	−6.6	−0.2	−14.4	7.0	16.7	17.2
Change in reserves[3]	−36.0	−52.9	−87.5	−61.2	−89.6	−158.4	−235.7	−344.3	−310.0	−315.5

(Figure 1.9); growth could also prove stronger than expected in China in 2005 (although, as discussed below, at the risk of a sharper slowdown later on). On the downside—apart from geopolitical concerns, which remain significant if unquantifiable—the key risks include the following:

- *Financial market conditions could tighten significantly.* A sharp increase in U.S. long-run interest rates—which have risen by some 50 basis points since early February—would adversely affect domestic demand, especially if driven by a rise in inflationary expectations or weaker foreign demand for U.S. securities (Box 1.2); prompt significant financial market deleveraging and downward adjustments in prices of riskier assets, underscoring the need for vigilance by both supervisors and regulators; and lead to a significant deterioration in emerging market financing conditions. If higher U.S. rates led to higher long-run interest rates elsewhere, they would also raise the risk of a synchronized decline in housing markets, which is of particular concern where housing prices are already elevated and household balance sheets are most exposed to rising rates. In addition, as discussed below, with the U.S. current account deficit remain-

Table 1.2 ***(concluded)***

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Middle East[8]										
Private capital flows, net[2]	7.9	19.1	–3.1	–2.2	4.5	–4.0	–2.4	–21.0	–31.2	–25.1
Private direct investment, net	8.3	10.1	4.5	3.5	6.8	4.2	11.6	8.8	9.5	11.2
Private portfolio flows, net	–6.8	–2.3	0.7	3.9	–2.9	–4.9	–5.1	–10.5	–15.0	–12.3
Other private capital flows, net	6.4	11.3	–8.3	–9.6	0.5	–3.3	–9.0	–19.3	–25.7	–24.0
Official flows, net	–1.1	7.9	14.3	–33.3	–16.4	–5.5	–44.6	–49.2	–61.6	–57.6
Change in reserves[3]	–16.6	8.9	–1.0	–29.5	–11.3	–3.5	–33.4	–51.2	–81.2	–79.1
Western Hemisphere										
Private capital flows, net[2]	99.6	70.8	38.7	40.5	27.8	3.3	15.2	12.7	22.4	30.3
Private direct investment, net	57.7	62.0	65.9	69.3	71.3	43.8	34.7	45.4	48.7	50.4
Private portfolio flows, net	29.9	25.5	1.0	1.3	–10.0	–15.5	–10.1	–14.2	–8.2	–0.1
Other private capital flows, net	12.0	–16.7	–28.2	–30.1	–33.6	–25.0	–9.5	–18.5	–18.1	–20.0
Official flows, net	5.4	16.9	5.5	–7.4	26.4	19.8	8.7	–7.3	–8.3	–10.5
Change in reserves[3]	–26.4	7.0	11.8	1.6	1.6	–2.3	–35.8	–21.9	–21.3	–13.2
Memorandum										
Fuel exporters										
Private capital flows, net[2]	25.3	17.7	–21.2	–51.8	–13.7	–24.9	4.5	–25.8	–53.6	–41.7
Nonfuel exporters										
Private capital flows, net[2]	173.1	67.0	110.3	112.6	74.7	100.7	144.9	222.4	228.7	235.6

[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. In this table, Hong Kong SAR, Israel, Korea, Singapore, and Taiwan Province of China are included.
[2]Because of data limitations, "other private capital flows, net" may include some official flows.
[3]A minus sign indicates an increase.
[4]The sum of the current account balance, net private capital flows, net official flows, and the change in reserves equals, with the opposite sign, the sum of the capital account and errors and omissions. For regional current account balances, see Table 25 of the Statistical Appendix.
[5]Historical data have been revised, reflecting cumulative data revisions for Russia and the resolution of a number of data interpretation issues.
[6]Consists of developing Asia and the newly industrialized Asian economies.
[7]Excluding the effects of the recapitalization of two large commercial banks in China with foreign reserves of the Bank of China ($45 billion), net private capital flows to emerging Asia in 2003 were $101.1 billion while other private capital flows net to the region amounted to $28.0 billion.
[8]Includes Israel.

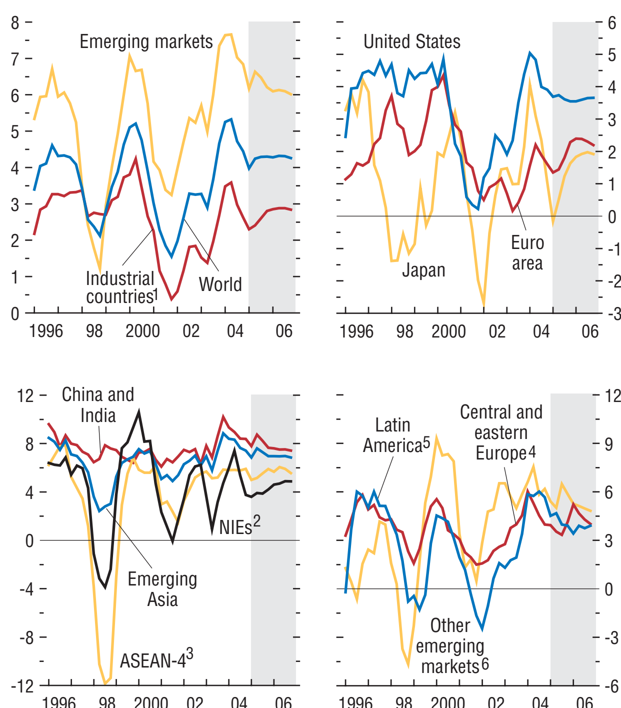
ing at record levels, further—and possibly disorderly—depreciation of the U.S. dollar cannot be ruled out.

- *As the* World Economic Outlook *went to press, oil prices had risen nearly $6 a barrel above the* World Economic Outlook *baseline for 2005; the market remains highly vulnerable to shocks, with significant upside risk over the longer term* (see Chapter IV, "Will the Oil Market Remain Tight?"). In the past, a permanent $5 a barrel increase in oil prices has been expected to lower global GDP growth by up to 0.3 percentage point; in practice, the impact over the last year has been less than feared, partly because higher prices have in part been a consequence of strong global growth, and partly reflecting the greater credibility of monetary policies (so that interest rates have not had to be raised to ward off second-round inflationary effects). The impact of further sharp increases, however, could be more marked, especially if they were to adversely affect confidence or inflationary expectations; there would also be a greater danger of negative supply-side effects over the longer run. Higher oil prices also pose particular risks for cyclically less advanced industrial countries, some heavily indebted emerging markets, and many poor countries.
- *The global expansion is becoming increasingly unbalanced.* Global growth remains unduly dependent on the United States and China; growth in the euro area and Japan—together accounting for nearly one-fourth of global output—has once again been disappointing. If this situation persists, it will widen global imbalances; it would also raise the risks of a more significant slowdown later on, especially if growth in the United States and China were to weaken simultaneously.

Figure 1.7. Global Outlook

(Real GDP; percent change from four quarters earlier)

After some slowdown during 2004, global growth is expected to stabilize at slightly above trend levels in 2005 and beyond.



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, Estonia, Hungary, Latvia, and Poland.

[5]Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

[6]Israel, Russia, South Africa, and Turkey.

In some respects, industrial and developing countries are better placed to manage these risks than they were in the past. Macroeconomic policy frameworks, particularly on the monetary side, have improved; economies have generally become more flexible, albeit to differing extents; financial institutions are more resilient to shocks, as past *Global Financial Stability Reports* have emphasized; and external vulnerabilities in emerging markets have been reduced significantly. That said, the scope for short-term policy maneuver in response to the unexpected is limited, and a combination of shocks—such as lower global growth, higher interest rates, and rising oil prices—could create significant difficulties for many emerging market and developing countries. Moreover, three overarching global vulnerabilities remain, which—while essentially medium-term in nature—are increasingly affecting the short-term outlook.

- *Global imbalances have deepened,* and WEO projections suggest little improvement in the foreseeable future. The U.S. external deficit has so far been financed relatively easily, aided by continued financial globalization. However, the demand for U.S. assets is not unlimited and, as recent market reaction to the possibility of central bank reserve diversification underscores, a continuing sharp rise in U.S. net external liabilities will carry increasing risks (see Chapter III, "Globalization and External Imbalances"). As a matter of arithmetic, a reduction in global imbalances will require domestic demand to grow more slowly than GDP in the United States, and to grow faster than GDP in surplus countries. This will likely need to be accompanied by a further depreciation of the U.S. dollar over the medium term, and by appreciations elsewhere—including in a number of countries in emerging Asia. The broad strategy to address imbalances—medium-term fiscal consolidation in the United States; steps toward greater exchange rate flexibility, supported by continued financial sector reform in emerging Asia; and continued structural reforms to remove

supply constraints, enhance investment efficiency, and boost growth in Europe and Japan—is generally agreed, but implementation has lagged (Box 1.4, "What Progress Has Been Made in Implementing Policies to Reduce Global Imbalances?"). As discussed in more detail below, the pace at which oil-producing countries utilize higher oil revenues will also play an important role.

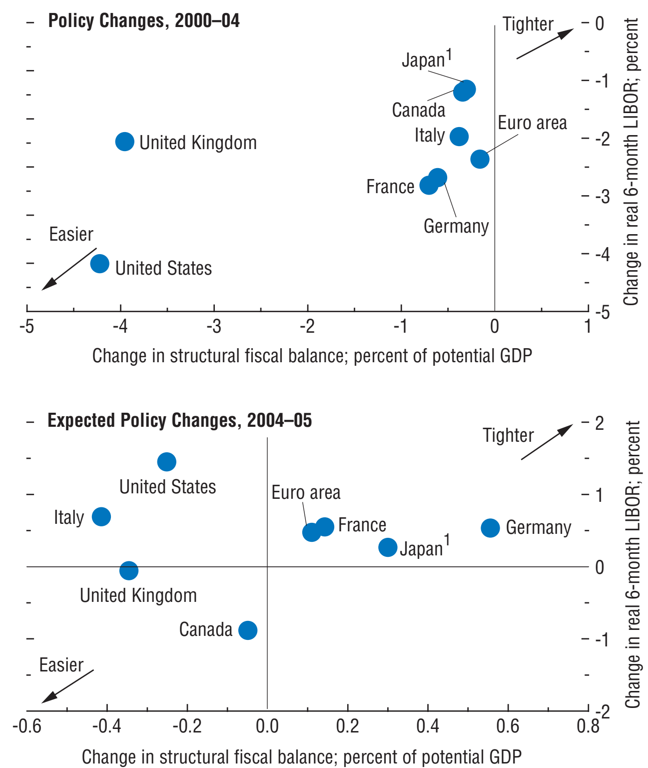
- *Fiscal positions in many countries remain very difficult, posing a significant medium-term threat to macroeconomic stability.* In the largest industrial countries, fiscal deficits remain high—except in Canada—while projected improvements are generally unambitious, and in many cases not underpinned by credible measures (Table 1.3). In emerging markets, fiscal indicators have generally improved, notably in Latin America, but many countries have a long way to go to bring public debt ratios to sustainable levels (between 25 and 50 percent of GDP).[3] Despite some progress, notably in the euro area and Japan, most industrial and emerging market countries remain ill-prepared for coming pressures from aging populations, with health care systems in particular requiring greater attention.
- *Structural weaknesses constrain growth in key areas and increase vulnerability to shocks.* Challenges vary widely across regions, but include accelerating labor and product market reform in the euro area; addressing remaining corporate and financial sector weaknesses in Japan and much of emerging Asia; strengthening the investment climate in Latin America; improving banking supervision in central and eastern Europe; and developing the institutional infrastructure for non-oil sector development in the Middle East.

Beyond the potential risks to macroeconomic stability, these three vulnerabilities pose significant downside risks to global growth. As past *World Economic Outlooks* have noted, history sug-

[3]See "Public Debt in Emerging Markets: Is It Too High?" *World Economic Outlook*, September 2003, for a detailed discussion.

Figure 1.8. Fiscal and Monetary Policies in the Major Advanced Countries

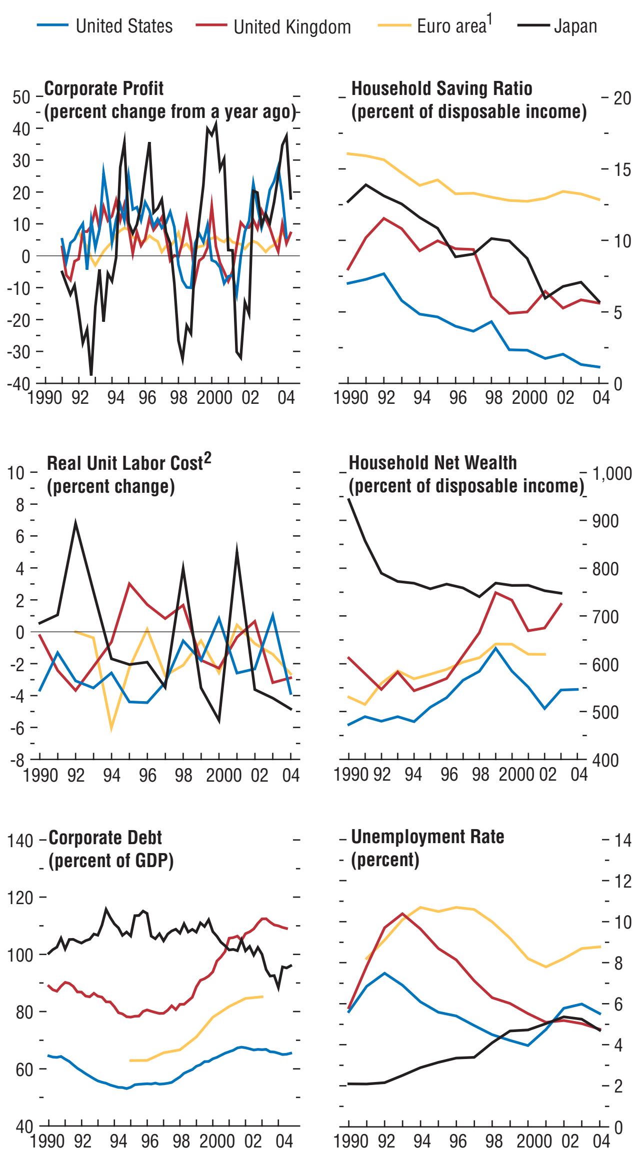
Monetary policies are generally expected to tighten moderately in 2005, although fiscal policies are more mixed.



Source: IMF staff estimates.
[1]For Japan, excludes bank support.

Figure 1.9. Household and Corporate Balance Sheets

Corporate profits have grown strongly, aided by falling unit labor costs. Household savings diverge widely across regions, but in most cases have continued to decline, partly reflecting rising net wealth.



Sources: OECD, *OECD Economic Outlook;* European Central Bank; Haver Analytics; and IMF staff calculations.

[1]Excludes Luxembourg for the household saving ratio. For household net wealth, includes France, Germany, and Italy. For corporate debt, includes Austria, Belgium, Finland, France, Germany, Italy, the Netherlands, Portugal, and Spain.

[2]Unit wage cost for the United Kingdom.

gests that even an orderly adjustment in the U.S. current account imbalance is likely to be accompanied by slower U.S. growth. Given the constraints described above, this is unlikely to be offset by stronger activity elsewhere. Moreover, rising public debt—either implicit or explicit—will put upward pressure on long-run interest rates, as well as increasingly limiting the scope for policy adjustment in response to unexpected shocks. Finally, structural rigidities limit the ability to take full advantage of the opportunities from globalization—including the emergence of China—and technological change.

Against this background, the key policy priorities appear to be the following.

- *First, with policy interest rates generally well below neutral levels, most countries will eventually need to transition toward higher interest rates; however, given the divergences noted above, the appropriate timing and pace increasingly differ.* Among the largest countries, there is a strong case for monetary conditions to be tightened in China to prevent a resurgence of investment; in the United States, a measured pace of tightening remains appropriate for the time being. In contrast, in Japan the quantitative easing policy should remain in place until deflation is firmly beaten; in the euro area monetary policy should remain firmly on hold until a self-sustaining recovery is clearly established, and if present economic weakness persists and inflationary pressures remain subdued, the possibility of an interest rate cut cannot be ruled out. In the event of further dollar depreciation, monetary policy should be increasingly differentiated, with an increased bias toward tightening in the United States and toward easing in countries with appreciating currencies. In emerging markets, the appropriate response varies, but in many cases—notably in emerging Asia—greater flexibility in exchange rates will be necessary. In this connection, while exchange rate appreciation will worsen the current account, it also tends to reduce external debt ratios—owing to the valuation effects discussed in Chapter III—thus helping to improve sustainability.

Table 1.3. Major Advanced Economies: General Government Fiscal Balances and Debt[1]

(Percent of GDP)

	1989–98	1999	2000	2001	2002	2003	2004	2005	2006	2010
Major advanced economies										
Actual balance	–3.5	–1.2	–0.2	–1.8	–4.1	–4.6	–4.2	–4.2	–4.1	–3.0
Output gap[2]	–0.2	0.6	1.4	–0.1	–1.4	–2.0	–1.2	–1.3	–0.9	—
Structural balance	–3.4	–1.4	–1.3	–1.9	–3.6	–3.8	–3.7	–3.7	–3.7	–3.1
United States										
Actual balance	–3.4	0.6	1.3	–0.7	–4.0	–4.6	–4.3	–4.4	–4.2	–2.9
Output gap[2]	–0.8	1.9	2.2	–0.5	–2.0	–2.5	–1.6	–1.3	–1.0	—
Structural balance	–3.1	–0.1	0.5	–0.6	–3.3	–3.7	–3.7	–3.9	–3.9	–3.0
Net debt	54.1	44.6	39.3	38.3	40.9	43.6	45.2	47.0	48.7	51.0
Gross debt	69.5	62.8	57.1	56.6	58.6	60.5	61.0	61.9	62.7	62.3
Euro area										
Actual balance	. . .	–1.3	–1.0	–1.8	–2.4	–2.8	–2.7	–2.6	–2.6	–1.5
Output gap[2]	. . .	0.2	1.6	1.1	—	–1.3	–1.2	–1.5	–1.2	—
Structural balance	. . .	–1.5	–1.9	–2.5	–2.6	–2.4	–2.0	–1.9	–1.9	–1.4
Net debt	. . .	61.8	59.3	59.1	59.1	60.8	61.3	61.6	61.6	59.8
Gross debt	. . .	72.2	69.6	69.6	69.5	70.8	71.2	71.6	71.5	68.9
Germany[3]										
Actual balance	–2.5	–1.5	1.3	–2.8	–3.7	–3.8	–3.7	–3.5	–3.4	–2.0
Output gap[2]	1.1	0.2	1.6	1.1	–0.1	–1.5	–1.1	–1.6	–1.1	—
Structural balance[4]	–3.3	–1.9	–2.5	–3.9	–3.7	–3.5	–3.1	–2.5	–2.3	–1.6
Net debt	38.4	54.9	52.8	53.5	55.5	58.7	61.1	63.6	65.0	66.0
Gross debt	50.3	61.2	60.2	59.4	60.9	63.8	66.1	68.6	69.8	70.3
France										
Actual balance	–3.7	–1.8	–1.4	–1.4	–3.2	–4.2	–3.7	–3.1	–3.1	–1.0
Output gap[2]	–1.0	–0.6	1.2	1.0	—	–1.4	–1.3	–1.4	–1.1	—
Structural balance[4]	–2.9	–1.4	–2.0	–2.1	–3.2	–3.2	–2.7	–2.6	–2.3	–1.0
Net debt	37.7	48.8	47.5	48.2	49.1	53.9	55.4	56.1	56.5	53.3
Gross debt	46.9	58.5	57.1	56.8	58.7	63.6	65.0	65.7	66.2	63.0
Italy										
Actual balance	–8.4	–1.7	–0.6	–3.0	–2.6	–2.9	–3.0	–3.5	–4.3	–3.4
Output gap[2]	—	–0.5	0.7	0.9	—	–1.2	–1.7	–2.2	–1.9	—
Structural balance[4]	–8.2	–1.6	–2.3	–3.6	–3.5	–2.6	–2.6	–3.0	–3.5	–3.4
Net debt	106.6	109.2	105.6	105.5	103.1	103.1	102.6	102.2	102.4	105.7
Gross debt	112.7	115.5	111.2	110.7	108.0	106.3	105.8	105.4	105.5	108.9
Japan										
Actual balance	–1.9	–7.2	–7.5	–6.1	–7.9	–7.8	–7.1	–6.9	–6.5	–6.4
Excluding social security	–4.1	–8.2	–8.0	–6.2	–7.7	–7.9	–7.0	–6.7	–6.1	–5.7
Output gap[2]	0.9	–1.7	–0.4	–1.3	–2.6	–2.3	–0.9	–1.3	–0.5	—
Structural balance	–2.2	–6.5	–7.2	–5.5	–6.8	–6.8	–6.7	–6.4	–6.3	–6.4
Excluding social security	–4.3	–7.8	–7.9	–5.9	–7.1	–7.4	–6.8	–6.4	–6.0	–5.7
Net debt	23.3	53.8	59.3	64.6	71.6	76.0	82.0	88.9	94.3	111.2
Gross debt	85.6	131.0	139.2	148.9	158.5	164.7	169.4	176.0	180.0	187.5
United Kingdom										
Actual balance	–3.7	1.0	3.9	0.8	–1.7	–3.3	–3.0	–3.1	–2.9	–2.4
Output gap[2]	–0.2	–0.1	1.0	0.9	–0.2	–0.7	–0.2	—	—	—
Structural balance[4]	–3.6	0.9	1.3	0.2	–1.9	–3.0	–2.7	–3.0	–2.9	–2.5
Net debt	33.4	40.1	34.3	32.8	32.8	34.6	35.2	36.9	38.0	41.2
Gross debt	43.8	44.7	41.7	38.5	38.1	39.5	40.4	42.0	43.1	46.3
Canada										
Actual balance	–5.1	1.6	2.9	1.1	0.3	0.6	1.4	1.3	1.2	1.4
Output gap[2]	–0.3	0.7	2.1	0.4	0.7	–0.3	–0.4	–0.5	–0.3	0.1
Structural balance	–4.8	1.3	1.9	0.8	—	0.8	1.6	1.5	1.4	1.4
Net debt	78.9	75.4	65.3	59.5	56.5	51.9	47.6	43.9	40.6	28.3
Gross debt	110.5	111.6	101.5	99.1	95.4	90.9	84.3	78.7	73.8	55.6

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

[1]Debt data refer to end of year. Debt data are not always comparable across countries. For example, the Canadian data include the unfunded component of government employee pension liabilities, which amounted to nearly 18 percent of GDP in 2001.

[2]Percent of potential GDP.

[3]Data before 1990 refer to west Germany. 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, 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, in particular 0.5 percent of GDP for France in 2005.

Box 1.1. The Indian Ocean Tsunami: Impact on South Asian Economies

On December 26, 2004, a magnitude 9.0 earthquake occurred off the west coast of Sumatra, Indonesia, setting off a string of tidal waves in the Indian Ocean that caused a natural disaster of tragic proportions. The human toll has been devastating, with over 140,000 people estimated to have lost their lives and a further 150,000 missing. Over 1½ million were displaced from their homes by the disaster. The countries suffering the highest casualties were Indonesia (227,000) and Sri Lanka (37,000), with India (16,500) and Thailand (8,500) suffering major losses as well.[1] Deaths were also reported in Bangladesh, Malaysia, Maldives, and Myanmar, as well as in Seychelles, Kenya, Somalia, and Tanzania.

The human cost of this disaster is clearly beyond measurement. While it is still too early to know the precise economic costs, in some countries and areas they will be sizable. Because so many homes have been destroyed and livelihoods lost, the disaster will cause hardship for hundreds of thousands of individuals. Preliminary damage and needs assessments, undertaken by the World Bank and Asian Development Bank in conjunction with national authorities, have already been completed. Based on these preliminary assessments, damage is estimated at 4½ percent of GDP (2005, pre-tsunami) in Sri Lanka, 1½ percent of GDP in Indonesia, ⅓ percent of GDP in Thailand, and less than ¼ percent of GDP in India. The damage sustained by Maldives, estimated at about one-half of GDP, was far more significant in relative terms than that sustained by the larger countries, owing to extensive damage to infrastructure and tourism facilities.

Despite the considerable physical damage, which will take years to repair, in most cases the disaster is not expected to have a major impact on economic growth. Tourism was one of the hardest-hit sectors, especially in Maldives and Thailand. However, it is expected to recover relatively quickly (with tourists diverting to unaffected areas, such as the western coast of Thailand and Bali), and certainly faster than when severe acute respiratory syndrome (SARS) hit the region in 2003. The other sector that sustained a serious blow was fishing; Sri Lanka is estimated to have lost nearly two-thirds of its fishing fleet. In this case, recovery could take much longer, as it will be difficult for surviving fishermen, many of whom are poor, to finance the acquisition of new boats and fishing gear. Agriculture has also been damaged in some small areas, with paddy production likely to suffer over the medium term from the salinity of the flood waters.

In the near term, the loss of housing and jobs in the most affected sectors and regions will inflict a considerable cost on countless individuals and families. All in all, however, because tourism and fishing account for a relatively small share of national economies, the direct impact of the disaster on total economic growth is likely to be marginal in most countries. And to the extent that reconstruction efforts are launched quickly, growth in the most severely affected countries is likely to meet, or may even exceed, pre-disaster projections. The exceptions to this are Sri Lanka, where growth this year could be reduced by ¾ percentage point, and Maldives, where severe damage to the tourism industry, which accounts for roughly one-third of GDP, could reduce growth by up to 5½ percentage points, to 1 percent. A more modest impact, on the order of ¼ percentage point, is forecast in Thailand. There may be some direct impact on inflation in the most heavily impacted countries as food and transportation prices rise, though this should generally be temporary and limited to the affected areas.

In the most seriously affected countries, public spending is expected to rise considerably to finance reconstruction. In Indonesia, such spending in 2005 is projected at ½ percent of GDP ($1.7 billion), and initial plans in Sri Lanka call for 2½ percent of GDP (about $½ billion) in reconstruction spending this year. In

Note: The author of this box is Andrea Richter Hume.

[1]Figures include the missing, most of whom are presumed dead.

The Indian Ocean Tsunami: Human and Economic Impact on Southern Asia

	Human Toll		Real GDP Growth in 2005[1] (projection, in percent)		Damages[2]		Aid Pledges[3] (US$ millions)
	Dead and missing	Displaced	Pre-tsunami	Post-tsunami	US$ millions	% of GDP	
India	16,389	646,967	6.8	6.8	2,000	0.2	0
Indonesia	>227,000	>425,000	5.5	5.25–5.5	4,500	1.6	3,955
Maldives	108	13,000	6.5	1.0	406	47.0	108
Sri Lanka	36,940	420,259	6.0	5.3	1,000	4.5	308
Thailand	8,438	. . .	5.9	5.6	500	0.3	0
Total	288,875	1,505,226	. . .	. . .	8,406	. . .	4,371

Source: United Nations and national official estimates, and IMF staff projections.
[1]IMF staff estimates.
[2]Based on preliminary damage and needs assessments undertaken by the World Bank and Asian Development Bank in conjunction with national authorities and other international agencies. Uses pre-tsunami forecasts for 2005 GDP.
[3]Represents actual commitments made to date.

Maldives, reconstruction spending during 2005 is expected to amount to 13 percent of GDP ($110 million).

Potentially sizable reconstruction expenditure may present a macroeconomic management challenge to the hardest-hit economies. To the extent that such spending generates demand for imports, the balance of payments will come under pressure, though significant financing should be provided by donors in the form of grants and other assistance (see below). In fact, large aid inflows could also put upward pressure on regional exchange rates, as evidenced already in Sri Lanka. To the extent that such spending falls on domestic products and services, however, it could stoke inflationary pressures, suggesting that monetary authorities will need to remain vigilant.

In most countries, financial assistance from the donor community is expected to play a major role in financing reconstruction. At the annual Indonesia donors' meeting held in mid-January, donors pledged nearly $4 billion to finance reconstruction spending in 2005–09, covering most of Indonesia's tsunami-related financing needs. Of this, roughly $1.7 billion was pledged for 2005. Maldives is expecting about $67 million in disbursements of new grants and concessional loans in 2005. However, substantial additional contributions are needed to close the financing gap. In the case of Sri Lanka, the government expects to receive about $500 million in assistance during 2005. But with public reconstruction projects expected to cost $1½ billion over the next three years, Sri Lanka is seeking additional donor financing to limit the burden on the public purse.

The IMF has been actively engaged in assisting governments in the affected countries cope with the aftermath of the disaster. Assistance is being provided in several ways. On the technical front, the IMF has been supporting government efforts to assess the implications of the disaster for macroeconomic policy, including the likely impact on economic growth, fiscal policy, and the balance of payments. On the financial front, quick-disbursing funds are available under the IMF's emergency assistance for natural disasters policy, designed for cases in which a natural disaster has a large negative impact on the balance of payments. Normally, access of up to 25 percent of a member's quota in the IMF is granted, though access can be larger in exceptional cases. The IMF's Executive Board recently decided to set up an administered account to subsidize emergency assistance for natural disasters provided to its poorest member countries (i.e., those that are eligible for the IMF's Poverty Reduction and Growth Facility).

On March 4, the IMF's Executive Board approved emergency assistance of SDR 4.1 million (about $6.3 million, or 50 percent of quota) for Maldives, and SDR 103.35 million (about $157.5 million or 25 percent of quota) for Sri

Box 1.1 *(concluded)*

Lanka. The approved amounts became available immediately. The rate of charge on the assistance will be subsidized to 0.5 percent a year, subject to resource availability. Sri Lanka is also benefiting from the IMF's policy on repayments, which has allowed it to shift repayments to the more extended "obligations" basis following the disaster. In the case of Indonesia, because the disaster is expected to have only a minor impact on the balance of payments, no request for emergency IMF financing is expected.

The Paris Club of official creditors has offered a debt moratorium to the tsunami-affected countries. In mid-January, they offered a temporary moratorium on debt payments from the countries affected by the natural disaster, until further information from the damage and needs assessments became available. In early March, creditors agreed not to expect any debt repayment on eligible sovereign claims from the affected countries until December 31, 2005. (The moratorium would cover overseas development assistance as well as previously rescheduled commercial credits.) The deferred amounts would be repaid over five years (including one year of grace), and moratorium interest accrued in 2005 would be capitalized and paid with the deferred amounts. The moratorium interest rates would still need to be determined on a bilateral basis with each creditor.

A temporary moratorium on debt service to Paris Club creditors would bolster reserves and help finance reconstruction without requiring offsetting spending cuts or a diversion of domestic financial resources. A one-year moratorium would entail significant debt-service savings in 2005, amounting to $0.3 billion for Sri Lanka and $4½ billion for Indonesia. The Sri Lankan government has welcomed the offer, but has expressed its intention to continue to press for an extension of the moratorium for two more years. The Indonesian government has expressed strong interest in the offer as well. For Maldives, because debt owed to the Paris Club is very small, the debt relief offer is not much help.

India and Thailand, which have sizable foreign reserves, low external public debt, and ready market access, have declined the Paris Club's offer. Thailand has also turned down most other offers of aid, and is planning to self-finance its reconstruction needs. The government has already approved a relief package amounting to about 0.8 percent of GDP ($1½ billion). India has accepted reconstruction loans from the World Bank, the Asian Development Bank, and the United Nations amounting to roughly 0.15 percent of GDP, which will cover most of the estimated damage cost. The government has already released some additional budget spending in calamity relief for the most affected states this year, and next year's budget, announced at end-February, proposes an additional relief package for the Andaman and Nicobar islands.

- *Second, full advantage must be taken of the expansion to address the medium-term risks outlined above.* While this will in many cases require greater policy ambition, increased policy credibility will also be critical. Notably, prompt action—along the lines described above—is needed to assist adjustment in global imbalances. An orderly and gradual adjustment of global imbalances is most likely to be feasible if all countries are playing their part in addressing what is fundamentally a multilateral problem, and if financial markets are convinced that strong and realistic medium-term policy frameworks are in place. If, in contrast, markets start to doubt the resolve of policymakers and simultaneously assess that the current account deficit will become unsustainable at some point, they are likely to sell dollar assets preemptively, substantially raising the risk of an abrupt dollar adjustment.[4]

[4]See Rajan (2004).

- *Third, from a multilateral perspective, successful and appropriately ambitious trade liberalization under the Doha Round remains critical to support medium-term global growth.* The priority now is to translate the mid-2004 framework agreements into a more specific policy package to be taken up at the December 2005 World Trade Organization (WTO) Ministerial Conference in Hong Kong SAR. While there has been considerable progress in agriculture, some key issues—including the transition period for eliminating export subsidies and the depth of cuts to domestic agricultural support—remain to be resolved. This in turn would facilitate more ambitious agreements in areas such as services, where progress has so far been slow.

Finally, most developing countries continue to face enormous challenges in meeting the Millennium Development Goals.[5] While India and China are likely to achieve the goal of halving poverty between 1990 and 2015, on current trends most sub-Saharan African countries will miss this target by wide margins; the outlook for achieving most other key Millennium Development Goals is even less promising. In this connection, even if the IMF staff's relatively upbeat growth forecasts are achieved, in most countries projected growth remains well short of what is required. With macroeconomic stability now broadly achieved, the key remains to press forward with the remaining policy and governance reforms required to improve the growth and investment environment (see the second essay in Chapter II, "Output Volatility in Emerging Market and Developing Countries"). As one element, it will be essential that the benefits of newfound oil resources—as well as other natural resources—be effectively utilized.

To be successful, such efforts must be supported by substantially higher assistance from the international community. To date, despite important progress, developed countries have yet to deliver on the commitments they made in 2002 at Monterrey, commitments that themselves fell well short of what is needed to meet the Millennium Development Goals. As the UN Millennium Project Report (UN Millennium Project, 2005) stresses, the year 2005 should inaugurate a decade of bold action. Two particular priorities are a substantial increase in official development assistance—still less than one-third of the UN target of 0.7 percent of GNP—targeted on those countries with strongest policies and most severe poverty; and a substantial improvement in market access for developing countries under the Doha Round. In this connection, with some three-fourths of the world's poor working in rural areas competing with industrial country farmers who earn one-third of their income from subsidies, an early reduction in agricultural trade barriers is especially important. But it is also worth recalling that developing countries would reap the largest gains from their own trade reforms, underscoring the need for all countries to take full advantage of the Doha Round to liberalize.

United States and Canada: More Ambitious Fiscal Consolidation Is Needed in the United States

In the United States, the slowdown in mid-2004 proved relatively mild. After slowing sharply in the second quarter, consumption growth picked up briskly, reflecting the ebbing impact of higher oil prices, rising equity and house prices, and higher spending on automobiles in response to manufacturers' incentives. Business investment—while still below historical norms at this stage of the cycle—also grew solidly, aided by buoyant corporate profitability, which has been underpinned by continuing strong—albeit slowing—productivity growth that has contained labor costs. While the current account deficit—discussed further below—continued to widen, real GDP growth for 2004 is

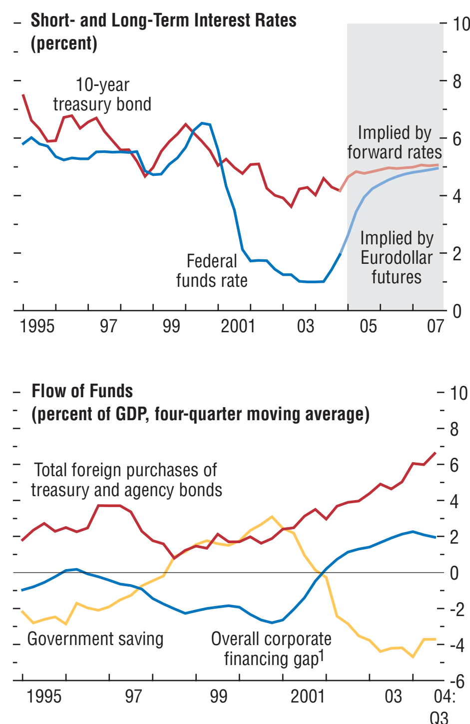
[5]See the April 2005 *Global Monitoring Report* for a full discussion.

Box 1.2. What Are the Risks from Low U.S. Long-Term Interest Rates?

This box examines the reasons for the low level of U.S. long-term interest rates, and assesses the risks to the global economy of an unexpected rise. Dipping below 4 percent in mid-February, nominal yields on 10-year U.S. government bonds have been close to long-term lows and were actually falling even as the Federal Reserve started to raise the federal funds rate (see the figure).[1] Nominal rates subsequently backed up to about 4½ percent in early April, but remained low by historical standards. While the low level of nominal rates partly reflects subdued inflation, a comparison of nominal and inflation-adjusted yields indicates that real returns are also abnormally depressed. This has helped support wealth and domestic spending, including by increasing borrowing in the relatively interest-sensitive mortgage market that has helped buoy house prices.[2]

Low nominal bond yields in part reflect easy monetary conditions and the gradual expected pace of tightening made possible by a high level of monetary credibility. In contrast to earlier episodes of monetary tightening, expectations of future inflation have remained well anchored even as markets project a slow withdrawal of monetary stimulus, partly reflecting a significant level of economic slack that has limited inflationary pressures. The more recent rise in long-term yields can largely be attributed to a partial reversal of these forces due to some increase in inflation concerns as well as expectations of a less gradual tightening. Markets expect the short-term federal funds rate to rise from 2¾ percent currently to some 4 percent by end-2005. As long-term rates reflect the expected future path of short-term rates (plus a liquidity premium) the slow pace of anticipated tightening helps keep long-term rates down—the yield curve implies that 10-year interest rates would rise by some 50 basis points over this period. However, this would still leave nominal and real rates well below historical averages, which Chairman Greenspan has described as "a conundrum."

U.S. Interest Rates and Flow of Funds



Sources: Bloomberg Financial Markets, LP; Haver Analytics; U.S. Federal Reserve Board; and IMF staff estimates.
[1]Nonfinancial plus financial corporate, sign reversed.

Beyond the expected path of monetary policy—and the possibility that markets are simply mispricing—current yields could also reflect a range of factors, including economic fundamentals, structural considerations, and cyclical dynamics. Among these are the following.

- Economic fundamentals appear unlikely to help explain the remaining gap in long-term yields. The U.S. government is projected to continue to run a sizable fiscal deficit over the next few years, implying significant

Note: The author of this box is Calvin Schnure.

[1]Low rates are not simply a U.S. phenomenon, and indeed nominal yields in many industrialized countries are below those on U.S. treasuries.

[2]The outstanding stock of mortgages as a share of GDP is at a record high, having risen by an unprecedented 9 percentage points since 2001, to 61 percent.

issuance of government bonds that will tend to raise real returns. Technological change associated with the information technology (IT) revolution also appears to have raised the trend growth of productivity and real GDP, increasing the rate of return on capital and hence real interest rates (see Laubach and Williams, 2001).

- Structural factors could be playing a role in depressing long-term yields. Greater risk aversion induced a flight to quality after the equity market decline in 2000, increasing demand for government bonds and moderating yields. In addition, regulatory changes such as those encouraging a closer match between the duration of assets and liabilities of pension funds may have also bolstered demand for long-term bonds (these issues are discussed in more detail in the IMF's April 2005 *Global Financial Stability Report*).
- Cyclical factors, in the form of an ample supply of loanable funds, are also likely to be depressing long-term real interest rates. Firms and foreign investors are providing record sums. With buoyant corporate profitability as yet not significantly offset by higher investment, the overall corporate financing gap of nonfinancial and financial businesses has improved by an unprecedented 5 percentage points of GDP since 2001 (see the figure). Over the same period, inflows of foreign capital have risen by a similar ratio, with about half of the increase coming from foreign official purchases of U.S. treasury and agency securities—largely reflecting reserve accumulation in emerging Asia—and the remainder from the private sector. The resulting increase in the supply of funds has more than offset the rapid rise in borrowing by the government over the same period, helping to put downward pressure on real rates.

Against this background, what might be the risks of an unexpected rise in U.S. long-term interest rates? The most benign scenario would be if long-term interest rates were driven upward by a reduction in net loanable funds owing to increased investment by domestic firms. While the rise in rates could have adverse consequences for the domestic housing market and consumption, rising business investment would help offset the effects on aggregate demand. That said, higher U.S. bond yields would have negative spillovers to the rest of the world through borrowing costs, as long-term interest rates are highly correlated across countries and emerging market spreads generally rise in tandem with U.S. long-term rates.

A rise in interest rates unaccompanied by higher aggregate demand—for instance, driven by a weakening of corporate profits or a rise in inflationary pressures—would be a significantly greater concern. One worrisome scenario is that labor productivity growth slows more than currently expected, squeezing profit margins, lowering equity valuations, and driving up wage pressures as slack in labor markets is reduced. Again, the upward pressure on U.S. long-term interest rates would likely dampen demand for housing as well as consumer spending, but with no offset from stronger business investment. Lower domestic demand would also exacerbate international spillovers by reducing demand for foreign goods. More generally, the impact of slower productivity growth could have other negative consequences for growth and inflation in the United States and elsewhere.[3]

Finally, a reduction in the net supply of funds from the rest of the world could generate similar risks for the U.S. economy, but not necessarily for other countries. Such an outcome could reflect a reduced foreign private sector appetite for U.S. assets owing to concerns about the value of the dollar or a tapering of official inflows. The consequences elsewhere would depend upon the reasons for a slowing of funds to the United States. Assuming the slowing largely reflected more pessimistic perceptions of the U.S. economy, it could conceivably increase the funds available in other markets.

[3]Further increases in risk aversion in response to negative shocks in general could provide some offsetting downward pressure on U.S. bond yields through a "flight to quality."

Table 1.4. Advanced Economies: Real GDP, Consumer Prices, and Unemployment
(Annual percent change and percent of labor force)

	Real GDP				Consumer Prices				Unemployment			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Advanced economies	**2.0**	**3.4**	**2.6**	**3.0**	**1.8**	**2.0**	**2.0**	**1.9**	**6.6**	**6.3**	**6.1**	**6.0**
United States	3.0	4.4	3.6	3.6	2.3	2.7	2.7	2.4	6.0	5.5	5.3	5.2
Euro area[1]	0.5	2.0	1.6	2.3	2.1	2.2	1.9	1.7	8.7	8.8	8.7	8.4
Germany	–0.1	1.7	0.8	1.9	1.0	1.8	1.5	1.2	9.6	9.2	9.4	9.2
France	0.5	2.3	2.0	2.2	2.2	2.3	2.0	1.9	9.5	9.7	9.5	8.9
Italy	0.3	1.2	1.2	2.0	2.8	2.3	1.8	1.8	8.7	8.3	8.0	7.6
Spain	2.5	2.7	2.8	3.0	3.1	3.1	3.1	2.7	11.3	10.8	10.3	9.9
Netherlands[2]	–0.9	1.3	1.5	2.2	2.2	1.4	1.4	1.1	3.8	4.6	5.3	5.0
Belgium	1.3	2.7	2.1	2.3	1.5	1.9	2.2	2.0	7.9	7.8	7.8	7.7
Austria	0.8	2.0	2.1	2.3	1.3	2.0	2.0	1.8	4.4	4.5	4.5	4.2
Finland	2.4	3.7	3.1	3.0	1.3	0.1	1.3	1.6	9.0	8.8	8.4	8.1
Greece	4.7	4.2	3.0	3.0	3.4	3.1	3.1	3.1	9.7	8.9	8.8	8.8
Portugal	–1.2	1.0	1.8	2.3	3.3	2.5	2.2	2.2	6.4	6.8	6.8	6.8
Ireland	3.7	5.1	4.8	4.6	4.0	2.3	2.1	2.0	4.6	4.5	4.1	4.0
Luxembourg	2.4	4.4	3.5	3.4	2.0	2.2	2.3	2.4	3.8	4.4	4.8	5.2
Japan	1.4	2.6	0.8	1.9	–0.2	—	–0.2	—	5.3	4.7	4.5	4.4
United Kingdom[1]	2.2	3.1	2.6	2.6	1.4	1.3	1.7	2.0	5.0	4.8	4.7	4.7
Canada	2.0	2.8	2.8	3.0	2.7	1.8	2.1	1.9	7.6	7.2	7.2	7.1
Korea	3.1	4.6	4.0	5.2	3.5	3.6	2.9	3.0	3.4	3.5	3.6	3.3
Australia	3.4	3.2	2.6	3.3	2.8	2.3	2.7	2.7	6.1	5.5	5.1	5.3
Taiwan Province of China	3.3	5.7	4.0	4.3	–0.3	1.6	1.6	1.5	5.0	4.6	4.3	4.2
Sweden	1.5	3.5	3.0	2.5	2.3	1.1	1.6	2.4	4.9	5.5	5.1	4.4
Switzerland	–0.4	1.7	1.2	2.0	0.6	0.8	1.2	1.0	3.4	3.5	3.7	3.5
Hong Kong SAR	3.2	8.1	4.0	4.0	–2.6	–0.4	1.0	1.1	7.9	6.8	5.7	4.9
Denmark	0.4	2.3	2.2	1.9	2.1	1.2	2.0	1.8	5.8	5.9	5.6	5.5
Norway	0.4	2.9	3.7	2.8	2.5	0.4	1.4	2.1	4.5	4.4	4.0	4.0
Israel	1.3	4.3	3.7	3.6	0.7	–0.4	1.0	2.0	10.8	10.4	9.8	9.5
Singapore	1.4	8.4	4.0	4.5	0.5	1.7	1.5	1.5	4.7	4.0	3.6	3.4
New Zealand[3]	3.4	5.0	2.8	2.6	1.8	2.3	3.0	2.7	4.6	3.9	3.8	4.2
Cyprus	1.9	3.7	3.8	4.0	4.1	2.3	2.5	2.5	3.5	3.4	3.2	3.0
Iceland	4.3	5.7	5.4	2.5	2.1	3.1	3.4	3.5	3.3	3.1	2.3	1.7
Memorandum												
Major advanced economies	2.0	3.3	2.5	2.9	1.7	2.0	1.9	1.8	6.7	6.3	6.2	6.0
Newly industrialized Asian economies	3.1	5.5	4.0	4.8	1.5	2.4	2.2	2.3	4.3	4.1	4.0	3.7

[1]Based on Eurostat's harmonized index of consumer prices.
[2]The consumer price forecast does not include any possible statistical effects from the planned reform of the health care system in 2006.
[3]Consumer prices excluding interest rate components.

estimated to have reached 4.4 percent, significantly above potential (Table 1.4).

With incoming data generally robust, and business and consumer confidence strong, the outlook for 2005 is encouraging. GDP growth is projected to average 3.6 percent, somewhat higher than expected in the September 2004 *World Economic Outlook,* with a moderation in private consumption growth—reflecting the gradual withdrawal of fiscal and monetary stimulus and some rebuilding of household savings—offset by continued strength in investment. The risks to the forecast appear broadly balanced, with upside risks from the strength of corporate balance sheets, as well as rising housing and equity prices, offset by the possibility of a more pronounced rebound in household savings, higher long-run interest rates (see below), and continued oil price volatility.

The current account deficit has, however, continued to widen—to 5.7 percent of GDP for 2004 (Table 1.5)—despite the significant nominal effective depreciation of the dollar over the past three years. In part, this can be explained by faster growth in the United States relative to its advanced economy trading partners over the

Table 1.5. Selected Economies: Current Account Positions
(Percent of GDP)

	2003	2004	2005	2006
Advanced economies	**–0.8**	**–1.0**	**–1.1**	**–1.1**
United States	–4.8	–5.7	–5.8	–5.7
Euro area[1]	0.3	0.4	0.5	0.5
Germany	2.2	3.6	3.8	3.4
France	0.3	–0.3	–0.4	–0.1
Italy	–1.5	–1.5	–1.3	–0.9
Spain	–2.8	–5.0	–4.8	–5.4
Netherlands	2.9	3.4	4.2	4.5
Belgium	4.4	4.2	4.3	4.2
Austria	–0.9	–0.7	–1.0	–1.1
Finland	4.2	4.5	4.7	5.0
Greece	–6.2	–4.1	–3.5	–3.2
Portugal	–5.5	–7.9	–7.1	–6.9
Ireland	–1.4	–1.5	–1.7	–1.4
Luxembourg	9.4	7.1	9.2	10.1
Japan	3.2	3.7	3.3	3.5
United Kingdom	–1.7	–2.2	–2.3	–2.4
Canada	2.0	2.6	2.6	2.5
Korea	2.0	3.9	3.6	2.9
Australia	–5.9	–6.4	–5.6	–5.7
Taiwan Province of China	10.2	6.2	6.6	5.9
Sweden	7.6	8.1	6.1	7.0
Switzerland	13.2	12.0	11.1	11.3
Hong Kong SAR	10.3	9.6	9.4	9.3
Denmark	3.0	1.4	1.9	1.7
Norway	12.8	13.7	16.2	14.9
Israel	0.1	0.1	–0.2	—
Singapore	29.2	26.1	23.4	22.9
New Zealand	–4.2	–6.2	–6.4	–6.6
Cyprus	–3.4	–4.1	–3.4	–2.7
Iceland	–4.1	–5.2	–10.1	–11.8
Memorandum				
Major advanced economies	–1.6	–1.7	–1.9	–1.8
Euro area[2]	0.3	0.6	0.4	0.4
Newly industrialized Asian economies	7.4	7.1	6.8	6.2

[1]Calculated as the sum of the balances of individual euro area countries.
[2]Corrected for reporting discrepancies in intra-area transactions.

same period, and the lags with which exchange rate changes can be expected to feed through to net exports.[6] Indeed, little improvement is expected over the medium term, for a number of reasons: the growth differential in favor of the United States is expected to persist, offsetting some of the lagged effects of exchange rate movements; planned medium-term fiscal adjustment is insufficiently ambitious in contributing to increased national savings; and private investment levels are expected to catch up with historical norms. In addition, the combination of higher U.S. interest rates and rising net foreign liabilities will lead to an inexorable rise in interest payments abroad.

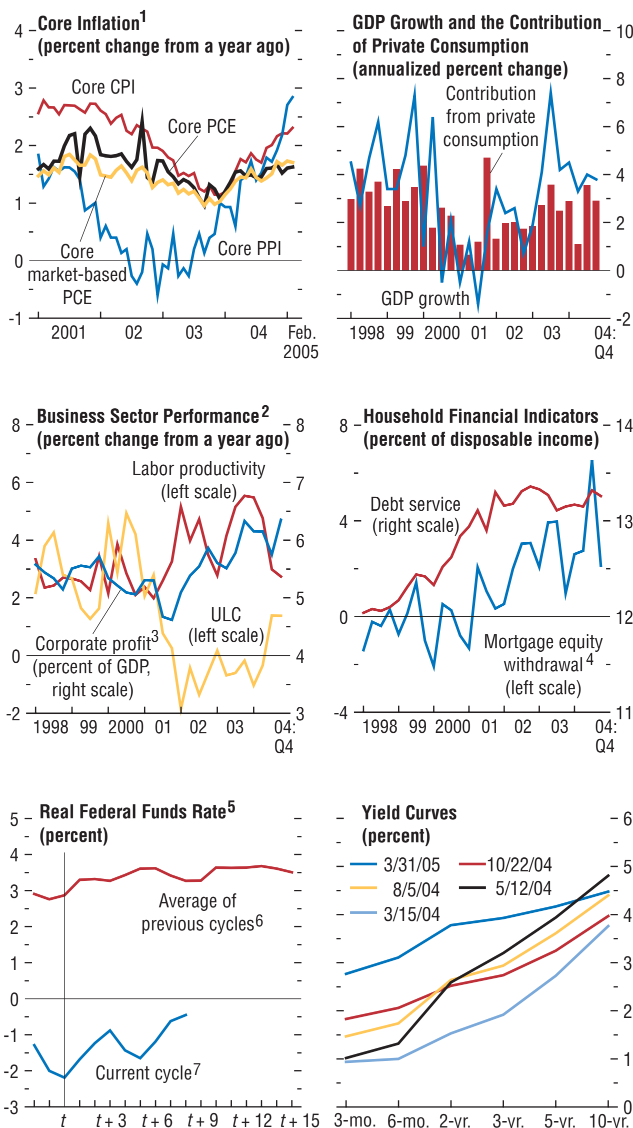
The market's concerns about the medium-term sustainability of the current account deficit have been the main factor driving the weakening of the U.S. dollar, although financing of the deficit thus far has not been a problem. Portfolio investment into the United States by both private and official investors has remained resilient despite the dollar's weakening. Foreign investors maintained a steady demand for debt securities, including treasury, agency, and corporate bonds throughout 2004, and they also stepped up purchases of equities by the end of the year. Purchases of securities originating or routed through Europe dominated, supported by rising Japanese investor interest in high-grade bonds and a pickup in official purchases from Asia late in the year.

Inflationary pressures have remained generally modest owing to the continued presence of economic slack and benign labor market conditions (Figure 1.10). Core inflation indicators have edged up, but second-round effects of the increase in oil prices have been generally well contained. The latter is, in part, attributable to the clear communication strategy of the Federal Reserve, which also ensured an orderly market response once the tightening cycle got under way in June 2004. Looking ahead, however, policy rates still have significant room to rise from their current low real levels before monetary policy becomes more neutral. The Federal Reserve's policy of tightening at a measured pace therefore remains appropriate for the time being, conditional on signs of inflationary trends in incoming economic data releases. The main risks to inflation are from pressures in the labor

[6]Federal Reserve Chairman Greenspan recently (in remarks at the Advance Enterprise 2005 Conference, February 4, 2005) suggested that increased hedging and greater variability in profit margins of foreign exporters may have lengthened the lag with which exchange rates affect net exports.

Figure 1.10. United States: Selected Financial and Economic Indicators

Inflation and interest rates remain subdued, and domestic demand is robust.



Sources: Haver Analytics; and IMF staff calculations.
[1]Excluding food and energy. PCE refers to personal consumption expenditure.
[2]Labor productivity and unit labor cost (ULC) in the nonfarm business sector. Corporate profit is after-tax profit without inventory valuation and capital consumption adjustments.
[3]After-tax corporate profit without inventory valuation and capital consumption adjustments.
[4]Defined as home mortgage borrowing less nominal residential investment.
[5]Federal funds rate minus year-over-year CPI inflation.
[6]Includes four tightening cycles, which began in March 1984, August 1987, April 1994, and July 1999 based on the Federal Reserve Board's discount window borrowing rate.
[7]Tightening began in June 2004 based on the Federal Reserve Board's discount window primary credit.

market, as slack diminishes and labor productivity slows, as well as from a further rise in oil prices.

A striking feature of the current conjuncture has been the persistently low level of long-term interest rates, although they have risen by some 60 basis points since early February (Box 1.2). From the beginning of the current U.S. monetary tightening cycle through early February, long-term interest rates actually declined as investor interest in fixed income securities persisted and inflationary expectations remained well anchored, leading to a substantial flattening of the yield curve. This, in turn, is likely to have moderated the impact on economic activity of the increase in policy interest rates. Adverse inflation surprises, a further weakening of the dollar and a sudden portfolio shift out of U.S. securities, a large-scale switch into equities from bonds, or increased long-term borrowing by the corporate sector all have the potential to lead to further upward pressures on long-term interest rates. Corporate balance sheets, after several years of restructuring, appear reasonably resilient to any abrupt long-term rate rises, but segments of the household sector, especially if faced with significantly slowing housing prices, may be forced to increase savings rapidly. The financial market impact of a sharp rise in interest rates is difficult to assess, but the long period of low interest rates and consequent risk taking may well have created pockets of exposure highly vulnerable to unexpected interest rate increases, and market intermediaries and regulators need to be vigilant to signs of emerging stresses.

The U.S. fiscal deficit (as a percentage of GDP) is now the largest among the major advanced economies, with the exception of Japan. Fiscal consolidation presents an important policy challenge going forward, both to ensure medium-term fiscal sustainability in the United States and to facilitate an orderly reduction in global current account imbalances. The U.S. administration's FY2006 budget proposal reiterates its commitment to halve the central government deficit by 2009, although a slight

Box 1.3. The Ending of Global Textile Trade Quotas

On January 1, 2005, quantitative restrictions that had been limiting trade in textiles and clothing for the past 40 years were eliminated. Up to the end of the Uruguay Round in 1994, trade in textiles and clothing was governed by over 1,300 bilateral quotas as part of the Multifiber Arrangement (MFA). In 1995, the MFA was replaced by the World Trade Organization (WTO) Agreement on Textiles and Clothing (ATC), which set a 10-year transitional period for the phasing out of the quotas. In practice, liberalization took place mostly at the beginning of 2005. Of the four WTO members that maintained import restrictions under the MFA, only Norway eliminated its quotas ahead of schedule.[1] In contrast, Canada, the European Economic Communities (EEC), and the United States backloaded liberalization. As a result, 83 percent of quotas covering about 80 percent of the value of imports under quotas during the ATC's reference period were left to be eliminated in 2005.

The quota expiry affects an important share of developing country exports. The United States and European Union alone accounted for more than half of the almost $400 billion in world imports of textiles and clothing in 2003, and developing countries for almost two-thirds of world exports. For about half a dozen countries textiles and clothing exports represent more than 50 percent of total exports. Unsurprisingly, therefore, during much of the 1990s, developing countries criticized the European Union and the United States for the slow pace of their liberalization.

Recently, however, there have been increasing concerns about the impact of liberalization. While developing countries overall are expected to benefit significantly in terms of exports and employment, the gains will be distributed unevenly. The quota system ended up protecting the export markets of the less competitive developing country exporters. Thus, some countries may face balance of payments pressures stemming from the liberalization as well as significant adjustment costs—the textiles and clothing industry often accounts for a disproportionate share of manufacturing employment and is geographically concentrated.

Experience from the elimination of earlier quotas, model simulations, and exporters' relative success in quota-free markets all indicate that only a handful of countries—in particular, China, India, and Pakistan—may end up reaping the benefits of liberalization. The phasing out of some textiles quotas in 2002 led to a sharp change in the structure of imports into the European Union and the United States. For these products, only China, Romania, and the Czech Republic were able to increase their exports to the European Union, while only China, Pakistan, and India increased their exports to the United States. Moreover, because of increased competition, the elimination of quota premia, and sluggish global demand, unit prices decreased substantially.

The table presents the results of an IMF staff simulation with the GTAP model of international trade. A flurry of other published simulations of the impact of the quota expiry virtually all come to similar conclusions.[2] The experience of traditionally quota-free countries also suggests that the liberalization might lead to a consolidation in the number of source countries and confirms the competitive strength of China, India, and Pakistan. China accounts for more than half of imports of clothing into South Africa, Australia, and Japan, which were quota-free markets. (Interestingly, China's share in Switzerland's imports of clothing did not increase and remained at the low level of about 10 percent.) China's potential exports attract

Note: The author of this box is Jean-Jacques Hallaert. Yongzheng Yang ran the GTAP simulation.

[1]In 1994, the MFA had 44 members, but only 6 participants (Canada, the EEC, the United States, Norway, Austria, and Finland) applied restraints under the Arrangement. Austria and Finland joined the EEC in 1995.

[2]For a review of quantitative studies, see OECD (2004).

Box 1.3 *(concluded)*

Impact of Quota Elimination on Textiles and Clothing Exports

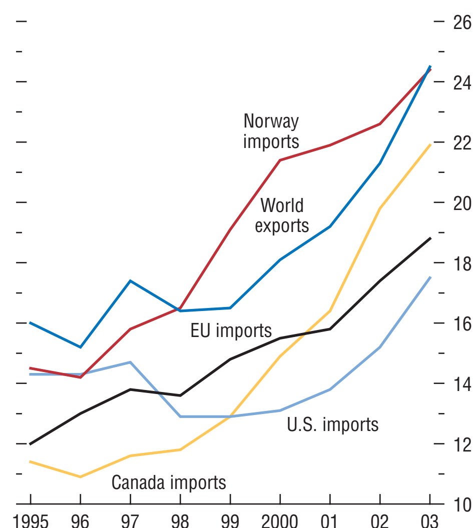
	Exports	
	Billions of 1997 U.S. dollars	Changes in percent
Developing countries	19.0	9.6
China	24.2	51.2
India	10.3	97.2
Rest of south Asia	1.5	12.1
Middle East and north Africa	–2.8	–29.9
Mexico	–3.3	–44.4
Central America and Caribbean	–4.3	–47.3
South America	–0.2	–7.0
Southern African Customs Union	–0.2	–21.3
Rest of sub-Saharan Africa	–0.4	–21.6

Source: IMF staff simulation with the Global Trade Analysis Project (GTAP) model.

Note: For a description of the GTAP modeling framework, see Hertel (1997). The model uses data for 1997. As a result, recent regional trade arrangements and preferential schemes such as the Everything but Arms (EBA) initiative and the African Growth and Opportunity Act (AGOA), which have an impact on textiles and clothing trade, are not taken into account.

China's Share of Textiles and Clothing Trade

(Percent)[1]



Source: World Trade Organization.

[1]China's share of world exports of textiles and clothing; and China's share of imports of textiles and clothing by Canada, European Union, the United States, and Norway.

much attention because while China already accounts for a rapidly growing share of world textiles and clothing exports (see the figure), its market share is expected to increase still further in the period ahead. And indeed, dynamic growth in China's imports of textiles and clothing machinery suggests that production capacities are building up.

The prospects for rapid and substantial change in world markets have prompted protectionist action targeting mainly China. Calls by some developing countries at the WTO to extend the quota system for a number of additional years were unsuccessful. U.S. manufacturers have filed a flurry of petitions under the special textiles safeguards included in China's WTO accession protocol, which allows limiting temporarily the increase in imports of Chinese textiles and clothing products that cause "market disruption." In contrast, the European Commission has not yet taken recourse to safeguards, but has indicated that it would take action if Chinese imports were diverted to the EU market as a result of U.S. safeguards. The European Commission has also proposed to exclude imports of Chinese textiles and clothing from its Generalized System of Preferences scheme (GSP). Finally, both the European Union and the United States have publicly called on the Chinese authorities to take steps to moderate China's exports of textiles and clothing. China announced recently that it would impose export taxes on 146 categories of textiles and clothing exports. (Turkey also imposed safeguards against Chinese exports. Argentina has established the legal framework for the use of safeguards against Chinese exports.)

Model simulations suggest that restraining Chinese exports may slow the speed of structural change in the textiles and clothing sector but would not eliminate it, in part because other competitive suppliers—for example, in south Asia—could be expected to take advan-

tage of restrictions on China. Moreover, this process is likely to distort the world market—distortions that the ATC intended to eliminate. Because quotas limited exports from efficient producers, importers such as retailers maintained a diversified supplier network, which they intend to streamline substantially when the quotas are eliminated. But the protectionist activity appears to have sown uncertainty, prompting importers to maintain a more diversified sourcing structure than they otherwise might have. As a result, the adjustment shock on less competitive suppliers would be lessened, though one would expect this effect to gradually weaken over time.

How should countries respond to the competitive challenge? The appropriate response is specific to country circumstances. In some cases, countries may be able to specialize in particular market niches. A common theme must surely be to tackle avoidable export hurdles. This might include cutting red tape, ensuring that access to low-priced inputs is not encumbered by import barriers or financing restrictions, ensuring the most efficient transport logistics, and creating an environment that favors investment.

increase in the nominal deficit is projected this fiscal year, largely reflecting supplemental funding for Iraq and Afghanistan. Medium-term fiscal plans are, however, not ambitious enough, and there are substantial risks that even they will not be achieved. Current budgetary plans assume historically tight expenditure restraint—with an envisaged reduction in nondefense discretionary spending to its lowest share of GDP in over 40 years—and do not include additional funding for Iraq and Afghanistan or the costs of reforming the Alternative Minimum Tax and social security.

Looking ahead, fiscal policies should aim for structural balance, excluding Social Security, over the course of the economic cycle. This objective would require a reduction of the deficit by 1 percentage point of GDP each year through the rest of the decade. With limits to discretionary spending cuts, broadening the tax base—including by shifting toward a more consumption-based system—will need to play an important role toward more ambitious consolidation. The recent appointment of a bipartisan panel on tax reform could play a facilitating role in these endeavors, including by exploring the potential for measures such as reducing the wide array of tax write-offs. The recent emphasis on Social Security reform is also welcome, but personal retirement accounts will not be sufficient to place the program on a financially sound footing to avoid widening fiscal deficits and rising debt in the coming decades, and will entail significant transition costs in the medium term. The priority needs to be on eliminating the funding deficits of the system by slowing benefit growth and/or increasing contributions. The much larger unfunded liabilities of the Medicare system also need attention, with the recent drug benefit plan exacerbating the system's enormous funding gap.

In Canada, growth recovered to 2.8 percent in 2004, aided by booming commodity prices. The economy is expected to maintain its momentum in 2005 underpinned by strong gains in employment and solid corporate earnings. With signs of shrinking economic slack, the Bank of Canada began to gradually withdraw stimulus in the fall, but has paused more recently in response to the currency's appreciation and little sign of inflation and wage pressures. A measured and patient pace of tightening remains appropriate in this context. Fiscal policy has contributed to maintaining the sound macroeconomic performance, with the general government running a significant surplus. In light of the implications of changing demographics, the government's ongoing plan to reduce debt ratios is appropriately ambitious, but priority also needs to

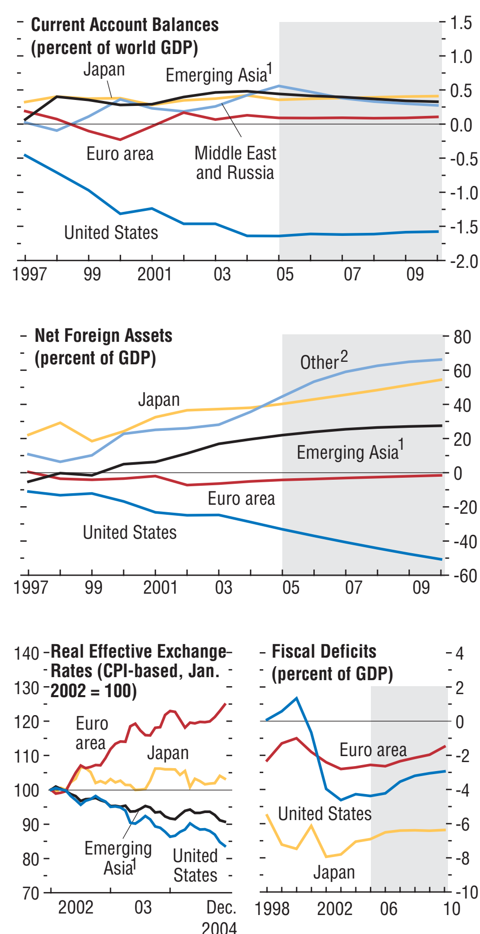
Box 1.4. What Progress Has Been Made in Implementing Policies to Reduce Global Imbalances?

Global imbalances have become more accentuated over the past year. In the United States, the current account deficit has widened to 5.7 percent of GDP, while the surplus in Japan has increased. Emerging Asia has continued to run a large current account surplus, and current account surpluses have increased in the Middle East and Russia as high oil prices have provided a significant boost to export revenues—in dollar terms, these surpluses are currently of a magnitude broadly similar to those in emerging Asia and Japan. As a result of these developments, the net external liabilities of the United States, equivalent to 25 percent of GDP and over 250 percent of exports at end-2003, have increased further, and the net external assets of emerging Asian countries, Japan, the Middle East, and Russia have risen.

Since one country's deficit is another country's surplus, policies to support an orderly resolution of global imbalances are a shared responsibility. In the Communiqué of the last meeting of the International Monetary and Financial Committee (IMFC) in October 2004, IMF Governors therefore underscored the importance of progress in several areas, including medium-term fiscal consolidation in the United States; steps toward greater exchange rate flexibility in emerging Asia, accompanied by continued financial sector reform, as appropriate; and continued structural reforms to boost growth in Europe and Japan. While there has been some progress toward implementing the strategy outlined above, it remains limited.

- In its recent budget, the U.S. administration reiterated its commitment to halve the central government fiscal deficit by 2009. The IMF staff continues to believe that this objective is insufficiently ambitious; moreover, there are substantial risks that it will not be achieved, since the projections exclude any additional funding for Afghanistan and Iraq; do not take into account the costs of reforming the Alternative Minimum Tax or of Social Security reform; and assume an unprecedented degree of expenditure restraint.
- There has been some progress in advancing structural reforms in Europe—including labor market reforms in Germany (Hartz IV) and France (allowing an enterprise to negotiate

Global Current Account Imbalances



[1]Consists of China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, and Thailand.

[2]Consists of Egypt, Jordan, Kuwait, Oman, Russia, and Saudi Arabia.

Note: The main authors of this box are Tim Callen and Gian Maria Milesi-Ferretti.

deviations from the 35-hour work week collectively with its labor force) and raising the effective retirement age in Italy—but, overall, the implementation and impact of the Lisbon strategy have been mixed at best, and reform fatigue has set in early. The European Commission has therefore recently proposed to prioritize the reform agenda, focusing more directly on measures to raise productivity and increase employment, although the recent rejection of the European Commission proposals to liberalize trade in services is a setback to reform efforts. In Japan, banks have continued to strengthen their balance sheets—nonperforming loans have declined further and capital positions have improved—and indicators of corporate financial health have improved. However, as discussed in the main text, significant problems remain, underscoring the need for further progress. Little has been done to tackle the inefficient nontraded goods sector.

- In emerging Asia, some currencies—including the Korean won, Thai baht, Taiwan dollar, and the Indian rupee—have exhibited somewhat greater flexibility against the U.S. dollar since mid-2004. Elsewhere, no concrete actions have been taken, although preparations for more flexible exchange rate management have continued—including through ongoing efforts to strengthen the banking system in China. In terms of financial sector reforms—which are key to sustaining stronger domestic demand in many of the NIEs and ASEAN-4—financial soundness indicators continue to improve,[1] but significant challenges remain, including further reducing high nonperforming loans and accelerating progress in debt restructuring in Taiwan Province of China and Thailand and addressing the household debt delinquency problem in Korea.

In sum, despite some progress, a credible policy package to address the imbalances over the medium term does not yet appear to be in place. Indeed, the current *World Economic Outlook* projections—which are based on the assumption of constant real exchange rates—envisage little change in the current constellation of global imbalances over the medium term. Specifically, the U.S. current account deficit remains around 5.5 percent of GDP while the surplus in Japan increases to over 4 percent of GDP. Surpluses in emerging Asia, the Middle East, and Russia are projected to narrow, although this will importantly depend on reforms to boost domestic demand in emerging Asia and on the pace at which higher oil revenues are spent in the latter two. The lack of progress in reducing imbalances clearly raises risks in the future. An abrupt decline in investors' appetite for dollar-denominated liabilities—a low-probability but high-cost event—could engender a rapid dollar depreciation and a sharp increase in U.S. interest rates, with potentially serious adverse consequences for global growth and international financial markets.

Finally, it should be noted that the global current account discrepancy widens by 0.4 percentage point of world output during 2004–10, indicating growing multilateral inconsistency in the projections. While some rise in the discrepancy is normal in an environment of rising interest rates and slowing global trade growth,[2] this nonetheless represents an additional important uncertainty about the future behavior of global imbalances.

[1]See Chapter II of the April 2005 *Global Financial Stability Report* for a detailed discussion.

[2]See Appendix II, Chapter 1, of the October 2000 *World Economic Outlook* for a detailed discussion.

continue to be given to structural reforms aimed at boosting productivity growth and economic flexibility. Fundamental reforms to increase the efficiency of health care systems are also needed to cope with emerging demographic pressures.

Western Europe: Renewed Concerns About the Strength of the Recovery

The modest recovery that had taken place in the euro area since mid-2003 lost momentum during the second half of 2004. Domestic demand has remained subdued against the backdrop of high and volatile oil prices and long-standing structural weaknesses, while slower global growth and the appreciation of the euro have undercut export growth, which was a key driver of the economy in the first half of 2004. Strong profit growth has yet to feed into a decisive upturn in investment spending as companies continue to focus on restructuring their balance sheets, while slow wage and employment growth and lagging confidence have held back consumption. As a result, area-wide GDP grew by just 0.2 percent (quarter-on-quarter) in both the third and fourth quarters of 2004. Activity contracted in Germany, Italy, the Netherlands, and Greece in the fourth quarter, but growth accelerated in France and Spain.

Economic indicators in early 2005 have been very mixed. While industrial production and retail sales in the euro area firmed in January, business and consumer confidence have generally been weak. Against this background, the 2005 growth forecast has been revised down to 1.6 percent (compared with 2.2 percent in the September 2004 *World Economic Outlook*). Underlying this projection is the assumption that growth will gradually pick up during the course of the year, although at a slower rate than previously expected. The favorable global environment is expected to underpin exports, investment should strengthen as corporate profits remain healthy, and a gradual improvement in the labor market is expected to support a pickup in consumer spending. The risks to this outlook, however, lie predominantly on the downside.

- Growth remains overly reliant on global developments, particularly in Germany, where external demand accounted for three-fourths of growth in 2004. German exports have grown strongly, boosted by the marked decline in unit labor costs and the favorable export structure—a high share of IT-related goods, a high proportion of exports going to China and the United States, and limited exposure to competition in third markets from emerging Asian countries (Figure 1.11). However, if large global current account imbalances put renewed upward pressure on the euro, or the downturn in the IT sector is more prolonged than expected, export growth will be affected.
- High and volatile oil prices, a drop in business confidence, an increase in household saving in the face of ongoing uncertainties about future pension and healthcare reforms, or a sharp drop in house prices in some countries—notably Ireland and Spain—could hold back domestic demand.

Headline inflation in the euro area continues to hover around 2 percent owing to the effects of oil price increases and hikes in indirect taxes and administered prices. Underlying price pressures, including wage and unit labor costs, however, are well contained—consumer price index (CPI) inflation excluding energy, food, alcohol, and tobacco was 1.4 percent in February 2005, compared with 2 percent in mid-2004—and headline inflation is expected to fall below 2 percent later this year as the impact of one-off factors wane. In these circumstances, monetary policy should remain firmly on hold until a self-sustaining recovery is clearly in place. Indeed, a further cut in interest rates cannot be ruled out if current economic weakness or a further appreciation of the euro were to result in lower-than-expected inflation.

Although fiscal deficits in the euro area are smaller than in the other major currency areas, public debt levels are high, and policy settings remain insufficient to deliver the budgetary adjustments required to cope with the fiscal pressures of population aging. The euro area–wide fiscal deficit is estimated at 2.7 percent of GDP in 2004, with deficits in France, Germany, and Greece all exceeding 3 percent of GDP. Budgets for 2005 envisage varying degrees of fiscal consolidation across the euro area. Although budgetary adjustments are projected in France and Germany, they rely on one-off measures, and questions remain whether the

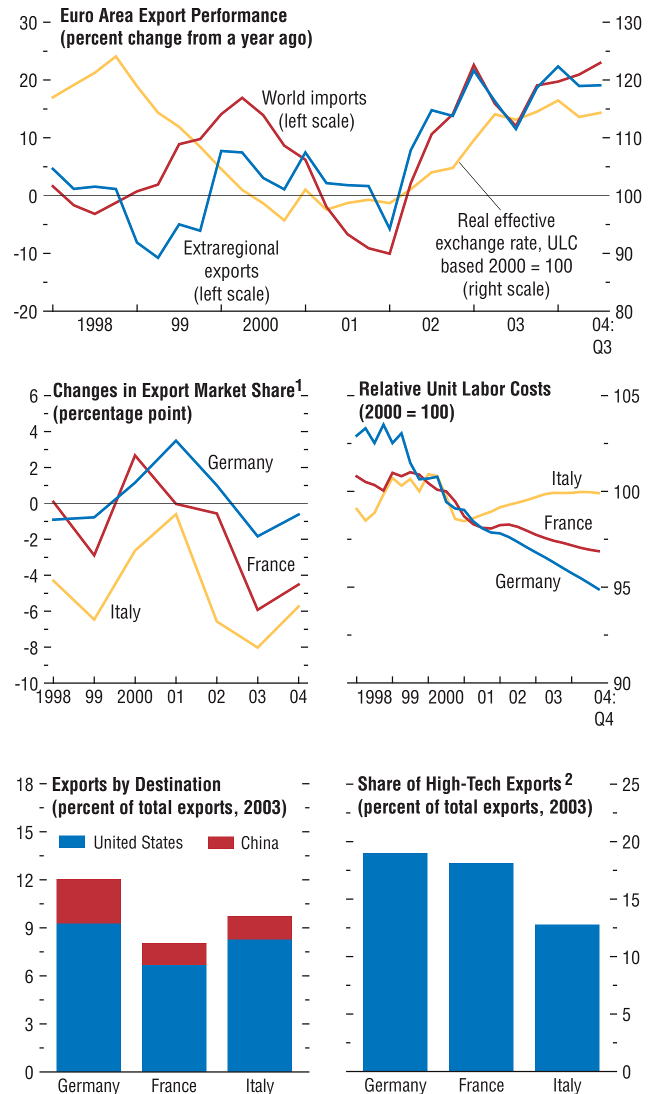
policies are in place to achieve and sustain the targets, while in Italy the budget deficit is projected to increase substantially. A faster-than-currently-planned pace of fiscal consolidation is needed in countries with weak budget positions, based on high-quality measures, allowing the automatic fiscal stabilizers to operate around the adjustment paths.

Reforms to the Stability and Growth Pact (SGP) have recently been agreed in Europe. The agreement provides governments with significant additional fiscal policy flexibility. It does not, however, strengthen enforcement mechanisms under the pact, which have proved ineffective in the past (France and Germany have been in breach of the deficit limit for three successive years and there has been fiscal misreporting by Greece), nor the incentives to adjust in good times—the Achilles' heel of euro area fiscal policies. A strong fiscal framework clearly remains an essential part of monetary union in Europe, and it is important that the implementation of the reformed SGP restore the credibility of the framework. In the final analysis, this credibility depends on fiscal policies at the national level, particularly in the larger countries. The reformed SGP's encouragement of better domestic governance arrangements is thus welcome. The establishment of national budgetary councils to publish independent assessments of budgetary policies and the long-term sustainability of public finances could be helpful in fostering transparency and greater public awareness and debate about appropriate fiscal policies.

Structural reforms need to be at the heart of Europe's efforts to improve its growth performance; higher potential growth, in turn, would help strengthen the medium-term fiscal position and facilitate the operation of the SGP. Labor utilization rates need to be raised in the face of stagnating working-age populations, while total factor productivity growth in the euro area has not matched the acceleration seen in recent years in the United States. But, as the High-Level Group headed by Mr. Wim Kok recently concluded, progress with implementing the structural reform agenda in Europe has at

Figure 1.11. Western Europe: Export Performance in Germany, France, and Italy

Despite exchange rate appreciation, export performance in the euro area has been robust. It has, however, varied across countries, with Germany outperforming, and France and Italy underperforming. Trends in unit labor costs and export structures have contributed to these differing performances.



Sources: IMF, *Direction of Trade Statistics;* United Nations Commodity Trade database; and IMF staff calculations.

[1]Calculated as export volume growth minus partner countries import volume growth.

[2]Defined as exports of pharmaceutical products, office and data processing machines, telecommunications equipment, electrical equipment, and scientific instruments.

best been mixed over the past five years. On the positive side, in centrally led areas, such as the Financial Services Action Plan, important progress has been made, while reforms have also been initiated at the national level, including pension, health care, and labor market reforms in Germany (under Agenda 2010) and in France, and pension reforms—including raising the effective retirement age—in Italy. Nevertheless, these reforms need to be deepened and prioritized, with a greater focus placed on addressing current distortions in the labor market—particularly overly generous entitlement systems (reducing such entitlement benefits would also have fiscal savings), high tax wedges, and restrictive labor laws—and on promoting greater competition in product markets. In this regard, the recent rejection of the European Commission proposals to liberalize trade in services in Europe is a setback to reform efforts.

Economic performance in the United Kingdom remains robust. Having slowed gradually through the year, as higher mortgage rates and weaker house price appreciation dampened consumption, GDP growth is estimated at 3.1 percent in 2004 and is projected at 2.6 percent this year. Domestic demand remains the key driver of growth, underpinned by continued robust wage growth and strong corporate profitability. Relatively high consumer indebtedness and the possibility of a sharp drop in house prices do present risks to this outlook. With the economy operating at or near full capacity, the Bank of England has tightened monetary policy over the past year, and is well positioned to respond to unexpected developments in either direction. Fiscal policy has provided substantial stimulus in recent years, and steps are needed to accelerate the pace of fiscal consolidation—which is very modest in the recent budget—to meet the government's budgetary objectives over the course of the next economic cycle. A recent Interim Report by the Pensions Commission has questioned the adequacy of private saving for retirement, and it will be important to encourage higher saving to ensure that pensioners do not fall back on the state in the future.

Elsewhere in Europe, growth in the Nordic countries accelerated in 2004, owing to exports (Sweden, Denmark), stronger investment (Sweden, Norway—the latter driven by the oil sector) and fiscal expansion (Norway and Sweden). In all three countries, monetary policy settings remain accommodative and will need to tighten as the recovery proceeds, while fiscal consolidation will be required to meet medium-term targets. In Switzerland, growth accelerated to 1.7 percent in 2004 as exports benefited from stronger global demand and expansionary fiscal and monetary policies boosted domestic demand. Monetary tightening has begun—although interest rates remain low—and measures will be needed to bring the fiscal position back to balance. Efforts to increase competition in domestic markets are needed to raise potential growth.

Japan: Will Growth Resume?

After growing strongly in the first quarter of 2004, the Japanese economy subsequently stalled, recording near-zero growth in the remainder of the year. Weaker global demand for IT products has undercut export and private sector investment growth, while consumption spending has declined. Real GDP is now estimated to have grown by 2.6 percent in 2004, some 1.8 percentage points lower than projected in the September 2004 *World Economic Outlook*, about 1 percent of which reflects methodological changes in the construction of the Japanese national accounts.

The stagnation of the economy during the last three quarters of 2004 has raised concerns about the short-term outlook. However, while there are downside risks, most notably from continued volatile oil prices and the possibility that a sharp appreciation of the yen could further undercut exports, there has been a noticeable improvement in economic fundamentals in recent years.

- The corporate sector is now stronger as profitability has increased (the ratio of current profits to sales stood at about 3.5 percent in

2004, the highest since the 1980s), leverage ratios have declined, and productivity gains have been made. Reflecting these improvements, corporate bankruptcies have fallen to their lowest level in a decade. Stronger corporate balance sheets and profits should support increased investment going forward.

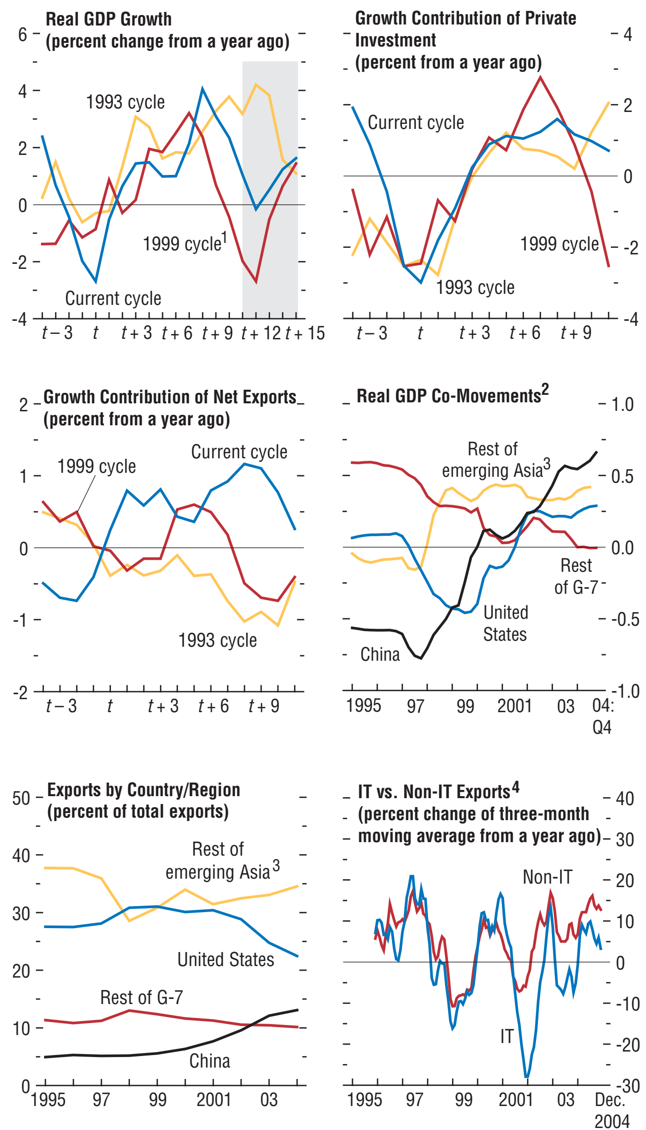
- The banking sector has also strengthened its financial position. The major banks, in particular, have improved their capital base and reduced their nonperforming loans (which the government expects to fall to about 4 percent by March 2005), and this has resulted in credit rating upgrades. The banks' improved financial health has supported a more accommodative lending attitude, although outstanding credit continues to decline, albeit at a moderating pace.
- Japanese corporations have taken advantage of the changing structure of global production and significantly increased their exposure to the fast-growing Asian region. Reflecting these increased trade linkages and, more generally, an increased synchronization of Japan's business cycle with those of Asia (most notably China) and the United States since the late 1990s, net exports have been a key engine of growth in recent years (Figure 1.12). With activity in Asia and the United States expected to remain strong in the near term, this should support a resumption of export growth.

While recent indicators have been somewhat mixed, together with stronger fundamentals they broadly suggest that growth should regain some momentum during the course of this year, although this rebound will be tempered as firms run down their inventories (particularly in the IT sector). Consequently, the economy is expected to grow by 0.8 percent in 2005, accelerating to 1.9 percent in 2006.

While deflationary pressures have eased in recent years, with the year-on-year decline in the core CPI now close to zero, a further appreciation of the yen or a more prolonged economic slowdown could put downward pressures on prices. In these circumstances, the Bank of

Figure 1.12. Japan: Where Is the Economy in the Current Expansion?

Net exports have been an engine of growth in the current expansion reflecting increased trade linkages and business cycle synchronization with Asia and the United States.



Sources: IMF, *Direction of Trade Statistics;* CEIC Data Company Limited; Haver Analytics; United Nations Commodity Trade database; and IMF staff estimates.

[1]Output growth during 1999 cycle peaked in 2000Q4.

[2]Ten-year rolling window of the year-over-year real GDP growth correlations.

[3]India, Indonesia, Hong Kong SAR, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, and Thailand.

[4]IT defined as office machinery, automatic data processing machinery, telecommunication machinery, electronic integrated circuits, and scientific and optical instruments.

Japan should maintain a very accommodative monetary policy until deflation is decisively beaten. Consideration also needs to be given to the appropriate monetary framework for a post-deflation environment. In this regard, once deflationary pressures have receded, the announcement of an explicit medium-term inflation objective would be helpful to stabilize inflation expectations.

Against the background of high public debt and intensifying demographic pressures from population aging, fiscal consolidation is a priority. Notwithstanding the recently adopted tax measures, the structural fiscal deficit is projected to decline only slightly to 6.4 percent of GDP in 2005. Over the medium term, the government plans to achieve a primary surplus by the early 2010s. However, the measures to achieve this goal have yet to be specified and a sizable surplus may be needed to put the public finances on a sustainable path. To increase the credibility of its plans, the government should consider announcing specific measures to achieve them, including further cuts in public investment, a broadening of the tax base, and an increase in the consumption tax rate. The government also needs to push ahead with further social security reforms to rein in medical and long-term care expenditures.

To create the conditions for sustained growth over the medium term, Japan needs to accelerate its structural reform program.

- In the financial sector, bank profitability and capital bases need to be strengthened further so that these institutions are able to extend credit and support investment and growth. The government has recently announced a reform plan aimed at creating a more efficient and flexible financial system, including strengthening the regional banks. The government also plans to privatize Japan Post, and it will be important to ensure that a level playing field is created among the entities resulting from the breakup of Japan Post and their private sector competitors.
- In the corporate sector, despite recent welcome improvements, in some cases debt levels remain high and returns on assets low. The continued presence of unviable firms in a number of sectors negatively affects the profitability of healthier entities, implying that broader progress in corporate restructuring is needed.
- Other reform priorities are increasing competition in the sheltered sector of the economy (including deregulation in the retail sector and by facilitating market entry and exit), enhancing labor market flexibility (including by increasing pension portability), and public enterprise reform.

Emerging Asia and the Pacific: A Continuing Expansion, but External Surpluses Persist

GDP growth in emerging Asia picked up to 7.8 percent in 2004 (Table 1.6), 0.5 percent higher than projected last September, and the highest since the Asian crisis. This strong result, however, owed much to the buoyancy of activity in late 2003 and early 2004. Since that time—with the important exception of China—GDP growth in most countries has slowed noticeably, partly a return to more sustainable levels, but also reflecting the moderation of the global expansion, the correction in the semiconductor market, and higher oil prices (although the impact of the latter was muted because the region mainly imports heavy crudes whose price increased relatively less in 2004—Appendix 1.1). Headline and—to a lesser extent—core inflation rose, but as yet remain moderate. In some cases (notably India, Indonesia, Malaysia, and Thailand), this partly reflected substantial oil price subsidies, reflected in a commensurate deterioration in the fiscal position.

Recent developments have been dominated by the recent catastrophic tsunami, and the devastating losses of human life and property inflicted on Indonesia, Sri Lanka, India, Thailand, and several other countries in the region. As discussed in Box 1.1, reconstruction costs—and the impact on fiscal and external balances—in the affected countries will be

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

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Emerging Asia[3]	**7.4**	**7.8**	**7.0**	**6.9**	**2.4**	**4.0**	**3.7**	**3.2**	**4.4**	**4.4**	**3.9**	**3.5**
China	9.3	9.5	8.5	8.0	1.2	3.9	3.0	2.5	3.2	4.2	4.2	4.0
South Asia[4]	**7.1**	**7.1**	**6.5**	**6.3**	**3.9**	**4.3**	**4.6**	**4.0**	**1.4**	**0.1**	**–0.7**	**–0.6**
India	7.5	7.3	6.7	6.4	3.8	3.8	4.0	3.6	1.2	0.3	–0.3	–0.3
Pakistan	5.6	6.5	6.7	6.3	2.9	6.7	7.9	6.5	4.1	0.3	–1.2	–0.8
Bangladesh	5.4	5.4	5.5	5.9	5.4	6.1	5.7	4.5	0.1	–1.2	–2.4	–2.5
ASEAN-4	**5.4**	**5.8**	**5.4**	**5.8**	**4.0**	**4.4**	**5.3**	**4.5**	**5.7**	**5.5**	**4.4**	**3.3**
Indonesia	4.9	5.1	5.5	6.0	6.8	6.1	7.0	6.5	3.0	2.8	2.2	0.9
Thailand	6.9	6.1	5.6	6.2	1.8	2.7	2.9	2.1	5.6	4.5	2.0	1.4
Philippines	4.7	6.1	4.7	4.5	3.0	5.5	6.8	4.9	4.3	4.6	2.6	2.0
Malaysia	5.3	7.1	6.0	6.2	1.1	1.4	2.5	2.5	12.9	13.3	13.6	12.2
Newly industrialized Asian economies	**3.1**	**5.5**	**4.0**	**4.8**	**1.5**	**2.4**	**2.2**	**2.3**	**7.4**	**7.1**	**6.8**	**6.2**
Korea	3.1	4.6	4.0	5.2	3.5	3.6	2.9	3.0	2.0	3.9	3.6	2.9
Taiwan Province of China	3.3	5.7	4.0	4.3	–0.3	1.6	1.6	1.5	10.2	6.2	6.6	5.9
Hong Kong SAR	3.2	8.1	4.0	4.0	–2.6	–0.4	1.0	1.1	10.3	9.6	9.4	9.3
Singapore	1.4	8.4	4.0	4.5	0.5	1.7	1.5	1.5	29.2	26.1	23.4	22.9

[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.
[3]Consists of developing Asia, the newly industrialized Asian economies, and Mongolia.
[4]Includes Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka.

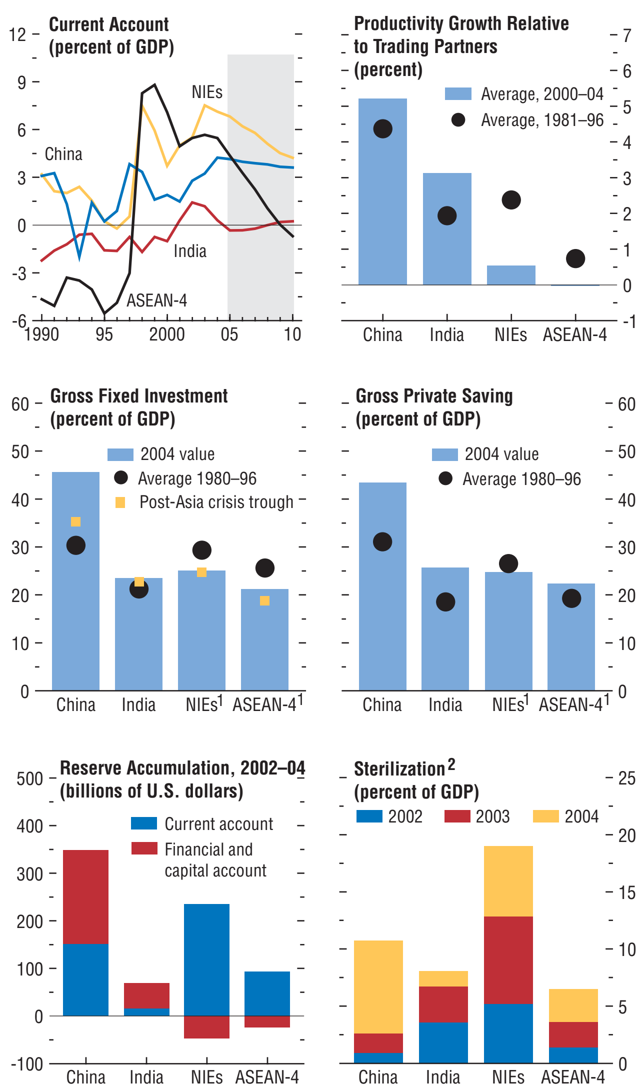
substantial. However, in most cases—except Maldives and to a lesser extent Sri Lanka—the impact on GDP growth will be small, since the affected areas account for a small portion of output, and the adverse effects are largely offset by reconstruction activities. For 2005 as a whole, regional GDP growth is projected to slow to a still robust 7 percent, with a moderate slowdown in China, continued strong growth in India, and—in the NIEs and ASEAN-4—a gradual recovery from the slowdown in the second half of 2004, underpinned by strengthening domestic demand. Short-term risks are tilted somewhat to the downside. On the one hand, GDP growth in China could be stronger than expected, boosting activity—especially in the NIEs—in 2005, albeit at the risk of a more pronounced slowdown later on.[7] On the other hand, oil prices—including for heavy crudes—are presently significantly above the WEO baseline, and in some countries the eventual pass-through of earlier increases will adversely affect demand. In addition, excess capacity in the IT sector could take longer than expected to work off, endangering the expected pickup in domestic demand, and external demand—particularly in Japan and Europe—could be weaker than expected. The Philippines and Indonesia are also relatively exposed to higher U.S. interest rates.

The tension between the objectives of maintaining low inflation and nominal exchange rate stability remains a key issue across the region. Given the strength of external positions, most countries are undertaking substantial sterilization, an activity that is generally costly and increasingly difficult to sustain over time (Figure 1.13). Looking forward, assuming constant real effective exchange rates, current account surpluses are generally expected to remain high (and given the rising global current account discrepancy—Box 1.4—risks are

[7]See "What Are the Risks of Slower Growth in China?" Box 1.2, *World Economic Outlook*, September 2004, for a detailed discussion.

Figure 1.13. Emerging Asia: Current Accounts, Savings, and Investment

High current account surpluses have been underpinned—to different extents—by strong productivity growth and savings, and relatively weak investment. Along with buoyant capital inflows, this has required substantial sterilization efforts across the region.



Sources: Bloomberg Financial Markets, LP; CEIC Data Company Limited; and IMF staff estimates.
[1]Weighted by PPP-GDP.
[2]Approximated as the increase in reserves minus the increase in base money.

on the upside); while individual country situations differ, regional currencies will likely need to appreciate significantly in real terms over the medium term. In these circumstances, barring unforeseen adverse developments, capital inflows may also remain buoyant. Against this background, greater exchange rate flexibility—both vis-à-vis the U.S. dollar and in trade-weighted terms—will be increasingly desirable from the perspective of short-run monetary management as well as consistent with medium-term fundamentals. While recent signs of greater exchange rate flexibility in a number of countries—notably Korea—are welcome, this now needs to be extended more broadly across the region.

Turning to individual countries, GDP growth in China—despite recent tightening measures—has remained very strong, with some slowdown in investment growth offset by a pickup in exports. While CPI inflation is still low, cost-push pressures—including wages and utility shortages, especially electricity—are becoming more widespread. Given the considerable economic momentum, further tightening of monetary conditions is likely to be required to prevent a resurgence of investment; with continued strong upward pressures on the renminbi from current and capital account inflows, this would be facilitated by greater exchange rate flexibility. The recent real effective depreciation of the renminbi and continued strong productivity growth relative to trading partners would help mitigate possible adverse effects on employment. On the fiscal side, the deficit in 2004 was considerably lower than budgeted primarily owing to surging revenues; maintaining a tight fiscal stance would help contain demand pressures, as well as help address medium-term expenditure pressures arising from potential bank restructuring and pension liabilities, and social and infrastructural needs. With investment in China extraordinarily high as a percentage of GDP, a key medium-term challenge is to improve the efficiency of investment, accompanied by a welfare-improving shift in the composition of demand toward consumption. In this

connection, further progress with bank and public enterprise reforms remains critical; greater labor market flexibility—including easing restrictions on internal migration—would also help manage the challenges of a rapidly growing labor force.

In the NIEs and ASEAN-4 countries, with the expansion set to continue, monetary tightening cycles are generally under way, with the exception of Korea, where domestic demand continues to be held back by overindebtedness in the household and small and medium-sized enterprise sectors. While domestic demand growth has picked up, its level remains strikingly low, with investment ratios in many cases barely above post-Asian crisis lows. While this may be partially cyclical in nature, it also underscores the need for further improvement in the investment climate, including through addressing remaining financial and corporate sector weaknesses and, in some cases, measures to improve infrastructure. Fiscal positions have generally improved since the crisis, but public debt remains high, a particular risk in the Philippines, where progress in implementing the fiscal elements of the new administration's reform package is lagging. Public debt in Indonesia, while declining sharply recently, is also elevated; while tsunami-related expenditures will be largely financed by higher aid, progress in reducing fuel subsidies, attracting private investment in infrastructure, and improving tax administration is needed to maintain confidence that deficits and debt will remain sustainable over the medium term. More generally, pressures from aging populations require increasing attention, and in some countries—including Korea, where dependency ratios will rise especially sharply—further action is needed to head off future pension fund shortfalls.

GDP growth in India has slowed modestly, but is expected to remain robust, with the impact of uneven monsoons and higher oil prices being offset by buoyant industrial activity and strong investment. In response to a sharp rise in inflation in the second half of 2004, and easing liquidity conditions—in part reflecting buoyant capital inflows—the Reserve Bank of India has appropriately raised interest rates and allowed somewhat more exchange rate flexibility. Inflation seems now to be moderating, but with short-run interest rates still very low in real terms and commercial credit growth exceeding 25 percent, the Reserve Bank of India will need to continue to monitor the situation closely. Since the general government deficit is still close to 10 percent of GDP, fiscal consolidation remains a key challenge, the more so given the ambitious social agenda set out in the new government's Common Minimum Program (which could ultimately raise expenditures by 10 percent of GDP). Beyond the medium-term risks to macro stability, and the constraints the deficit places on a pickup in investment, it may also constrain progress on structural reforms (notably in the financial sector). Recent fiscal responsibility legislation provides a good medium-term framework, but needs to be more fully implemented, with the proposed deficit reduction in the FY 2005/06 budget falling below the minimum annual adjustments the legislation requires. Further efforts to strengthen state government finances, which account for one-half of the overall deficit, are also essential. While the budget proposed only modest structural reforms, the strong economic environment provides an important opportunity to improve the business climate—a key step toward increasing private sector participation in infrastructure—including through addressing labor market rigidities; agricultural reform, which is critical for poverty reduction; further trade and capital liberalization; and strengthening the financial sector, which remains exposed to interest rate risk given its large holdings of government securities.

Elsewhere in south Asia, GDP growth has picked up markedly in Pakistan, while fiscal adjustment—supported by official inflows and debt relief—has led to a substantial improvement in public and external debt indicators. Further efforts to broaden the tax base and reduce evasion will be needed to maintain this improving debt trajectory while financing

Table 1.7. 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]			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Western Hemisphere	**2.2**	**5.7**	**4.1**	**3.7**	**10.6**	**6.5**	**6.0**	**5.2**	**0.4**	**0.8**	**0.2**	**–0.5**
Mercosur[3]	**2.6**	**6.1**	**4.4**	**3.7**	**13.4**	**5.7**	**6.4**	**5.0**	**1.5**	**1.9**	**0.7**	**–0.3**
Argentina	8.8	9.0	6.0	3.6	13.4	4.4	7.7	6.7	5.8	2.0	–1.2	–2.9
Brazil	0.5	5.2	3.7	3.5	14.8	6.6	6.5	4.6	0.8	1.9	1.1	0.4
Chile	3.3	6.0	6.1	5.4	2.8	1.1	2.5	3.1	–1.6	1.5	0.9	–1.3
Uruguay	2.5	12.0	5.0	3.5	19.4	9.2	7.0	6.2	0.7	–0.3	–0.2	–0.6
Andean region	**1.4**	**7.3**	**4.2**	**4.0**	**10.5**	**8.3**	**6.9**	**7.9**	**3.5**	**4.4**	**3.7**	**2.6**
Colombia	4.0	4.0	4.0	4.0	7.1	5.9	5.2	4.8	–1.5	–1.1	–2.6	–2.6
Ecuador	2.7	6.6	3.9	3.7	7.9	2.7	2.0	2.0	–1.7	–0.5	0.8	1.2
Peru	3.8	5.1	4.5	4.5	2.3	3.7	2.1	2.4	–1.8	–0.1	0.5	0.2
Venezuela	–7.7	17.3	4.6	3.8	31.1	21.7	18.2	25.0	13.6	13.5	12.0	8.4
Mexico, Central America, and Caribbean	**1.9**	**4.0**	**3.6**	**3.5**	**6.0**	**7.1**	**5.1**	**4.1**	**–1.6**	**–1.6**	**–1.8**	**–2.0**
Mexico	1.6	4.4	3.7	3.3	4.5	4.7	4.6	3.7	–1.3	–1.3	–1.4	–1.6
Central America[4]	3.5	3.5	3.2	3.4	5.7	7.2	6.0	5.0	–5.1	–5.1	–4.4	–4.0
The Caribbean[5]	1.4	2.1	3.0	5.3	19.4	29.0	7.8	6.7	0.4	–0.6	–2.7	–2.5

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Includes Argentina, Brazil, Paraguay, and Uruguay, together with Bolivia and Chile (associate members of Mercosur).
[4]Includes Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama.
[5]Includes Antigua and Barbuda, The Bahamas, Barbados, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago.

future social and infrastructural expenditure needs. In Bangladesh, GDP growth also remains solid despite devastating flooding last year. With macroeconomic management generally prudent, the central task is to press ahead with the structural reform agenda—strengthened tax administration, rehabilitation and divestment of the Nationalized Commercial Banks, and restructuring of energy sector enterprises—a task complicated by recent political tensions. While Pakistan has made substantial progress in modernizing its textile industry, adjustment to the ending of world textile trade quotas will be a major challenge for Bangladesh, underscoring the need for early development and implementation of a restructuring plan for the industry.

In Australia and New Zealand, GDP growth in 2004 remained strong, although activity moderated in the second half of the year, reflecting slowing global growth and higher oil prices; past exchange rate appreciation; and some easing in buoyant housing markets. In Australia, supply-side constraints, especially on exports, also contributed to slowing growth, while in New Zealand, lower net migration was a factor. The Reserve Bank of Australia (RBA) and Reserve Bank of New Zealand (RBNZ) each raised interest rates by 25 basis points in March 2005, the first such action from the RBA since late 2003, whereas the RBNZ had lifted rates by 150 basis points in 2004. With growth expected to slow in both countries in 2005, it is unclear if further monetary tightening will be necessary. Much will depend on labor market developments as unemployment is at historically low levels in both economies. Fiscal positions remain strong, characterized by budget surpluses and low and declining government debt, but both countries face significant pressures from aging populations, underscoring the need to press forward with reforms to increase labor participation; boost productivity, which despite recent progress is still well below U.S. levels; and keep health and pension spending on a sustainable path.

Latin America: Is Fiscal Policy on the Right Track at Last?

The strength of the recovery in Latin America has continued to exceed expectations, and regionwide growth in 2004, at 5.7 percent, was the highest since 1980 (Table 1.7). Growth was particularly strong in Argentina, Venezuela, and Uruguay—as these countries recovered from deep recessions—and in Brazil and Chile, which continue to benefit from sound macroeconomic policies and structural reforms. The favorable external environment continues to support economic activity, but it is now domestic demand that is leading growth, with private consumption and business investment growing briskly. Inflation, although remaining generally well contained, has picked up in a number of countries, while the current account recorded a surplus of 0.8 percent of GDP in 2004. In the Caribbean, growth in a number of countries was badly affected by the impact of hurricanes.

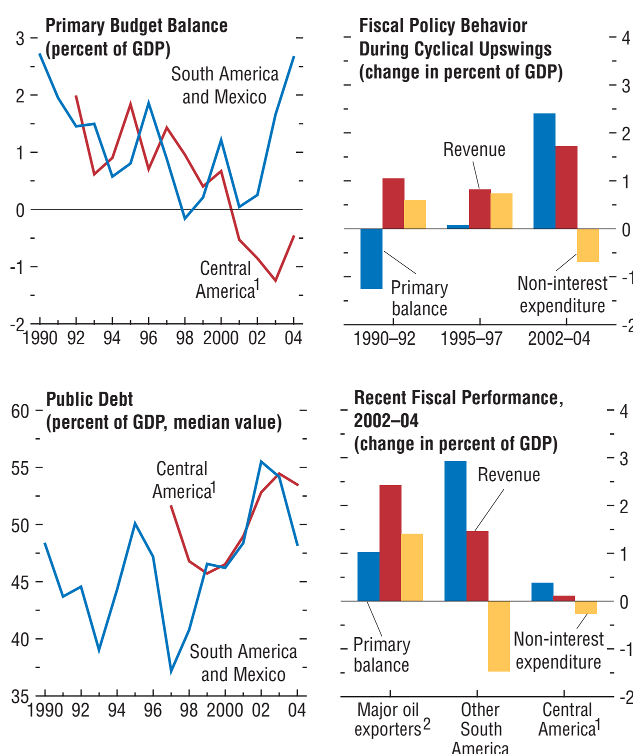
Looking forward, economic activity in the region appears to be easing to a more sustainable pace, and growth of 4.1 percent is projected for 2005. This outlook is not without risks, however, particularly if oil price volatility continues, interest rates in industrial countries rise more sharply than expected, spreads on emerging market debt continue to widen, or industrial country growth slows in a prolonged way. A further limited and orderly depreciation of the U.S. dollar is unlikely to have significant repercussions for Latin American economies as many regional currencies track movements in the dollar quite closely, although a disorderly depreciation could have a more serious impact if it resulted in turbulence in global financial markets and a deterioration in financing conditions for emerging markets.

It is encouraging that, in contrast to recoveries in the 1990s, many governments have taken advantage of the favorable economic conditions to strengthen their fiscal positions, prefinance their 2005 obligations, and improve their debt structures, although there are differences between fiscal developments in major oil-exporting and other countries in the region (Figure 1.14).

Figure 1.14. Latin America: Fiscal Performance Is Improving, but Public Debt Remains Too High

(Unweighted averages)

Fiscal performance in Latin America has been stronger during the current recovery than in cyclical upturns in the 1990s. Public debt, however, remains too high in many countries in the region. Further, oil-exporting countries have not taken full advantage of high oil prices to improve their fiscal position.



Source: IMF staff calculations.

[1]Consists of Costa Rica, El Salvador, Guatemala, Honduras, and Panama.

[2]Consists of Ecuador, Mexico, and Venezuela.

- In major oil-exporting countries—Ecuador, Mexico, and Venezuela—the increase in oil prices has resulted in significant revenue gains. Primary expenditures, however, have also risen substantially. Compared with 2002, the primary budget surplus in 2004 was only modestly better in Mexico—where there is a policy focus on raising public capital expenditure—and Ecuador, but rose more substantially in Venezuela.
- Other countries—with the exception of Argentina—have generally seen more limited revenue gains. Many of these countries have reduced primary expenditures (as a percent of GDP), and the average primary surplus has improved substantially since 2002. In Central America, primary expenditure restraint contributed to a small improvement in the primary surplus during 2002–04.

The improvement in budgetary outcomes is welcome, but public debt in Latin America, while declining, remains high and is a significant source of vulnerability (recent valuation gains from the appreciation of local currencies against the U.S. dollar have contributed to the reduction in debt, although it is unclear whether these gains will be sustained). Consequently, fiscal consolidation and more general measures to improve public debt sustainability—including structural reforms to boost growth—remain a priority, and the current favorable economic outlook provides an important opportunity to push ahead in these areas. It is particularly important that oil-exporting countries take full advantage of current high oil prices to strengthen their fiscal positions. A clear lesson from previous episodes of fiscal consolidation is that budget surpluses must be pursued in a sustainable manner, rather than based on unrealistic spending cuts or distortionary taxes that undermine efficiency and growth, and that ultimately have to be reversed. In this regard, strong institutions that support prudent fiscal policy are essential. In addition, fiscal reforms will need to focus on strengthening the tax base and increasing room in the budget for additional spending on infrastructure investment and the social safety net (although improving the effectiveness of the delivery of social services and ensuring that the social safety net is well targeted will be as critical to efforts to reduce poverty and inequality as additional spending).

Given the recent uptick in inflation, central banks in a number of countries—including Brazil, Mexico, and Peru—have appropriately tightened monetary policy, and have thereby enhanced the credibility of their relatively new inflation-targeting frameworks. Exchange rate flexibility has played a key role in supporting these frameworks, as well as in helping to improve external sector performance and increasing the region's resilience to shocks. While the inflation-targeting frameworks do not preclude intervention in the foreign exchange market—indeed, building reserves as market conditions permit remains a priority in Argentina and Brazil—such intervention needs to be consistent with achieving the inflation objective. With inflation now much more firmly under control, countries should be taking every opportunity to enhance incentives for local currency intermediation.

Turning to individual countries, the strong recovery in Argentina is continuing. The economy expanded by 9 percent last year, with business investment growing robustly. Inflation has picked up in recent months, but is expected to end the year within the central bank's target band. Fiscal performance exceeded expectations in 2004, with the primary budget surplus estimated to have reached 5.1 percent of GDP. If the recovery is to be sustained and unemployment reduced, continued prudent fiscal policies—which facilitate debt reduction, the phased elimination of distortive taxes, and increased social and infrastructure spending—the normalization of relations with private creditors and greater progress with structural reforms will be required. In Uruguay, the recovery is advancing ahead of expectations—with growth of 12 percent last year—and financial indicators have continued to improve, although public debt remains very high.

In Brazil, the government's adherence to sound macroeconomic policies and its pursuit of

structural reforms are paying off. The economy—spurred by robust investment and strong exports—grew strongly in 2004, and is expected to expand by a further 3.7 percent this year. Inflation has picked up and the central bank has responded by raising interest rates on a number of occasions since September. Fiscal performance has exceeded expectations, with a primary surplus of 4.6 percent of GDP in 2004. It will be important to maintain a tight fiscal stance in 2005 and beyond to continue bringing down public debt, and fiscal adjustment will have to be supported by tax and pension reforms. The authorities have recently passed legislation for bankruptcy reform, judiciary reform, and public-private partnerships, and should continue to take advantage of the current favorable conditions to press ahead with their reform agenda.

The Chilean economy is expanding robustly, spurred by strong export growth—related to the favorable copper market—and private investment. Inflation has returned to the official target range (after falling below the target in early 2004) and the central bank has begun to tighten monetary policy. The government continues to adhere to the structural budget balance rule, and strong revenues underpinned an overall fiscal surplus of over 2 percent of GDP in 2004.

In the Andean region, the Venezuelan economy is expected to slow in 2005, although there are upside risks in the oil and non-oil sectors. It is important that the authorities take decisive measures to strengthen the fiscal position, reduce reliance on oil prices, and implement market-friendly reforms to maintain bouyant activity in the non-oil sector. In Colombia, growth remains robust, although the current account deficit is expected to widen, reflecting in part a decline in export volumes. In Peru, growth is also strong; and the central bank met its end-2004 inflation target. Exchange rates in both Colombia and Peru have appreciated against the U.S. dollar, and the central banks have stepped up purchases of foreign exchange to limit upward pressures on their currencies. (Colombia has also introduced restrictions on short-term capital inflows.) It is important, however, that exchange rate management remain consistent with achieving stated inflation objectives. In Ecuador, growth has been boosted by a substantial increase in oil exports, providing the government with a favorable environment to press ahead with its reform agenda.

Mexico is experiencing a broad-based recovery, spurred by the upturn in the U.S. manufacturing sector and financial sector reforms that have boosted confidence and domestic demand. Consumer price inflation, however, has been above the Bank of Mexico's 2–4 percent target range, and monetary policy has been tightened over the past year. On the fiscal side, while the government's budget targets have been met, fiscal consolidation needs to be strengthened at a time of high oil prices and a recovery in growth. This will require expenditure restraint and tax reform to increase revenues from the non-oil sector. Further structural reforms beyond those in the financial sector are needed to boost medium-term growth, including reforms in the energy and telecommunications sectors to raise efficiency and promote investment, and labor market reforms to increase productivity and employment in the formal sector.

In Central America, growth has picked up and economic imbalances have been reduced, although volatile oil prices present a risk to the outlook. Ratification of the Central American Free Trade Agreement (CAFTA) would provide a much needed growth impulse, particularly against the background of the recent elimination of world textile trade quotas which will likely hurt the textile sectors in a number of countries in the region (Box 1.3). Accelerated structural reforms, supported by sound fiscal and monetary policies, will be needed to maximize the benefits of CAFTA and meet the competitive challenges in key export markets. In the Caribbean, a number of countries face significant difficulties in the aftermath of recent hurricanes. Volatile oil prices and high public debt levels present further challenges in the region, and efforts are particularly needed to strengthen budgets and improve public debt sustainability.

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

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Emerging Europe	**4.6**	**6.2**	**4.5**	**4.5**	**9.5**	**6.7**	**5.4**	**4.1**	**–4.3**	**–4.9**	**–4.7**	**–4.3**
Turkey	5.9	8.0	5.0	5.0	25.3	10.6	9.0	6.1	–3.4	–5.2	–4.5	–3.7
Excluding Turkey	4.1	5.5	4.3	4.3	3.7	5.2	3.9	3.2	–4.7	–4.8	–4.8	–4.6
Baltics	**8.0**	**6.9**	**6.9**	**6.3**	**0.6**	**3.1**	**3.9**	**3.6**	**–8.8**	**–10.9**	**–10.3**	**–9.6**
Estonia	5.1	6.2	6.0	5.5	1.3	3.0	3.7	2.7	–13.2	–13.8	–11.0	–9.7
Latvia	7.5	8.0	7.3	6.2	2.9	6.3	5.7	5.3	–8.2	–12.3	–10.9	–9.8
Lithuania	9.7	6.6	7.0	6.8	–1.2	1.2	2.9	3.0	–7.0	–8.6	–9.5	–9.3
Central Europe	**3.6**	**4.8**	**3.8**	**3.9**	**2.2**	**4.2**	**3.1**	**2.7**	**–3.9**	**–3.8**	**–4.0**	**–4.0**
Czech Republic	3.7	4.0	4.0	3.9	0.1	2.8	2.5	2.7	–6.2	–5.2	–4.8	–4.4
Hungary	3.0	4.0	3.7	3.8	4.7	6.8	4.0	3.8	–9.0	–9.0	–8.6	–8.1
Poland	3.8	5.3	3.5	3.7	0.8	3.5	3.1	2.5	–1.9	–1.5	–2.1	–2.5
Slovak Republic	4.5	5.5	4.8	4.9	8.5	7.5	3.6	2.8	–0.9	–3.4	–6.0	–4.6
Slovenia	2.5	4.4	4.0	4.0	5.6	3.6	2.3	2.0	0.1	–0.6	–1.4	–2.2
Southern and southeastern Europe	**4.6**	**7.2**	**5.3**	**5.0**	**10.7**	**9.5**	**6.6**	**4.8**	**–6.8**	**–7.2**	**–6.4**	**–5.8**
Bulgaria	4.3	5.7	5.5	5.5	2.3	6.1	4.0	3.5	–9.3	–7.4	–7.6	–6.9
Cyprus	1.9	3.7	3.8	4.0	4.1	2.3	2.5	2.5	–3.4	–4.1	–3.4	–2.7
Malta	–1.8	1.5	1.5	1.8	1.9	2.7	2.4	1.9	–5.8	–10.3	–4.0	–3.0
Romania	5.2	8.3	5.5	5.0	15.3	11.9	8.2	5.7	–6.8	–7.5	–6.9	–6.3

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

Emerging Europe: Current Account Deficits Remain a Challenge

In 2004, emerging Europe enjoyed its strongest growth performance since the beginning of transition, as robust economic activity in central Europe and Turkey broadened the expansion that was led by the Baltic states and southern and southeastern Europe. The initial recovery, with rapid domestic credit growth financing a consumption boom in much of the region, has broadened to the export sector, even though exchange rates—despite some recent depreciation—have strengthened markedly since 2004. Current account deficits, however, have generally widened as strong domestic demand boosted imports while inflation rose in most countries in the region—with the notable exception of Turkey—in response to higher global oil prices, the effects of domestic credit growth, and one-off EU accession–related tax adjustments (Table 1.8).

Looking ahead, the pace of activity is expected to moderate in 2005 as the cycle matures in central Europe and the Baltic states, and Turkey's growth eases to a more sustainable pace. In turn, this is expected to lead to some narrowing of current account deficits and lower inflation across the region. The risks to the outlook appear tilted to the downside at this juncture. A prolonged slowdown in western Europe would likely hurt export growth, while a further sharp decline of the U.S. dollar against the euro also presents risks, as most regional exchange rates move with the euro. While the majority of regional exports are to western Europe, those economies with more significant non–euro area exports could see their current account positions deteriorate, while most countries will get little benefit from valuation effects on external debt as a relatively small proportion of liabilities are dollar denominated. The continued rise in oil prices presents a further risk to growth and current accounts. Finally, the rapid growth of credit presents a risk to banks in a number of countries, particularly if credit quality were to weaken in the face of an unexpected slowdown in growth or large exchange rate movements, and this poses a challenge for banking supervision.

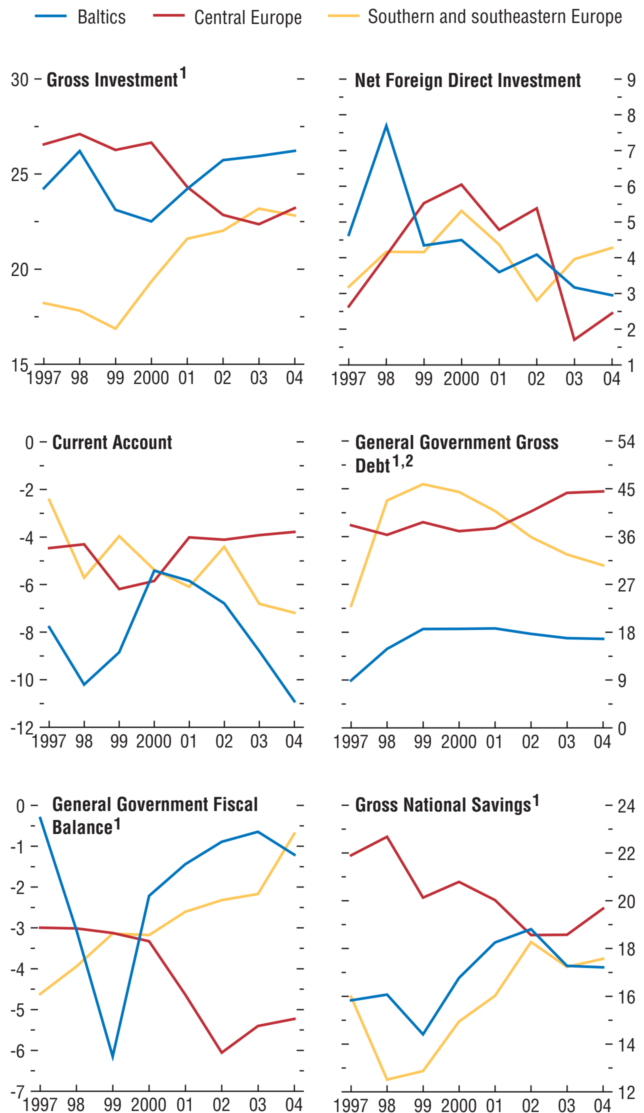
Against this outlook, the region's high and widening current account deficits remain a key vulnerability. The underlying sources of these deficits, however, vary across countries (see Figure 1.15), suggesting differing policy priorities.

- In the Baltic countries and southern and southeastern Europe, investment rates have risen but saving has stagnated as a decline in private saving—due to strong credit growth that has financed increased consumption—has offset improving fiscal balances. Measures to contain current account deficits therefore will need to focus on restraining domestic credit growth and increasing private saving, while maintaining tight fiscal policies.
- In central Europe, while investment rates have declined, deteriorating fiscal balances have contributed to widening current account deficits in a number of countries. The key policy challenge is to foster the recent pickup in investment to underpin future growth prospects, while also reining in current account deficits. This will require ambitious fiscal consolidation to raise saving, while implementing reforms—including in the labor market and the state-owned sector—to improve the investment climate. Attracting more foreign direct investment will also help with the financing of the current account deficits.

Turning to developments in individual countries, Poland has enjoyed a strong recovery on the back of buoyant exports and large inventory accumulation. Inflation has risen owing to a number of one-off factors including accession-related tax increases, but wage pressures remain limited against the background of a still weak labor market. Growth is expected to moderate somewhat, with the strengthening of the zloty in 2004 slowing exports, while past interest rate increases are expected to ease inflationary pressures by moderating domestic demand. The implementation of the Hausner plan has been disappointing, and it will be important to press ahead both with the unfinished parts of the plan and with broader fiscal reforms.

Figure 1.15. Emerging Europe: The Challenge of Current Account Deficits
(Percent of GDP)

National savings have stagnated, but investment has been higher.



[1]Weighted by PPP-GDP for the aggregates.
[2]For southern and southeastern Europe, net debt is used for Cyprus.

Economic activity in Hungary has continued to strengthen, with moderating consumption growth being offset by a rebound in investment and exports. Looking ahead, growth is expected to slow somewhat, while the recent strength of the forint and low wage pressures suggest moderate inflationary pressures. The twin fiscal and current account deficits remain the main risks to the outlook, given the sizable external financing requirements going forward and the sensitivity of capital inflows to changes in the market environment. The fiscal targets in the medium term envisage relatively unambitious consolidation, and stronger fiscal efforts centered on expenditure restraint are needed to maintain confidence, reduce the external deficit, and pave the way to ERM II accession.

In the Czech Republic, the recovery has continued at a relatively stable pace, led by rapidly rising exports and related investment. Strong domestic demand and increases in indirect taxes in the run-up to EU accession pushed inflation higher in 2004, although it remained well contained, and the monetary tightening cycle in place last year ended with a cut in interest rates in January 2005. Strong growth and higher VAT and nontax receipts helped revenues in 2004, although further fiscal adjustment is a key policy priority, with the authorities' three-year adjustment plan an important component of further consolidation. As in other countries, further structural and labor market reforms also need to be pursued. In the Slovak Republic, growth picked up in 2004 as domestic demand strengthened, headline inflation remained high largely owing to administered price and indirect tax increases, and the current account deficit widened. Growth is expected to ease somewhat this year, but fiscal consolidation should be accelerated given the back-loading under the government's current three-year fiscal framework and the risks to inflation.

In the Baltic countries, activity remains strong, supported by robust domestic demand and exports. Following accession to the European Union, monetary policies in all three economies are well anchored, with Estonia and Lithuania joining the ERM II mechanism in end-June 2004, and Latvia pegging the lat to the euro at the beginning of 2005. Strong credit growth, fueled by foreign borrowing by banks, has contributed to high current account deficits, and these are expected to moderate only slightly this year as growth eases to more sustainable rates. Efforts to increase domestic savings will be key to reducing the vulnerabilities going forward, accompanied by strong supervision of the banking system. Slovenia entered the ERM II arrangement at end-June 2004, but reducing inflation to the Maastricht criterion level and maintaining competitiveness, including through labor market reforms and wage policies, present a continuing policy challenge.

Growth in Bulgaria and Romania continues to be strong, fueled by rapid credit growth. As a result, current account deficits remain high and underscore the need to maintain tight fiscal policies and contain wage and credit growth going forward. Structural reforms to improve the investment climate would help boost foreign direct investment. The National Bank of Romania has allowed greater exchange rate appreciation to achieve its inflation objectives, and progress in structural reforms and the fight against corruption need to be stepped up to allow smooth entry into the European Union in 2007. In Bulgaria, a 25 percent increase in the minimum wage and pressures for fiscal easing prior to the mid-2005 parliamentary elections have reduced the scope to contain the current account deficit.

In the Balkan countries, while growth has picked up in Bosnia and Herzegovina and in Serbia and Montenegro, current account deficits remain high, highlighting the need for structural reforms to boost export competitiveness. In Croatia, economic activity has slowed, in part owing to fiscal consolidation, inflation remains subdued, and the current account has narrowed somewhat. Looking ahead, tight fiscal and monetary policies will be needed to further reduce the current account deficit.

Strong macroeconomic policies and structural reforms, along with improved confidence,

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]			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Commonwealth of Independent States	**7.9**	**8.2**	**6.5**	**6.0**	**12.0**	**10.3**	**11.4**	**8.8**	**6.4**	**8.5**	**9.4**	**6.9**
Russia	7.3	7.1	6.0	5.5	13.7	10.9	11.8	9.7	8.2	10.2	11.4	8.7
Ukraine	9.6	12.1	7.0	4.0	5.2	9.0	12.5	5.9	5.8	11.0	7.2	2.5
Kazakhstan	9.3	9.4	8.0	7.7	6.4	6.9	7.3	6.5	–0.2	2.3	1.8	–0.8
Belarus	6.8	11.0	7.1	6.0	28.4	18.1	13.0	11.0	–2.9	–3.0	–3.4	–3.3
CIS-7	**7.2**	**8.4**	**9.5**	**14.2**	**8.6**	**7.9**	**8.9**	**7.3**	**–6.9**	**–9.4**	**–3.6**	**0.8**
Armenia	13.9	10.1	8.0	6.0	4.7	7.0	2.0	3.0	–6.8	–5.8	–5.5	–5.5
Azerbaijan	10.8	10.1	21.6	38.3	2.2	8.1	7.6	5.0	–28.3	–27.3	–7.8	6.0
Georgia	11.1	8.5	6.0	5.0	4.8	5.7	6.8	4.0	–7.2	–7.5	–8.1	–6.0
Kyrgyz Republic	6.9	6.0	5.0	5.9	3.1	4.1	4.0	3.7	–2.8	–3.0	–6.3	–4.6
Moldova	6.3	7.0	5.0	4.0	11.7	12.3	10.0	8.1	–7.3	–7.1	–6.1	–5.9
Tajikistan	10.2	10.6	8.0	7.0	16.4	7.1	5.7	5.5	–1.3	–3.9	–4.2	–4.2
Uzbekistan	1.5	7.1	3.5	2.5	14.8	8.8	14.1	13.0	8.9	0.8	4.5	3.9
Memorandum												
Net energy exporters[3]	7.6	7.4	6.4	6.4	12.8	10.4	11.3	9.4	7.1	9.0	10.3	7.9
Net energy importers[4]	9.2	11.5	7.0	4.5	8.8	10.1	11.7	6.5	2.1	5.5	3.1	0.4

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year as is the practice in some countries.
[2]Percent of GDP.
[3]Includes Azerbaijan, Kazakhstan, Russia, Turkmenistan, and Uzbekistan.
[4]Includes Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Ukraine.

spurred robust growth in Turkey in 2004, while inflation fell to its lowest level in 30 years. The current account deficit widened, however, while its financing, albeit at short maturity, was supported by improving market sentiment and helped by the European Union's decision to begin accession negotiations with Turkey in October 2005. Looking ahead, growth is expected to ease to more sustainable rates, although the current account deficit may be adversely affected by the appreciation of the lira and strong domestic demand. Abrupt shifts in market sentiment pose a risk to the financing of the current account deficit, and policies should focus on reducing the deficit and maintaining market confidence—including on the fiscal side by ensuring that the target for the primary surplus is achieved, and exceeded if strong growth leads to significant revenue overperformance—and reducing public debt, which, despite recent gains, remains high. At the same time, sustaining the positive growth momentum will require persisting with structural reforms, including with respect to taxes and expenditures; strengthening the legal and supervisory system for banks; state bank restructuring; and improving the investment climate to attract nondebt inflows.

Commonwealth of Independent States: Has Disinflation Bottomed Out?

Growth in the Commonwealth of Independent States remained very strong during 2004, underpinned by buoyant energy and metals prices and strong domestic demand, and reinforced by strong regional linkages that boosted exports from energy importers. Looking forward, while GDP growth is expected to moderate to more sustainable levels in 2005, the outlook remains generally favorable; external and commodity price developments are expected to be generally supportive of activity, although capacity constraints and inadequate investment are beginning to limit the benefits that some economies can reap (Table 1.9). A further rise in oil prices is the key upside risk to the outlook while,

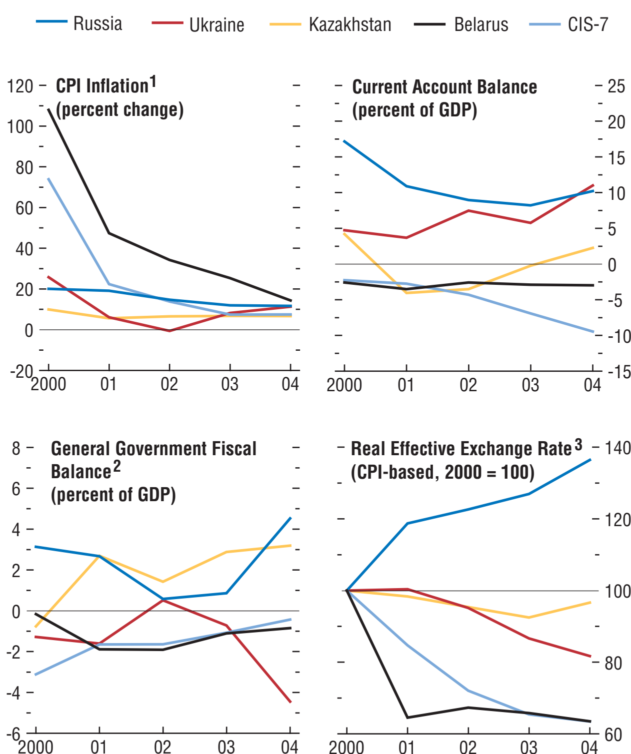
as discussed below, the signs of recent weakening growth and investment in Russia pose a potential downside risk, given its dominant role in the region.

Countries in the region have in general made impressive progress on disinflation in recent years with sound monetary and fiscal policies in the context of a commodity price boom (Figure 1.16). However, with concerns about capacity constraints against the background of strong growth, capital inflows, and many country authorities' efforts to slow currency appreciation, signs are emerging that the pace of disinflation may be slowing down significantly, presenting policymakers with a challenging environment. Sustaining disinflation will require prudent management of the revenue gains from oil and commodity exports under mounting pressures for domestic spending, and making the transition to more flexible exchange rates. More generally, monetary policy and banking supervision need to deal with the challenges of rapid money and credit growth in this environment.

Turning to developments in individual countries, GDP growth in Russia slowed in the second half of 2004, mainly owing to weakening oil production growth and a slowing of investment. While the underlying reasons for these developments are not fully clear, they include the fallout from the Yukos affair, which led to oil supply disruptions and reignited concerns about the protection of property rights and increased state intervention; slower credit growth in the aftermath of the mid-2004 banking sector turbulence; and slow progress with reforms. The forecast for 2005 assumes a gradual reversal in these developments, but much will depend on early measures to improve the investment climate, including limiting regulatory intervention and reinvigorating the reform effort. Despite the slowdown, inflationary pressures remain strong, with labor markets in high-growth regions particularly tight; with external reserves continuing to rise rapidly—the rising current account surplus has more than offset the capital account deterioration—greater upward exchange rate flexibility will be needed if the official inflation

Figure 1.16. CIS: Has Disinflation Lost Momentum?

The commodity boom has helped current account and fiscal balances, but inflationary pressures remain.



Sources: IMF, INSDATA; and IMF staff calculations.
[1] December-over-December percent change. For 2004, it is November-over-November percent change. CIS-7 is weighted by PPP-GDP, excluding Georgia owing to lack of data.
[2] CIS-7 is weighted by PPP-GDP.
[3] CIS-7 is weighted by PPP-GDP, excluding Georgia owing to lack of data.

target for 2005 is to be achieved. Additionally, it will be important to avoid any further discretionary relaxation of fiscal policy—in this connection, the authorities' intention to prepay Paris Club debt is welcome. That said, once inflationary pressures ease, more of the oil market–related revenues could be used to support a well-designed structural reform program.

In Ukraine, GDP growth soared to 12.1 percent in 2004, driven primarily by external factors—including booming metals prices, strong demand in China and Russia, and a highly competitive exchange rate. This was accompanied by a sharp increase in the current account surplus to 11 percent of GDP, and—with monetary policy primarily aimed at maintaining the nominal peg to the U.S. dollar—rising inflation. In 2005, GDP growth is projected to moderate, but—with the financial turbulence surrounding the December presidential elections likely to have only a temporary adverse effect—remain strong. With the key short-term challenge to reduce overheating pressures and bring inflation back to single digits, monetary policy will need to be tightened, aided by a more flexible exchange rate policy. With budgetary policies having been eased markedly in the run-up to the elections—including a sharp hike in pensions—this will need to be supported by substantial fiscal consolidation. Over the medium term, the key challenge remains to build the institutions necessary to support a market economy and—with private investment still very low—to improve the investment climate.

GDP growth in Kazakhstan remained rapid in 2004, underpinned by high global oil prices and an expanding oil sector, and the outlook for 2005 remains highly favorable. With demand pressures intensifying, and inflation currently above the authorities' band for the year, overheating has become a risk. While the budget should remain in surplus in 2005 and is not expected to impart further stimulus, continued large foreign inflows will keep pressure on monetary policy and increased upward exchange rate flexibility will be needed. With credit growth booming, heightened vigilance over banks' portfolios is desirable, accompanied by increased efforts to strengthen bank supervision. Adjustment of banks' reserve requirements—particularly on foreign liabilities, which are rising rapidly—should help moderate credit growth and inflows of capital. While diversification beyond the oil sector is important to help achieve stable medium-term growth, the use of industrial policies that can lead to distortions and the misallocation of resources should be avoided.

The strong growth momentum in the largest countries of the region has provided support to the low-income CIS-7 economies, with the more advanced reformers once again on average faring better. Azerbaijan benefited from higher oil and gas prices and associated foreign direct investment, while higher metals prices benefited Tajikistan (aluminum), Armenia (copper), and the Kyrgyz Republic (gold). Uzbekistan's current account surplus shrank with the fall in cotton prices and energy sector–related imports. Given their relatively high debt burdens—except in Armenia—the CIS-7 economies remain vulnerable to changes in the external environment, while several countries will also find it very challenging to achieve their Millennium Development Goals. This underscores the need to pursue long-term fiscal and structural reforms and to improve the business environment, and the importance of strong and sustained support from the international community. Greater harmonization of trade rules with multilateral standards, liberalization of transit regimes within the CIS-7 and with neighboring countries, and the removal of nontariff barriers also need high priority to pave the way for growth going forward by realizing the gains from closer economic integration with larger economies and diversification of the export base.

Africa: Turning The Corner?

In sub-Saharan Africa, real GDP growth accelerated to 5.1 percent in 2004 (2.8 percent in per capita terms), the highest in almost a decade (Table 1.10). Growth has been underpinned by

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]			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Africa	**4.6**	**5.1**	**5.0**	**5.4**	**10.6**	**7.7**	**7.7**	**5.9**	**–0.3**	**0.2**	**0.8**	**0.5**
Maghreb	**6.1**	**4.9**	**4.2**	**4.7**	**2.2**	**3.1**	**2.9**	**2.8**	**7.2**	**6.8**	**7.7**	**7.3**
Algeria	6.9	5.3	4.6	4.7	2.6	3.6	3.5	3.5	13.3	13.3	15.4	14.7
Morocco	5.2	3.5	3.0	3.8	1.2	2.0	2.0	2.0	3.6	1.2	—	0.3
Tunisia	5.6	5.8	5.0	5.9	2.8	3.6	2.5	2.5	–2.9	–2.1	–2.5	–2.5
Sub-Sahara	**4.2**	**5.1**	**5.2**	**5.6**	**13.3**	**9.1**	**9.2**	**6.8**	**–2.7**	**–1.9**	**–1.3**	**–1.6**
Horn of Africa[3]	**1.9**	**9.1**	**7.2**	**6.9**	**10.6**	**8.6**	**6.6**	**6.1**	**–6.7**	**–6.7**	**–5.5**	**–6.2**
Ethiopia	–3.9	11.6	5.7	4.6	15.1	9.0	5.4	5.0	–2.7	–6.1	–8.1	–7.5
Sudan	6.0	7.3	8.3	8.6	7.7	8.4	7.5	7.0	–8.2	–6.8	–4.5	–5.5
Great Lakes[4]	**4.1**	**5.4**	**5.3**	**5.9**	**8.2**	**6.9**	**6.8**	**4.1**	**–2.4**	**–4.0**	**–5.4**	**–6.4**
Congo, Dem. Rep. of	5.7	6.8	7.0	7.0	12.8	3.9	12.7	5.2	–1.5	–2.5	–4.8	–6.7
Kenya	1.6	3.1	3.3	3.7	9.8	11.5	6.6	3.6	–0.2	–3.7	–4.9	–5.7
Tanzania	7.1	6.3	6.5	7.0	4.5	4.6	4.3	4.0	–2.4	–5.8	–5.4	–6.6
Uganda	4.7	5.9	5.2	6.4	5.1	5.9	3.5	3.5	–6.2	–1.9	–4.4	–6.0
Southern Africa[5]	**2.5**	**4.9**	**5.9**	**9.1**	**59.9**	**40.3**	**27.1**	**18.1**	**–4.0**	**–0.1**	**–1.5**	**–1.1**
Angola	3.4	11.2	13.8	24.5	98.3	43.6	20.1	11.7	–5.2	6.5	3.3	4.7
Zimbabwe	–10.0	–4.8	–1.6	—	431.7	282.4	187.2	103.7	–5.0	–5.3	–2.7	–3.7
West and central Africa[6]	**7.2**	**5.6**	**5.5**	**5.8**	**9.4**	**8.2**	**9.4**	**5.5**	**–3.6**	**–0.4**	**2.4**	**1.3**
Ghana	5.2	5.5	5.6	5.9	26.7	12.6	14.5	8.4	1.7	1.2	–1.3	–0.6
Nigeria	10.7	3.5	7.4	5.8	14.0	15.0	14.8	7.3	–3.7	2.8	7.8	5.1
CFA franc zone[7]	**5.4**	**7.6**	**4.0**	**4.2**	**1.3**	**0.7**	**2.8**	**2.9**	**–4.0**	**–2.6**	**–1.7**	**–1.5**
Cameroon	4.5	4.3	3.9	4.6	0.6	0.3	2.0	2.0	–2.4	–1.7	–0.6	–0.8
Côte d'Ivoire	–1.6	–0.9	–1.4	2.0	3.3	1.5	2.0	2.0	3.9	3.1	4.1	3.5
South Africa	**2.8**	**3.7**	**4.0**	**3.5**	**5.8**	**1.4**	**4.5**	**5.0**	**–0.9**	**–2.5**	**–3.0**	**–2.6**
Memorandum												
Oil importers	3.5	4.7	4.5	4.8	10.1	6.8	7.2	5.9	–1.8	–2.7	–3.1	–3.1
Oil exporters	8.3	6.2	6.4	7.1	12.4	10.6	9.0	5.8	3.9	7.7	10.2	9.0

[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 Djibouti.
[4]Includes Burundi and Rwanda.
[5]Includes Botswana, Comoros, Lesotho, Madagascar, Malawi, Mauritius, Rep. of Mozambique, Namibia, Seychelles, Swaziland, and Zambia.
[6]Includes Cape Verde, The Gambia, Guinea, Mauritania, São Tomé and Príncipe, Sierra Leone, and CFA franc zone.
[7]Includes Benin, Burkina Faso, Central African Republic, Chad, Rep. of Congo, Equatorial Guinea, Gabon, Guinea-Bissau, Mali, Niger, Senegal, and Togo.

the strength of the global economy, including high oil and commodity prices, improved domestic macroeconomic policies and progress with structural reforms, and the ending of several protracted armed conflicts. Growth was particularly strong in countries where oil production increased sharply (notably Angola, Chad, and Equatorial Guinea) and where agriculture recovered after a drought (Ethiopia and Rwanda), but conflicts and political instability (Côte d'Ivoire) and poor governance (Zimbabwe) continued to affect some other countries. Despite the appreciation of currencies pegged to the euro, high commodity prices underpinned an improvement in the region's current account balance. Inflation continued to decline, reaching single digits in 2004, the lowest rate for nearly three decades, although inflation in some countries—notably Zimbabwe—remained very high.

Looking forward, prospects generally remain favorable, with growth of 5.2 percent in 2005 and 5.6 percent in 2006 projected, aided by prudent macroeconomic policies, continuing structural reforms, and a supportive global economy. Oil-exporting countries are expected

to enjoy the strongest growth—as production continues to expand—while growth in non-oil-producing countries is expected to be affected by the slowdown in non-oil commodity prices. In particular, Benin, Burkina Faso, and Mali will continue to be hurt by persistently low cotton prices. Seychelles and Somalia were hit by the recent tsunami. While the tsunami's impact on growth in the Seychelles is expected to be modest, the fiscal position and balance of payments will be adversely affected this year. For Somalia, insufficient information is available to make an assessment of the tsunami's impact on the macroeconomy. There are several important risks to this outlook, however, including a less benign global economy and a disorderly depreciation of the dollar. In particular, a sharp depreciation of the dollar is likely to weaken non-oil exports of the CFA franc zone countries given their peg to the euro and their increasing dependence on dollar-zone markets (United States and Asia). Moreover, higher oil prices would adversely affect growth and the balance of payments in non-oil-producing countries, particularly if non-fuel commodity prices weaken. A further important challenge for a number of countries in the region (notably Kenya, Lesotho, Madagascar, Malawi, Mauritius, South Africa, and Swaziland) will be adjusting to the elimination of world textile trade quotas, which will increase the competition they face in the United States and the European Union from low-cost Asian countries; as a result textile production, employment (primarily of women workers), and exports are likely to fall.[8]

The encouraging growth performance in recent years has renewed optimism that sub-Saharan Africa may be entering a period of strong and sustained economic expansion.

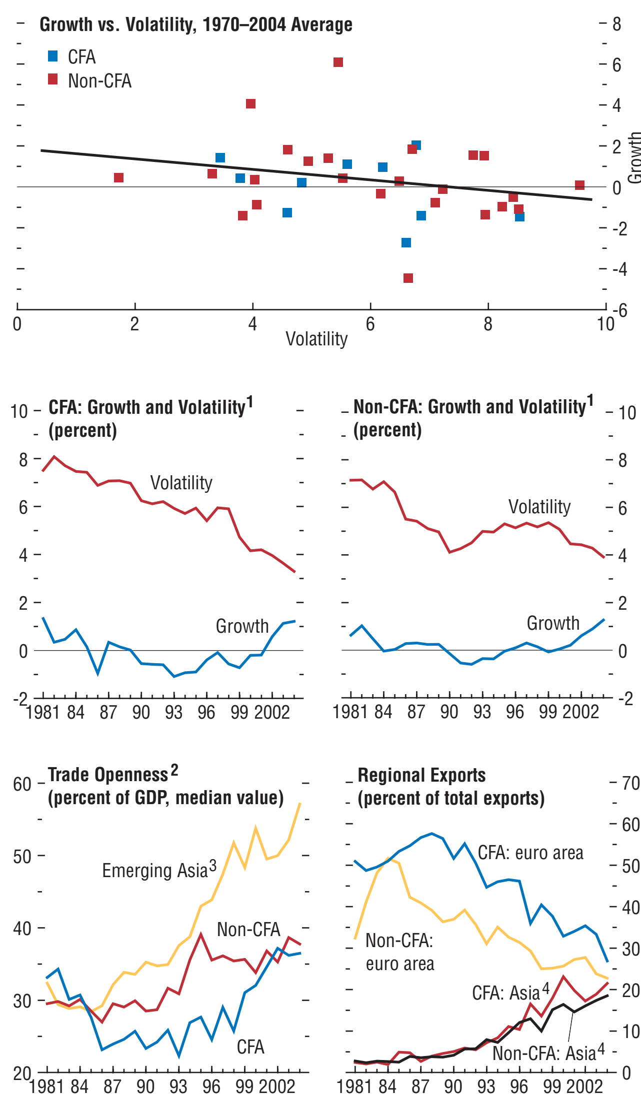
- Per capita income growth in sub-Saharan Africa has accelerated and become positive over the past five years—a significant improvement compared with the previous two decades when sub-Saharan Africa recorded the worst growth performance among developing country regions.
- Per capita income volatility in sub-Saharan Africa has fallen over the past two decades, particularly among CFA franc zone countries (Figure 1.17). As discussed in Chapter II, however, sub-Saharan Africa remains the most volatile region of the world. In the absence of well-developed capital markets and insurance schemes—such as the social security systems prevalent in industrial countries—the effects of volatility in poor countries are substantial, as households and firms face large non-insurable employment, income, and investment risks (see Pallage and Robe, 2003).

What factors help explain this stronger growth and lower volatility? While growth and volatility are influenced by many factors, economic reforms—that result in scarce resources being used more efficiently and in improved incentives for investments in high-return activities—and strong macroeconomic policies have played an important role in improving the prospects for sustained growth and macroeconomic stability across the world (see Chapter II and Krueger, 2005). A large number of countries in sub-Saharan Africa have made progress in reforming their economies and strengthening macroeconomic policy implementation over the past decade, and an important part of the improvement in growth and reduction in volatility in the region can be attributed to these reform and stabilization efforts (see the IMF's forthcoming sub-Saharan Africa *Regional Economic Outlook*). One component of this has been the adoption of trade reforms that, by introducing more competition and mitigating the negative effects of volatility on economic growth, have helped improve the growth potential of countries in sub-Saharan Africa (Box 1.5, "How Does Macroeconomic Instability Stifle Sub-Saharan African Growth?"). Trade regimes

[8]This negative effect, however, will be mitigated by the existence of preferential trade agreements with the United States and the European Union and other trade actions affecting Chinese exports in this sector.

Figure 1.17. Sub-Saharan Africa: Output Growth and Volatility

Macroeconomic volatility has a significant adverse impact on growth. The reduction in volatility in sub-Saharan Africa is one of the factors that has helped improve growth in recent years.



Sources: IMF, *Direction of Trade Statistics;* INS DATA; Penn World Table Version 6.1; and IMF staff calculations.

[1] Median per capita output growth and volatility (standard deviation) of growth rates calculated over a 10-year rolling window.

[2] Defined as the ratio of exports plus imports to GDP.

[3] Consists of China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, and Thailand.

[4] Excluding Japan.

in countries in sub-Saharan Africa, however, remain generally more restrictive than in the dynamic economies of emerging Asia.

Despite these encouraging developments, per capita income growth in most countries in sub-Saharan Africa is still unlikely to be sufficient to meet the Millennium Development Goals. Therefore, countries need to deepen their reform programs to further strengthen growth prospects, including by promoting private sector investment, developing infrastructure, and strengthening institutions (including better transparency, governance, and property rights). Progress under the New Partnership for Africa's Development—a multicountry initiative to make progress in these areas—has so far been slow and limited. In addition, further trade, financial sector, and public sector reforms remain key to enhancing growth prospects in the region. These reforms must be complemented by continued prudent macroeconomic policies, including better fiscal management of oil and commodity revenues. The implementation of an effective strategy to moderate the impact of the HIV/AIDS pandemic is also critical. The international community, in turn, must support these domestic reform efforts with increased aid, debt relief, and improved market access.

Turning to sub-Saharan Africa's largest economies, South Africa is experiencing stronger output growth and important gains in formal sector employment. The economy expanded by 3.7 percent in 2004, and growth is expected to reach 4 percent this year. Activity is being underpinned by buoyant domestic demand, which has been fueled by low interest rates, the wealth effects of booming asset prices—particularly housing prices—and, lately, more expansionary fiscal policy. As a result of strong domestic demand and continued appreciation of the rand, the current account deficit widened to 2.5 percent of GDP in 2004. Capital inflows, buoyed by high domestic returns, have helped the central bank to continue to strengthen its international reserves position. The inflation outlook looks broadly favorable, although monetary

Box 1.5. How Does Macroeconomic Instability Stifle Sub-Saharan African Growth?

Many countries in sub-Saharan Africa have undertaken important steps to generate a more stable macroeconomic environment in recent years. However, output volatility remains high, adversely affecting long-term growth, and more needs to be done to create an environment under which the strong and sustained growth needed to reduce poverty can be attained. Recent research shows that volatility has a particularly damaging effect on economic growth in low-income countries (Hnatkovska and Loayza, 2005). The countries in sub-Saharan Africa, in addition to being poor, share several other common features that further magnify the negative effects of volatility on growth. This box briefly reviews some of these features, which are associated with the dynamics of investment, the strength and composition of economic linkages with the global economy, the development level of the domestic financial sector, and the nature of macroeconomic policies.

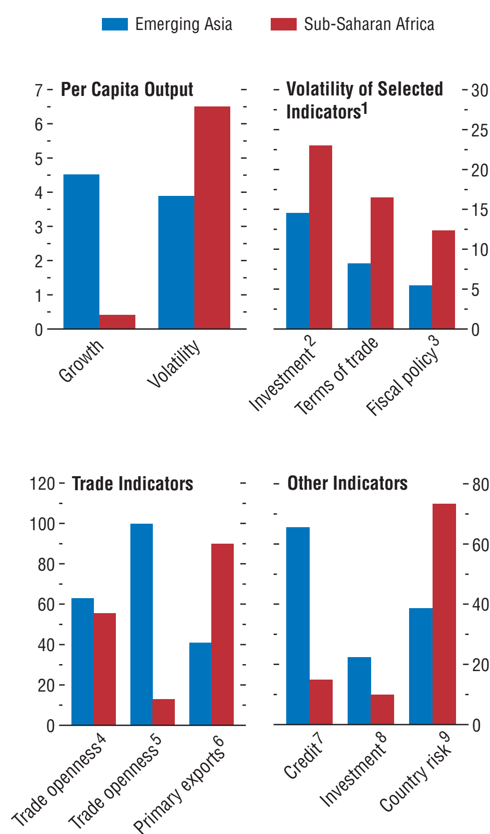
Dynamics of Investment

Investment plays a critical role in transmitting the negative impact of volatility to growth in Africa (Kose, Prasad, and Terrones, 2005). While sub-Saharan Africa's low rate of investment has always been a major impediment to economic growth, the high volatility of investment in the region has been particularly damaging (see Fischer, Hernández-Catá, and Khan, 1998, and the October 1999 *World Economic Outlook*). The average growth rate of investment in sub-Saharan Africa has been the slowest of any region over the past three decades, while its volatility has been the highest (see the figure).

Why has the volatility of investment been so high in sub-Saharan Africa? The major culprit driving investment volatility in the region has been the high risk attached to the return on investment. The average risk on investment return is determined by several factors, including those affecting overall macroeconomic volatility as well as uncertainty associated with the scope and implementation of future government policies (see Azam and others, 2002). Not surprisingly, the typical measures of country risk indicate that investment is much riskier in sub-Saharan Africa than in other regions.

Note: The main authors of this box are M. Ayhan Kose and Marco Terrones.

Selected Regional Characteristics, 1970–2000



Sources: Penn World Table Version 6.1; IMF, *International Financial Statistics;* and Kose, Prasad, and Terrones (2005).
[1]Standard deviation of growth rates.
[2]Real per capita investment.
[3]Real per capita government consumption.
[4]Sum of exports and imports divided by GDP.
[5]Updated Sachs and Warner trade indicator. See Wacziarg and Welch (2003).
[6]Share of primary exports to total exports.
[7]Credit to GDP ratio.
[8]Investment to GDP ratio.
[9]100 – institutional investor index.

Box 1.5 *(concluded)*

Substantial growth benefits could be gained by stabilizing investment fluctuations in the region. For example, a reduction in investment volatility of the typical sub-Saharan African country to the level of a typical emerging Asian country—even if the average level is unchanged—would imply a ½ percentage point increase in annual per capita real GDP growth.[1]

Strength and Composition of Trade Linkages

Sub-Saharan Africa's trade linkages with the global economy remain relatively weak, limiting the region's ability to cope with the adverse impact of volatility on growth. Despite recent improvements in the region as a whole, the trade policy regimes of several countries in sub-Saharan Africa are highly restrictive, reflecting the presence of high and dispersed tariffs and widespread use of nontariff barriers. Several studies conclude that trade integration has a central role in helping achieve rapid growth in developing countries, including those in sub-Saharan Africa (see Krueger, 2004). Moreover, recent research shows that trade has a special role in mitigating the adverse impact of macroeconomic volatility on growth. For example, trade integration could help a developing economy to export its way out of a recession since a given exchange rate depreciation could have a larger impact on that economy's export revenues than in an economy with weaker trade linkages. Stronger export revenues could also help in servicing external debt, which is quite substantial in a number of sub-Saharan African countries. There are significant growth benefits associated with further liberalizing trade regimes in sub-Saharan Africa: if the countries in the region were to raise the level of trade integration to the average of emerging Asia, their annual per capita real GDP growth would increase by about 1 percentage point.[2]

Sub-Saharan African economies depend on a narrow range of commodities for their export earnings. In particular, primary goods constitute close to 90 percent of total exports in sub-Saharan Africa, which is more than double that in emerging Asia. Mainly because of this, terms of trade fluctuations are very volatile in the sub-Saharan African countries, adversely affecting growth.[3]

Domestic Financial Sector and International Financial Integration

Having underdeveloped domestic financial systems and limited integration with global financial markets tends to magnify the negative impact of macroeconomic volatility on growth in the region. Total credit to the private sector as a ratio of GDP in the sub-Saharan African countries is roughly one-fifth of that in emerging Asian countries, implying that the financial sector plays only a minor role in these economies. Moreover, sub-Saharan Africa lags behind other developing regions in attracting capital flows (see Reinhart and Tokatlidis, 2003). Recent research finds that greater financial development not only significantly contributes to economic growth, but also dampens the adverse impact of volatility on economic growth. For example, if the level of financial sector development in sub-Saharan Africa increases to that of emerging Asia, this could increase the annual growth rate of per capita real GDP by ½ percentage point. International financial integration also appears to weaken the negative relationship between volatility and growth since it expands the set of risk-sharing opportunities.

[1]The calculations reported in this box draw on Kose, Prasad, and Terrones (2005).

[2]To achieve this growth gain, however, reciprocal liberalization for key commodities in target markets will be needed. In addition, to mitigate the adverse impact of trade liberalization on fiscal balance, the sub-Saharan African countries would also need to implement fiscal reforms.

[3]Terms of trade shocks are an important channel transmitting the adverse effects of volatility on growth since they have a significant impact on savings and investment decisions (see Kose and Riezman, 2001; Belaney and Greenaway, 2001; and Calderon and others, 2004). Terms of trade shocks in sub-Saharan Africa are also highly persistent (see Cashin and others, 2004).

Nature of Macroeconomic Policies

Sub-Saharan African countries also suffer from the detrimental effects of highly volatile and procyclical fiscal policies on economic growth. Government revenues in sub-Saharan Africa are dependent on extremely volatile commodity exports, which results in large fluctuations in these revenues (Dehn, Gilbert, and Varangis, 2005). Meanwhile, inadequate expenditure control and the lack of a medium-term budget framework often mean that government expenditures move in tandem with revenues—leading to highly procyclical fiscal policy in most sub-Saharan African countries (Kaminsky, Reinhart, and Vegh, 2004). Recent research shows that highly volatile and procyclical fiscal policies often lead to an increase in the amplitude of macroeconomic fluctuations and lower economic growth (Fátas and Mihov, 2003).

In sum, economic growth in sub-Saharan Africa has strengthened in recent years, while volatility has fallen. Despite these welcome developments, however, growth is still below the rates that will be needed to achieve the Millennium Development Goals, and volatility remains the highest in the world. While macroeconomic stability is not a sufficient condition for economic growth in sub-Saharan Africa, recent research shows that it plays an important role. Without it, the impact of all other potential factors hindering economic growth in the region become much more damaging. This box—together with the analysis in Chapter II—suggests that creating a more attractive investment climate, expanding and diversifying exports, deepening the domestic financial sector, and designing prudent fiscal policies will all be important elements of the effort to further reduce economic volatility and enhance growth in the region.

growth is very rapid and unit labor costs are rising, raising the risk that without monetary tightening, the 3–6 percent inflation target may be missed. Notwithstanding the recent gains in employment, unemployment is likely to remain high unless reforms are implemented to reduce existing labor market rigidities.

In Nigeria, short-term economic performance continues to be greatly influenced by developments in the oil and gas sectors. The economy grew by 3.5 percent in 2004 and is expected to expand by 7.4 percent this year as a major offshore oil field and two new liquefaction trains come on stream. The adoption of more prudent macroeconomic policies has helped contain inflation, move the current account balance into a surplus, and increase international reserves sharply. Looking ahead, further reforms—centered around a strengthening of fiscal policy and monetary policy, civil service reform, and efforts to reduce corruption—together with sound macroeconomic policies are critical for the achievement of rapid and sustained economic growth. The government should take advantage of the current favorable environment to implement other reforms, including trade liberalization, the unification of the exchange rate, and privatization to help increase the efficiency and resilience of the economy.

In the Maghreb region, the outlook remains positive notwithstanding an expected slowdown in output growth this year. In Algeria, the economy slowed in 2004—and is projected to slow further this year—reflecting a moderation in the expansion of hydrocarbon production. Fiscal policy has remained expansionary, as expenditures have been linked to hydrocarbon revenues. Starting with the 2005 budget, the government has begun the process of fiscal consolidation by delinking government spending from volatile hydrocarbon revenues. Financial sector reform, including the privatization of state-owned banks, and the pursuit of foreign trade liberalization are priorities to enhance economic growth and reduce the still-high levels of unemployment.

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]			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Middle East	**5.8**	**5.5**	**5.0**	**4.9**	**7.1**	**8.3**	**8.6**	**8.3**	**8.3**	**13.7**	**17.2**	**14.9**
Oil exporters[3]	**6.5**	**5.7**	**5.2**	**5.0**	**8.8**	**9.0**	**9.2**	**9.4**	**10.1**	**15.7**	**20.3**	**17.5**
I.R. of Iran	6.6	6.6	6.0	5.9	15.6	15.6	15.0	15.0	1.5	5.2	6.4	4.5
Saudi Arabia	7.2	5.3	4.1	3.3	0.6	0.2	1.0	1.0	13.8	19.8	27.7	25.1
Kuwait	9.7	7.2	3.2	3.2	1.0	1.8	1.8	1.8	17.5	29.1	37.8	34.7
Mashreq	**3.0**	**4.2**	**4.5**	**4.7**	**3.4**	**6.7**	**8.1**	**6.6**	**1.0**	**0.1**	**0.3**	**−0.4**
Egypt	3.1	4.1	4.8	5.0	3.2	8.1	9.9	8.0	2.4	4.4	4.5	3.4
Syrian Arab Republic	2.6	3.4	3.5	3.6	5.0	3.5	4.0	4.0	3.5	−0.4	−0.4	−2.9
Jordan	3.3	6.7	5.0	5.5	2.3	3.4	3.5	2.0	11.3	−0.8	−1.7	−5.0
Lebanon	3.0	5.0	4.0	3.5	1.3	3.0	2.0	2.5	−13.6	−16.1	−16.3	−12.9
Memorandum												
Israel	1.3	4.3	3.7	3.6	0.7	−0.4	1.0	2.0	0.1	0.1	−0.2	—

[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 I.R. of Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, and Yemen.

The Middle East: How Is the Recycling of Oil Revenues Affecting the Global Economy?

Oil-exporting countries in the Middle East have experienced a substantial increase in export earnings over the past two years as oil prices and oil production have risen. These revenues—together with sound financial policies and progress with structural reforms—have supported strong growth, which averaged 5.7 percent in 2004, and have underpinned large current account and fiscal surpluses. Growth in the non-oil-producing countries has also picked up as they have benefited from the strong growth in the oil producers and, in some cases, the positive impact of domestic reforms. Although growth is expected to slow, the outlook for the region remains positive with growth of 5 percent projected for 2005 (Table 1.11); indeed, with oil prices currently well above the baseline used in the World Economic Outlook forecasts, there is a clear upside risk to this projection. On the downside, continuing geopolitical uncertainties in the region could hurt growth. With the exchange rates of many countries in the region linked to the U.S. dollar, further dollar depreciation is not likely to have significant implications for most countries, unless it is associated with a slowing in global growth and a decline in oil prices.

Current expectations are that oil prices will remain high over the medium term. The prospect of a sustained period of high oil prices presents an important opportunity for oil exporters to press ahead with the reforms needed to boost medium-term growth prospects, increase employment prospects for the rapidly growing working age population, and reduce existing vulnerabilities, including from high public debt levels in a number of countries (see Box 1.6, “How Should Middle Eastern and Central Asian Oil Exporters Use Their Oil Revenues?”). Growth-enhancing reforms in the oil-exporting countries will also provide benefits to other countries in the region, particularly through trade links and remittance flows (see Chapter II for an assessment of the macroeconomic benefits of remittances).

From a global perspective, the behavior of the Middle Eastern oil-producing countries could have a bearing on how the current constellation of external imbalances unwinds. The combined current account surplus of these countries was larger (in dollar terms) than that in developing Asia last year. Over the medium term, it is likely that these surpluses will decline as increased

domestic consumption and investment boosts imports. Further, while the impact on the global economy of the financial flows from the region has declined relative to earlier periods of high oil prices, these flows could have an impact on international financial markets, although it is difficult to know where the investments are directed (Figure 1.18).

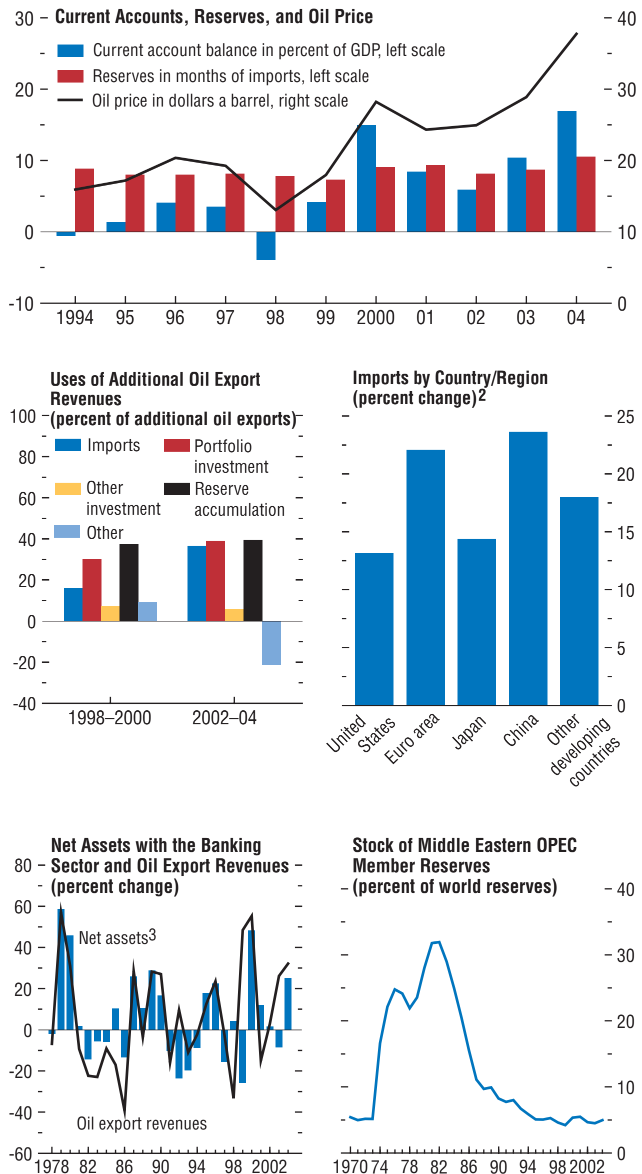
Turning to individual countries, the economic outlook in the Islamic Republic of Iran remains favorable, with growth of 6 percent expected during 2005–06. The economy is benefiting from high oil prices and previously implemented reforms that have boosted the non-oil sector. Activity has also been underpinned by expansionary monetary and fiscal policies, but with inflation entrenched at about 15 percent, tighter macroeconomic policies are now required. Sustaining strong growth and reducing unemployment—which, although declining, remains high—is a policy priority, and this will require an acceleration of structural reforms, particularly in the labor market and financial sector.

Progress toward restoring economic stability in Iraq is continuing, although the recovery appears to be proceeding more slowly than had earlier been envisaged and inflation has risen sharply in recent months. A tightening of monetary policy is now required. With the elections completed, the government must focus its efforts on developing institutions to support a market-based economy, on reconstructing infrastructure, and on maintaining macroeconomic stability. The recent decision by the Paris Club to reduce their claims on Iraq by 80 percent is an important step toward achieving debt sustainability.

In Saudi Arabia, the economy expanded by 5.3 percent last year and inflation remained subdued. While oil sector output is projected to slow this year, the non-oil sector is expected to remain robust—supported by increased tourism and the continued expansion of the petrochemical sector—and overall GDP growth is projected at 4.1 percent. The sharp rise in oil revenues has underpinned a significant increase in the current account and fiscal surpluses and a

Figure 1.18. Middle East: How Are OPEC Members Using the Higher Oil Revenues?[1]

High oil prices have underpinned a considerable strengthening in the external position of Middle Eastern OPEC countries. Higher oil revenues have boosted imports and increased investment overseas. The impact on global financial markets, however, is more limited than during previous periods of high oil prices.



Sources: IMF, *Direction of Trade Statistics;* Bank of International Settlements; and IMF staff calculations.

[1]Consists of I.R. of Iran, Iraq, Kuwait, Libya, Qatar, Saudi Arabia, and the United Arab Emirates.

[2]First 11 months of 2004 over the same period of 2003.

[3]Net assets with the banking sector are defined as the stock of assets of Middle Eastern OPEC members vis-à-vis BIS reporting banks less liabilities to these banks. Data are fourth quarter over fourth quarter percent change. Data for 2004 are as of 2004Q3.

Box. 1.6. How Should Middle Eastern and Central Asian Oil Exporters Use Their Oil Revenues?

The rise in oil prices and the associated increase in oil earnings present a window of opportunity for oil-exporting countries to address their economic challenges. This box focuses on the Middle Eastern and central Asian oil-exporting countries, although the general analysis and implications are applicable to many oil-exporting developing countries. In particular, progress in generating employment for growing working-age populations and fostering the development of the private non-oil sectors can be facilitated by the increased financial resources now available. In principle, increased public spending accompanied by an acceleration of structural reforms, with due care to avoid low-return outlays seen during past oil booms in some countries, could place the economies on a higher sustained growth path and, by creating jobs, help improve social outcomes.[1]

Oil export receipts of Middle Eastern and central Asian oil-exporting countries increased by an estimated $100 billion in 2004. Most of the increase was due to higher oil prices, although some countries also expanded production significantly to meet rising global demand. While about two-thirds of oil export receipts constituted fiscal revenues in these countries on average, there were substantial cross-country variations owing to differences in production, extraction costs, the fiscal regime, and the extent of government ownership of oil fields and the distribution system. With oil prices expected to remain high in 2005, Middle Eastern and central Asian oil-exporting countries are likely to continue to earn substantial revenue from oil and must decide how much of this revenue should be spent and how much should be saved.

One obvious factor that will help guide this choice in all countries is how long the increase in oil earnings is expected to last. If it is very temporary, then clearly more of the extra revenue should be saved. But the large increase in long-term futures prices of oil since mid-2003 suggests that a sizable portion of the rise in oil exporters' earnings is expected to persist over the medium term, implying that a higher level of spending could be sustainable and appropriate. The extent to which spending can and should be expanded depends on the circumstances of individual countries.

In countries where the social return on human capital development or infrastructure investment is high, there is a strong case for spending a larger part of the additional oil revenue in these areas.[2] For example, in countries where human development indicators are poor—such as Algeria, Sudan, Syria, Uzbekistan, and Yemen, as suggested by their ranking on the UN Human Development Index (see the table)—increased spending on education and health could be especially effective. Similarly, in countries where unemployment is a serious problem (e.g., Algeria, Bahrain, I.R. of Iran, Iraq, and Saudi Arabia), schemes to boost private sector employment—possibly through a combination of increased spending and tax cuts—may well carry high social returns. In other countries, infrastructure investment may offer high returns by enhancing the growth prospects of the private sector. Clearly in Iraq there are major infrastructure rebuilding requirements, but aging infrastructure also poses a constraint on growth elsewhere. As two widely used indices that measure the quality of the road network and the efficiency of the elec-

Note: The main authors of this box are Aasim Husain and Hamid Davoodi.

[1]The positive and significant direct impact of increased social spending on human capital accumulation and growth is supported by empirical studies. See, for example, Baldacci and others (2004).

[2]Increased investment spending in response to higher oil prices is supported by economic theory. Hotelling's rule for optimal exhaustible resource management indicates that if the return to public investment exceeds the world real interest rate—which in turn equals the return to holding oil in the ground over the long run—rates of oil extraction should rise and proceeds should be used to increase fixed investment. Similarly, higher earnings from a given rate of extraction, in such circumstances, should be used to finance higher investment.

Selected Economic and Social Indicators of Middle Eastern and Central Asian Oil-Exporting Countries

		Infrastructure Development			
	Human development Index rank[1] 2002	Paved roads (percent of all roads; 1995–2001)	Electric power losses (percent of output; 2001)	Proven oil reserves (billion barrels; end-2004)	Ratio of overall fiscal balance to GDP (percent, 2004)
Algeria	108	69	16	11.8	4.7
Azerbaijan	91	92	13	7.0	0.9
Bahrain	40	. . .	9	0.1	7.3
I.R. of Iran	101	56	16	125.8	2.7
Iraq	. . .	84	. . .	115.0	–43.0
Kazakhstan	78	94	17	9.0	2.7
Kuwait	44	81	3	101.5	21.0
Libya	58	57	. . .	39.0	18.8
Oman	74	30	17	5.5	7.7
Qatar	47	. . .	7	15.2	9.1
Saudi Arabia	77	30	8	261.9	7.4
Sudan	139	36	15	0.6	1.4
Syria	106	21	. . .	2.5	–5.7
Turkmenistan	86	81	13	0.5	–2.0
Uzbekistan	107	87	9	0.6	16.4
United Arab Emirates	49	100	9	97.8	–1.3
Yemen	149	12	26	4.0	–3.7
Memorandum					
World[2]					
High-income countries	22	93	6	. . .	. . .
Middle-income countries	78	52	11	. . .	. . .
Low-income countries	142	16	23	. . .	. . .

Sources: UNDP, *Human Development Report* (2004); World Bank, *World Development Indicators* (2004); Radler (2004); and IMF staff estimates.

[1]The rank represents a country's relative position out of 177 countries and is based on a composite index of life expectancy, enrollment rate, adult literacy rate, and per capita income.

[2]Simple average over country groups, based on the World Bank's income classification.

tricity distribution system suggest (see the table), Kazakhstan, Oman, Syria, and Yemen stand to gain substantially from improved infrastructure. In countries with a high incidence of poverty (e.g., Azerbaijan, Sudan, and Yemen), strengthening of social protection mechanisms is likely to take priority.

That said, overall macroeconomic conditions may affect some countries' ability to absorb additional public spending. In countries such as Azerbaijan, Iran, and Kazakhstan, where the non-oil sector is expanding rapidly, credit growth is high and persistent, and inflationary pressures are evident or emerging, the room for further relaxation of the budgetary position at present may be more limited. In countries where public spending has already been expanding at a rapid pace, such as Algeria and Kuwait, further acceleration could lead to an erosion in its quality and effectiveness, and a withdrawal of fiscal stimulus may be needed. Countries that have accumulated significant public debt in the past may find that the value of paying down part of this debt, by reducing budgetary vulnerability to oil price declines and creating room for dissaving during possible bad times in the future, exceeds the benefits of additional spending now. Indeed, Saudi Arabia has reduced its domestic debt significantly over the past year.

The remaining stock of proven oil reserves and future profile of oil production will also need to guide the decision on the appropriate use of oil revenues, as the sustainability of spending depends on these factors. In countries

Box. 1.6 *(concluded)*

such as Oman and Yemen—whose oil revenues account for a large fraction of government revenues and which face aging oil fields and rising oil extraction costs, and which have recently witnessed large downward revisions in the size of their proven oil reserves—a larger share of additional oil revenue will need to be saved to avoid a disorderly adjustment of the fiscal position in the future. Indeed, these factors point to fiscal prudence and the adoption of measures to enhance non-oil revenues and rationalize spending. By contrast, there is clearly more room to relax the fiscal stance in countries with plentiful oil reserves, as well as in countries where a substantial rise in the volume of oil production is projected over the medium term (e.g., Azerbaijan and Kazakhstan), although other factors need to be considered in determining how much of an expansion in spending would be advisable.

Thus, these principles provide some general guidance on the use of oil revenues, but their appropriate use in a particular country will depend on each country's circumstances. Indeed, the general principles may well offer conflicting guidance, as in the case of a country with large social and/or infrastructure needs that is faced with emerging overheating pressures or diminishing oil revenue. In such cases, competing considerations for the optimal use of oil revenue will need to be carefully balanced and may, in some countries, imply the need to increase spending gradually or to shift the composition of spending to increase its productivity. Where increased spending is judged to be appropriate, an adequate public expenditure management system will need to be in place to ensure that the additional spending is of high quality, and basing such increases within a longer-term framework will help secure budget sustainability. And due caution will need to be exercised—by adopting appropriate macroeconomic policies and pressing ahead with structural reforms to enhance productivity—to avoid an erosion in the competitiveness of the non-oil sectors of the economy.

reduction in public debt. Efforts are needed, however, to contain current spending and increase non-oil revenues to strengthen the underlying structure of the budget. Structural reforms are continuing to move forward, with important progress being made in the legislative and financial sector areas.

The Egyptian economy gained momentum during 2004 owing to a strong export performance and a revival in domestic consumption, and growth of 4.8 percent is projected for 2005. Sentiment has been strengthened by the government's commitment to reforms—which include a major reform of the tariff system, plans for a comprehensive restructuring of the banking sector, and renewed impetus on privatization—and the stock market has risen to all-time highs. The fiscal position, however, needs to be strengthened and public debt reduced, and monetary policy tightened further to counter high inflation.

Elsewhere in the Mashreq, growth in Jordan strengthened to 6.7 percent in 2004 and is expected to remain robust this year. Exports have been boosted by strong growth in partner countries and exchange rate depreciation, while domestic demand has rebounded as confidence has returned after the Iraq war. Macroeconomic policies have imparted stability to the economy, while key structural reforms are proceeding, including in the area of privatization. In the Syrian Arab Republic, the economy has recovered slowly following the Iraq war. Although growth of 3.5 percent is expected in 2005, the balance of risks remains on the downside. A significant acceleration of reforms—including the liberalization of the trade and foreign exchange regimes and the strengthening of the financial sector—is required to raise growth potential. In Lebanon, the economy has benefited indirectly from the increase in oil prices through higher capital, remittance, and tourism inflows from

elsewhere in the region, and this has boosted growth. Ongoing political developments, however, have increased financial market uncertainties, underscoring the benefits of pressing ahead with a strong economic reform program to maintain investor confidence.

In Israel, growth accelerated to 4.3 percent in 2004—supported by the favorable global environment and an improvement in the security situation—and is expected to be 3.7 percent this year. CPI inflation has remained very low, enabling the Bank of Israel to continue to reduce its policy interest rate, but is expected to return up into the target range of 1–3 percent during the course of this year. Regarding fiscal policy, the authorities have announced an ambitious agenda to reduce the size of government and public debt, and it is important that this be adhered to.

Appendix 1.1. Recent Developments in Commodity Markets

The main authors of this appendix are Sam Ouliaris and Hossein Samiei, with support from To-Nhu Dao and Paul Nicholson.

The overall index of primary commodity prices increased by about 11 percent in U.S. dollar terms (18 percent in SDR terms) between July 2004 and March 2005[9]—extending the robust boom in commodity prices that commenced in July 2002. Substantial increases in energy prices played a key role in strengthening the index. Oil prices stood at record highs in April 2005 owing to high oil consumption growth, a cold weather snap in the northern hemisphere, and uncertainties about OPEC's production plans. Led by beverages and metals prices, the index of nonenergy prices rose by about 3 percent in U.S. dollar and SDR terms. Nevertheless, nonenergy commodity price inflation eased considerably in the fourth quarter of 2004 owing to divergent movements in specific commodity prices and weakness in food and raw material prices in particular. Semiconductor markets posted significant gains in revenue during 2004; however, prospects for further revenue growth in 2005 appear limited owing to depressed prices and substantial gains in productive capacity.

Crude Oil

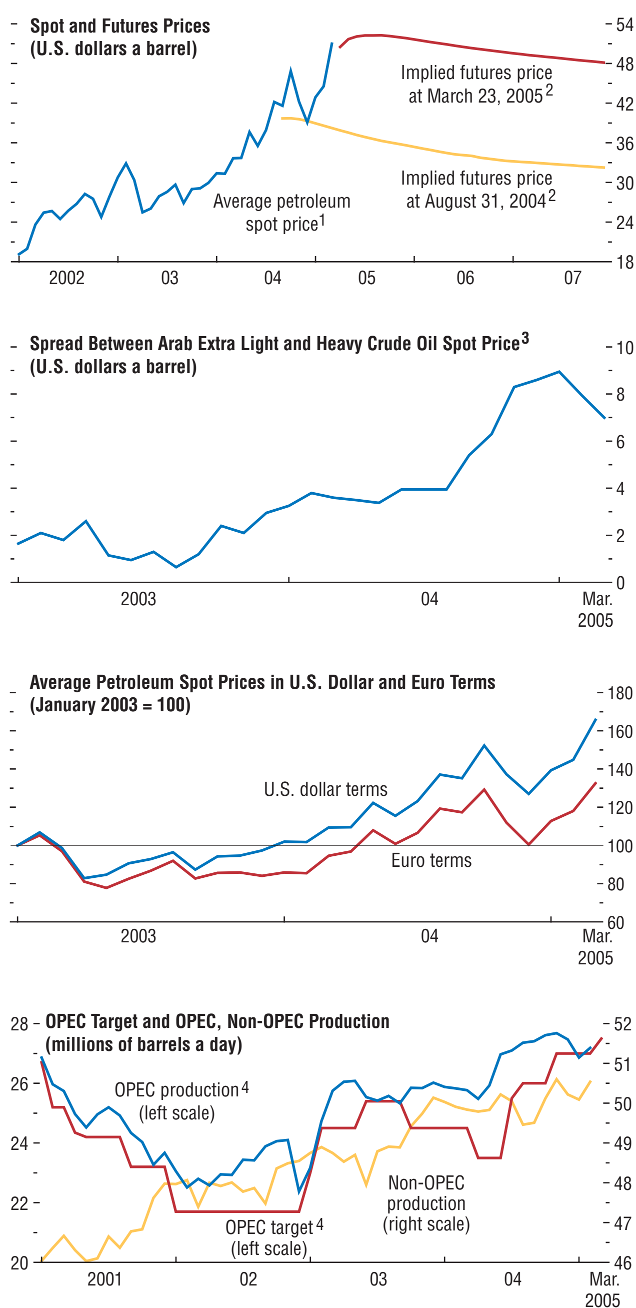
The average petroleum spot price[10] (APSP) rose to a record nominal high of $54.30 in early April 2005—a 73 percent increase relative to prices at the beginning of 2004 (Figure 1.19). Moreover, the rise in crude oil prices was broad based, with each component of the APSP reaching record highs. The increase in prices over the past year, which was largely unanticipated, reflected the combined influence of robust global demand for crude oil, temporary supply shocks, heightened geopolitical uncertainties, and limited spare capacity among OPEC producers. Futures markets in July 2004 implied that oil prices would ease for the rest of 2004 to average $32.50—about $5 less than the actual outcome of $37.65. The rise in prices was also accompanied by a considerable increase in volatility; the coefficient of variation of daily spot prices increased by over 79 percent relative to 2003 levels.

While the average U.S. dollar price of oil increased significantly during 2004, there were divergent movements in terms of non-U.S. currencies and specific grades of crude oil. The prices of heavier grades of crude oil were relatively subdued in the second half of 2004, while those of light sweet crudes surged, resulting in historically high spreads between light and heavy crudes. Also, the significant decline in the U.S. dollar during 2004 tempered the rise in domestic crude oil prices for many countries (e.g., EU member nations, where crude oil prices remain

[9]Unless otherwise stated, percentage changes and summary statistics apply to the July 2004–March 2005 period.

[10]The IMF average petroleum spot price is an equally weighted average of the West Texas Intermediate, Brent, and Dubai crude oil prices. Unless otherwise noted, all subsequent references to the oil price are to the APSP.

Figure 1.19. Oil Prices, Futures, and Production



Sources: International Energy Agency; Bloomberg Financial Markets, LP; IMF, *International Financial Statistics;* and IMF staff calculations.

[1]Average petroleum spot price of West Texas Intermediate, U.K. Brent, and Dubai Fateh crude.

[2]Five-day weighted average of NYMEX Light Sweet Crude, IPE Dated Brent, and implied Dubai Fateh.

[3]Saudi Arabian crude oil deliverable in Asia. Arab Extra Light (Berri) has an API gravity of 37 and a sulphur content of 1.15. Arab Heavy (Safaniya) has an API gravity of 27 and a sulphur content of 2.8.

[4]Excluding Iraq.

Table 1.12. Global Oil Demand by Region

(Millions of barrels a day, mbd)

	Demand 2004	Annual Change mbd	Annual Change Percent
North America	25.18	0.61	2.5
Europe	16.47	0.26	1.6
OECD Pacific	8.62	–0.15	–1.8
China	6.38	0.86	15.6
Other Asia	8.55	0.45	5.6
CIS	3.71	0.14	3.8
Middle East	5.88	0.32	5.7
Africa	2.81	0.07	2.4
Latin America	4.91	0.18	3.8
World	82.51	2.73	3.4

Source: International Energy Agency, *Oil Market Report*, March 2005.

close to early 2003 levels in local currency terms; see Figure 1.19).

Turning to oil market fundamentals, the global consumption of crude oil increased by 2.73 million barrels a day (or 3.4 percent) during 2004—the fastest growth since 1976. The surge in consumption was largely unanticipated. For example, in January 2004, the International Energy Agency (IEA) forecast that global demand would increase by only 1.2 mbd (or 1.6 percent)—in line with a growth in non-OPEC output of approximately 1.2 mbd.

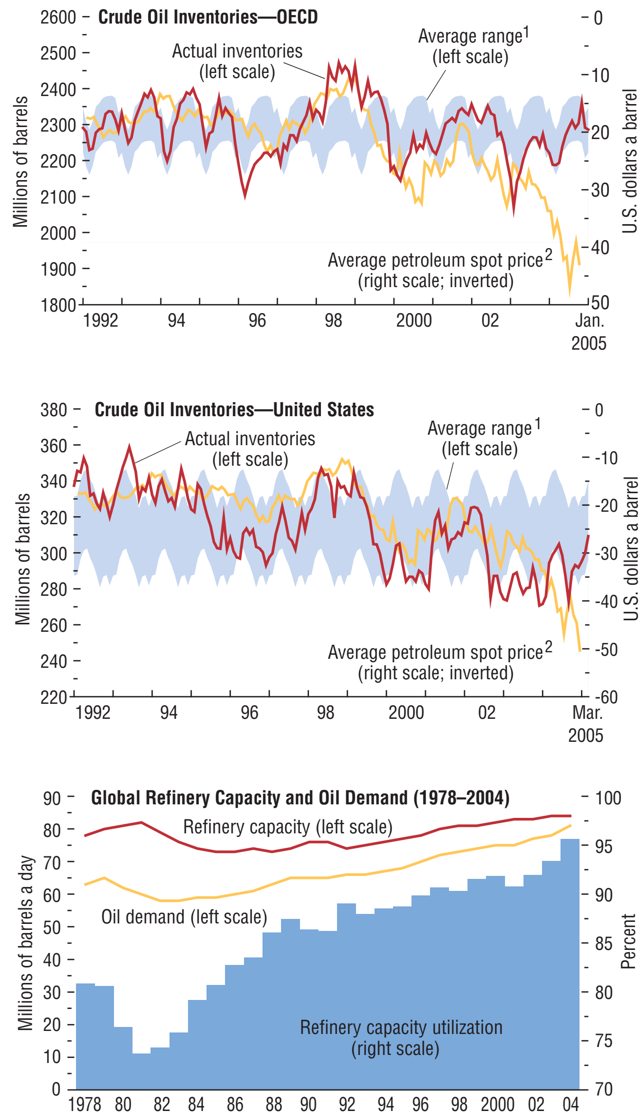
The key factor behind the robust growth in oil demand is the ongoing expansion of the global economy, with Asia (especially China) and North America leading the way (Table 1.12). China's consumption of crude oil increased by 0.86 mbd during 2004—contributing the most to the overall increase in consumption, and making it the second largest oil consumer after the United States—followed by North America (0.61 mbd) and other non-OECD Asian countries (e.g., India; 0.45 mbd). In the case of China, severe electrical power shortages encouraged the use of stand-alone, diesel-powered back-up generators, while expansion of pipeline and commercial oil storage absorbed substantial volumes of incremental crude and derivative products.

According to the IEA, average daily crude oil production from non-OPEC sources rose by about 1.1 mbd in 2004 (1.4 mbd including non-gas liquids)—similar to the growth recorded in

2003. Growth in non-OPEC output, however, was held back by significant declines in OECD production of about 0.35 mbd, arising from damaged oil infrastructure caused by Hurricane Ivan and structural declines in United Kingdom (0.2 mbd) and Norway output (0.1 mbd) of conventional crude. Despite ongoing tensions between OSA Yukos and the Russian government, crude oil output from CIS countries continued to rise, with Russia and Kazakhstan contributing more than half of the increase in non-OPEC output during 2004. Significant increases in synthetic crude oil production from Canada offset declines from more conventional sources, providing a net 0.1 mbd increase in non-OPEC supply. Early indicators compiled by the IEA suggest that non-OPEC output growth will slow to 0.9 mbd in 2005, owing in part to an unexpected shortfall in Russian output during the first two months of 2005.

The rise in non-OPEC output fell far short of the growth in global consumption during 2004, resulting in a significant increase in the demand for OPEC crude oil—the so-called call on OPEC. OPEC-10 members (OPEC excluding Iraq) adopted an accommodative stance toward the surge in demand, gradually raising official quotas from 23 mbd in April 2004 to 27 mbd in November 2004, and maintaining production close to full capacity levels until the end of 2004 (Figure 1.20). By the end of December 2004, actual OPEC-10 production was averaging 28 mbd for the year—about 1 mbd above official quotas, and a rise of nearly 2 mbd relative to 2003 levels. Notwithstanding frequent attacks on its oil infrastructure, oil production in Iraq recovered to about 2 mbd for 2004, supporting an overall increase in OPEC production in 2004 of 2.5 mbd—close to the growth in global demand. The significant increase in global production permitted a counterseasonal rise in OECD commercial inventories during the fourth quarter of 2004 to levels close to the average of the past decade. Crude oil inventories in the United States, however, despite a recent pickup, remain at the lower end of historical averages (Figure 1.20).

Figure 1.20. Commercial Oil Inventories and World Refinery Capacity



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

[1]Average of each calendar month during 1992–2004, plus a 40 percent confidence interval based on past deviations.

[2]Average petroleum spot price of West Texas Intermediate, U.K. Brent, and Dubai Fateh crude.

The sizable increase in commercial inventories and concerns about possible overproduction at the end of the cold season prompted OPEC-10 members to announce a cut in production of 1 mbd effective January 1, 2005, thereby reducing actual production closer to the official OPEC-10 quota as of November 2004. While actual OPEC-10 output remained above quota, crude oil prices rose significantly during the first three months of 2005 as colder weather hit the Northern Hemisphere and concerns about OPEC's production plans increased. Responding to significantly higher crude oil prices in March 2005, OPEC-10 members raised official quotas to a record high of 27.5 mbd on March 16, 2005, with the possibility of a further 0.5 mbd rise in official quotas before OPEC's next official meeting in June.

The surge in OPEC-10 output pushed upstream spare capacity to historical lows, increasing the sensitivity of spot prices to events that affect or threaten crude oil supplies. By the end of December 2004, however, with the addition of about 0.8 mbd capacity in Saudi Arabia, OPEC-10 spare capacity recovered from its historical low to about 1.4 mbd. Nevertheless, even this level of spare capacity—which is close to the 1.5–2.0 mbd target that OPEC has indicated it will aim for going forward—is unlikely to calm the oil market, especially if global demand continues to surge in 2005. According to the IEA, geopolitical tensions during the second half of 2004 threatened 1.5–3.0 mbd of crude oil output. Moreover, over 4 mbd were lost during the Middle East crisis of 1990–91, and the largest oil disruption since 1973 (Iranian revolution, 1978–79) resulted in a supply shortfall of approximately 5.6 mbd for six months. Spare capacity has averaged close to 5 mbd (8 percent of output) in the past three decades. Notwithstanding substantial precautionary inventories in OECD countries, higher spare capacity than currently is planned will be needed to reduce price volatility.

The erosion in spare capacity during 2004 highlighted structural imbalances in the oil sector, which led to higher spreads between light and heavy crudes in the second half of 2004.

- *While OPEC adopted an accommodative stance toward demand, the marginal barrel from OPEC—before the addition of the Qatif and Abu Sa'fah oil fields in Saudi Arabia at the end of 2004—was of the heavy sour type.* At the same time, hurricane-related damage to the U.S. pipeline network in the Gulf of Mexico in September shut in significant quantities of light sweet crude oil and disrupted the flow of imports to the mid-continent of the United States. The cumulative loss in U.S. output was about 40 million barrels by the end of 2004, causing price differentials between light sweet and heavy sour grades of crude oil to widen to historical highs.
- *The shortage of light sweet crude was also compounded by a structural imbalance in the refinery sector.* Global refinery capacity levels remain only slightly above 1980s levels, and utilization rates, which have risen gradually since 2002, remain over 90 percent. In addition, the majority of refinery capacity is simple distillation that is unable to process the heavier crudes. While such refineries can be modified to handle heavier crudes, the conversion process is costly and can take years to implement (Figure 1.20).

Looking forward, early April 2005 futures contract crude oil prices remain above the WEO baseline. Future contract prices imply that average annual prices will average around $52.23 for 2005 and $52.59 for 2006. Moreover, long-dated futures contract prices rose sharply in early 2005 and remain persistently higher—by about $23 relative to late 2002 levels—reflecting ongoing concerns about limited spare capacity relative to demand growth over the medium term (2007–10) that suggest a structural shift, despite ample reserves, toward permanently higher crude oil prices.

In addition, demand and supply conditions for 2005 point to high crude oil prices going forward. Early indicators for 2005 suggest that the demand for crude oil and derivative products continues to rise in North America, and there is little evidence of a slowdown in Chinese demand for diesel fuel in particular. Nevertheless, both

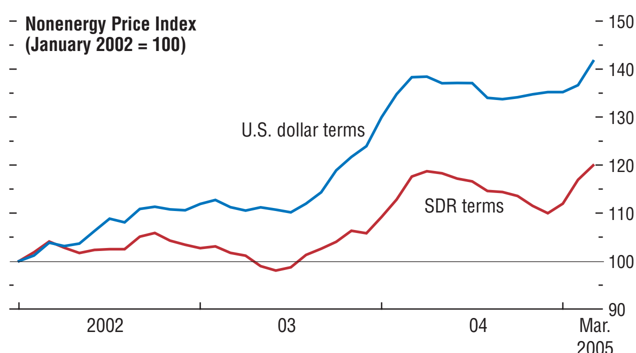
the IEA and OPEC are predicting a decline in the growth of oil demand for 2005 to between 1.8 and 1.9 mbd—nearly a 33 percent reduction compared with the 2.73 mbd growth for 2004. This expectation is based on the assumption that oil consumption growth in China will halve in 2005 relative to 2004 levels as coal-based power generation capacity increases, inventory building eases, and GDP growth in China slows. It also assumes that the substantially higher prices of 2003 and 2004 will begin to temper the growth in global consumption. As for OPEC's supply, analysts appear divided regarding the ability of OPEC member countries to satisfy the incremental growth in demand. With non-OPEC supply predicted to rise by 0.9 mbd in 2005, growth in the call on OPEC in 2005 should slow considerably, reducing downward pressures on spare capacity. After allowing for growth in nongas liquids, both the IEA and OPEC are projecting marginal (0.5 mbd) growth for the call on OPEC during 2005.

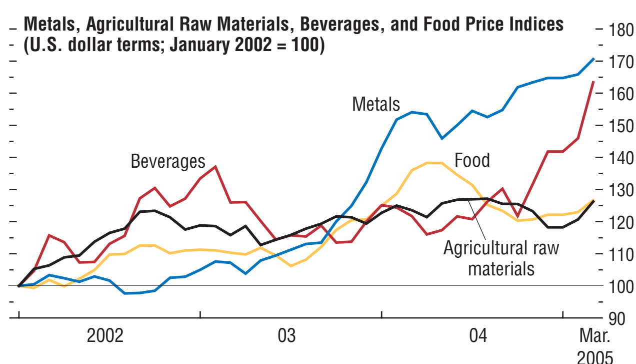
That said, global growth for 2005—the main driver of oil demand—at 4.3 percent remains strong and there is little evidence, as yet, that oil demand growth in OECD countries is easing owing to higher crude oil prices. The main uncertainty remains in China, where electricity shortages could persist because power generation capability is lagging behind demand. Also, China's per capita consumption of oil (about 2 barrels a year) is less than 15 percent of that in more advanced Asian economies such as Japan, Korea, and Taiwan Province of China, and these economies experienced a rapid increase in absolute per capita oil consumption only *after* achieving China's current level of industrialization. More generally, price controls and generous tax subsidies continue to shield end-users from the full effect of crude oil prices in a number of developing countries. As such, the rise in global demand during 2005 could easily exceed 1.8 mbd, placing further upward pressure on the call on OPEC and possibly crude oil spot prices if OPEC cannot respond owing to limited spare capacity. For example, even after allowing for a slowing in demand from China, the U.S. Energy Information Agency is predicting that global oil demand will grow by about 2.0 mbd in 2005.

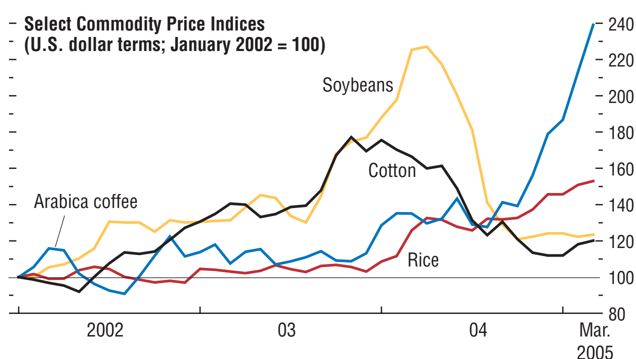
Whatever the outcome for global demand growth in 2005, global spare capacity is likely to remain low, suggesting that prices will continue to be sensitive to ongoing geopolitical tensions. Moreover, the competitive nature of the non-OPEC sector suggests that non-OPEC producers are unlikely to play a strategic role in maintaining global spare capacity. As such, OPEC's capacity expansion plans will be the critical factor going forward. Given the sizable capital outlays involved and the irreversible nature of investments in oil infrastructure, OPEC may be inclined to adopt a "wait-and-see" attitude, possibly—in the absence of a global slowdown—allowing capacity to lag behind the growth in demand. The major risk OPEC faces is that the higher crude oil prices and concerns over the availability of future crude oil supplies encourages a permanent shift to other sources of energy, resulting in a permanent fall in the elasticity of crude oil demand with respect to global income.

On balance, the oil market in the near term is likely to remain dependent on all oil-exporting nations maintaining output at close to capacity, leaving the global economy exposed to the risk of significantly higher oil prices arising because of an unanticipated supply disruption. There also remains the pressing issue of limited downstream capacity (refinery, pipeline, and shipping infrastructure), which was pushed ever closer to its limits by early 2005. The latter contributed to bottlenecks in derivative product (gasoline, diesel) markets, weakening its ability to handle sudden shifts in the quality of crude oil available on the market, newer gasoline standards, and seasonal shifts in demand. More stringent environment standards, particularly in the United States and Europe, and public aversion to petroleum-related investments—especially in refinery capacity—have raised the cost of developing downstream capacity. Given that investments in the oil sector take two to four years to plan and implement, robust growth in oil

Figure 1.21. Nonenergy Commodities







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

Table 1.13. Nonenergy Commodity Prices

(Percent change from July 2004 to March 2005)

	U.S. Dollar Terms	Contribution[1]	SDR Terms
Food	–3.6	38.1	–3.9
Beverages	35.3	21.9	38.2
Agricultural raw materials	–0.6	4.7	–3.5
Metals	10.4	35.3	10.7
Overall nonenergy	3.3	100.0	2.9

Sources: IMF, Primary Commodity Price Database; and IMF staff estimates.

[1]Contributions to change in overall nonenergy price index in U.S. dollar terms, in percent. Contributions to change in SDR terms are similar.

demand in coming years will most likely keep the oil market close to capacity.

Nonenergy Commodity Prices

Overall nonenergy prices rose by 3 percent in U.S. dollar and SDR terms during July 2004–March 2005, with the beverage and metals components contributing the most to the rise (Table 1.13).[11] There were divergent movements in commodity prices during 2004, with cotton prices, for example, falling by 34 percent relative to end-2003 levels, soybeans prices easing by 21 percent, and sugar, rice, pork, and coffee prices all rising by at least 30 percent (Figure 1.21). Record harvests and slower demand growth—natural market responses to higher commodity prices, especially for the softer commodities—depressed food and agricultural raw materials prices during the second half of 2004. Looking forward, the ongoing global economic expansion is expected to support commodity prices in 2005. Nevertheless, on balance, the increase in overall nonenergy prices is expected to slow in 2005 owing to favorable harvests and weaker demand resulting from higher metals prices.

The overall index of food items fell by about 4 percent because of favorable harvests, and IMF staff expect further downward pressure on prices in 2005. While wheat, corn, and soybean prices

[11]Unless otherwise stated, percent changes in this section refer to March 2005 over July 2004 price movements.

all strengthened in March, large stocks and robust supply growth should reduce food prices for the remainder of 2005. Meat prices finished 2004 about 17 percent higher than 2003 levels because of the growing popularity of low-carbohydrate diets. However, they stabilized recently as BSE-related import bans on North American exports were removed, and are expected to fall further in 2005.

The index of beverage prices increased by 35 percent in U.S. dollar terms largely because of a substantial increase in coffee prices of 56 percent, reflecting significant production losses in Brazil and Vietnam. While cocoa and tea prices strengthened during the first quarter of 2005, cocoa prices remain sensitive to political situations in Côte d'Ivoire and a possibility of a smaller-than-expected crop in that country. Looking forward, the index of beverage prices is expected to rise in 2005 even as the supply of coffee beans from Brazil recovers and India's output of tea increases.

Agricultural raw materials fell by 1 percent between July 2004 and March 2005. Despite recent falls, softwood lumber prices ended 2004 about 35 percent higher owing to strong housing demand in both the United States and Canada, but recently stabilized. Cotton prices fell because of a sizable increase in global production, with the bulk of the price fall occurring in the second half of 2004. However, the drop in cotton prices reversed in early 2005 owing to stronger-than-expected demand and a projected fall in the 2005/06 harvest. Despite rising in the first half of the year, rubber prices ended 2004 about 4 percent lower than 2003 levels as slower global demand growth and surging production resulted in a 10 percent increase in global inventories. Demand for hides remained constant throughout 2004, keeping prices subdued. The overall agricultural raw materials index is expected to strengthen slightly in 2005 on strong demand for timber in particular.

Metals prices increased 10 percent, finishing the year 2004 up almost 25 percent owing to low inventories and strong demand, especially from China, which has been a main catalyst for the continued surge in metals prices. Copper prices increased 20 percent. However, increased mine operations are expected to bring more product to market in the second half of 2005 and help ease prices. Aluminum prices increased 17 percent but the surge in energy prices appears to be taking its toll and demand by refiners for the product may be limited as cost could begin affecting final demand. Looking forward, limited inventories in other key metals and continued demand strength should help increase metals prices slightly in 2005.

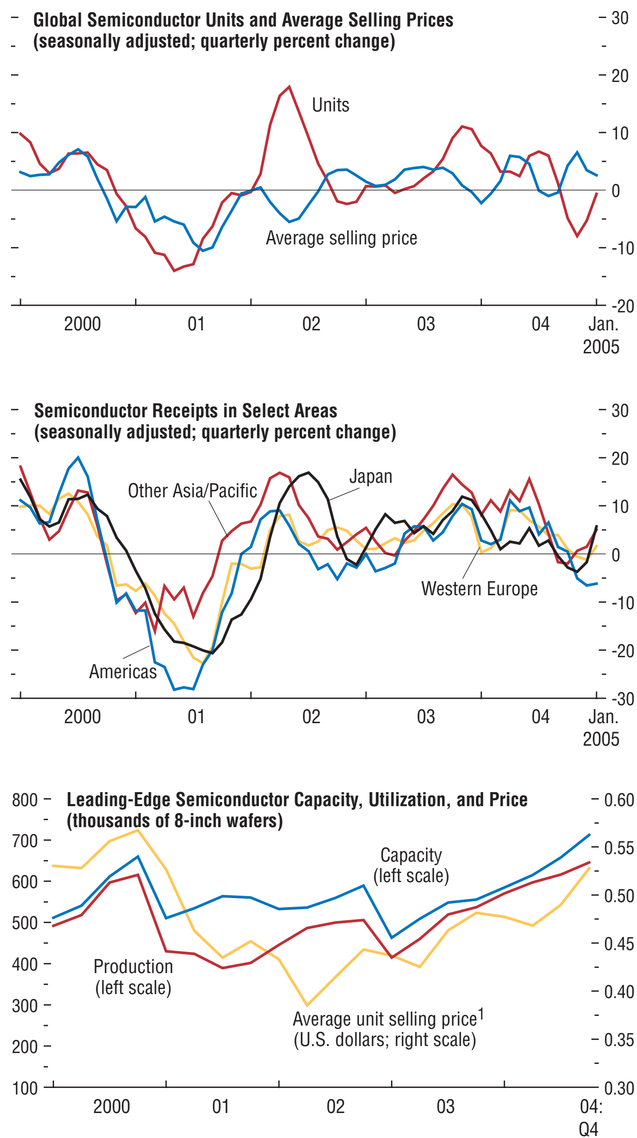
Semiconductor Markets

2004 was a record year for semiconductor sales, with revenues surging 30 percent relative to 2003 levels and by 5 percent compared with levels in 2000, the previous record year for sales (Figure 1.22). The Asia/Pacific region (excluding Japan) was responsible for the bulk of this increase, owing to a 44 percent increase in the consumption of semiconductors that supported further growth in technology manufacturing. By the end of 2004, the Asia/Pacific region was consuming nearly twice as many chips as the next largest market (Japan).

Countries appearing to benefit the most from the semiconductor boom are China, Korea, and Thailand, which have seen their exports of electronic goods grow by 236, 48, and 30 percent, respectively, since 2000. In addition, there are reports that as much as one-third of all venture capital spent inside of China in 2004 went toward the nation's chip industry. Additionally, Korea recorded its first year of net semiconductor exports since 2000.

Last year was also a record year for capacity expansion, with the semiconductor equipment sector experiencing 52 percent growth relative to 2003, mostly in the first half of the year. As a result, utilization in leading-edge technologies fell from over 97 percent utilization in early 2004 to almost 90 percent by the end of 2004. Utilization also fell because some firms have scaled back production to avoid unwanted inventory accumulation. While spending on semicon-

Figure 1.22. Semiconductor Market



Sources: World Semiconductor Trade Statistics; Semiconductor International Capacity Statistics; and IMF staff calculations.

[1] Price refers to the average selling price for all semiconductors.

ductor equipment has recently fallen, pushing down the North American book-to-bill ratio to 0.78, bookings have bottomed out and further spending falls are not expected.

Notwithstanding the surge in capacity, unit prices for semiconductor equipment rose—in line with expectations—during the second half of 2004 owing to strong seasonal demand. As a result, some firms have reported strong earnings for 2004, and particular semiconductor stock indices have grown faster than the broader market. Nevertheless, during the fourth quarter of 2004, the number of earnings reports in the tech sector below expectations were 85 percent higher than the number above expectations, suggesting that growth may ease in 2005. Additionally, Dynamic Random Access Memory (DRAM) spot prices saw a 30 percent fall since the beginning of February.

Looking forward, industry analysts remain concerned about the large amounts of capacity coming on stream. This could create an incentive to keep production high as the year progresses which should lower prices. Lower prices are expected to reduce sales revenue growth significantly in 2005. However, consumer spending is expected to remain buoyant in several markets as prices for newer technologies continue to decline.

Forecasting Crude Oil Prices

Though the dependency of the global economy on crude oil has fallen steadily during the past 30 years, the oil price baseline assumption remains an important variable for the twice-yearly *World Economic Outlook* exercise. At the beginning of each WEO round, crude oil prices are forecast up to eight quarters ahead, and then a further three years on an annual basis. The crude oil baseline needs to be projected using a well-defined procedure—one that is easily understood and is verifiable by external users.

The forecasting process is complicated by the nonstationarity (and changing volatility) of crude oil spot prices and the apparent randomness of the daily movements in the spot price. In

addition, crude oil spot prices have been subject to numerous unpredictable, yet significant, geopolitical events that typically have little to do with market fundamentals but have had a lasting impact on the level of crude oil prices.

For these reasons, a number of researchers recommend the so-called random walk (or "constant price") model to forecast crude oil prices. The random walk model uses the latest observable spot price to predict future crude oil prices. By construction, the random walk model implies that crude oil prices will not change throughout the forecast horizon. Though seemingly "naive," if the crude oil market were truly efficient, the latest spot price would embody all the relevant information about the market and the random walk model would yield the best possible prediction of the future spot price.

An alternative approach to forecasting crude oil prices, used, for example, by the International Monetary Fund and the European Central Bank, is to use futures contract prices. Futures trading of West Texas Intermediate (WTI) crude oil began in 1983 on the New York Mercantile Exchange (NYMEX), initially with a delivery period of up to six months. The delivery period was gradually extended to 24 months by 1995, in line with a substantial increase in the volume of contracts traded.

Futures markets provide an organized forum for traders to engage in hedging activity or speculation. The equilibrium prices of these contracts yield a summary or consensus view of future crude oil prices based on market trading. As such, a reasonable assumption is that the futures contract price is an unbiased predictor of the future spot prices. Provided the market is efficient and the volume of trading is sufficient, futures contract prices should reflect all available information about the crude oil market at a given point in time—much like the random walk model. They should also reflect traders' expectations of future developments in the crude oil market.

Of course, divergent opinions on future developments may produce future contract prices that are different from the random walk model. An informal examination of futures contract prices suggests that this is especially true for longer-dated futures contracts, which are typically lower than the current spot price.

The forecasting performance of future crude oil contract prices is formally evaluated by Kumar (1992). Using futures prices spanning the 1986–92 period and a forecast horizon of nine months, Kumar concludes that (1) crude oil futures contract prices provide an unbiased predictor of future spot prices and (2) oil price forecasts based on future contracts yield slightly more accurate forecasts than the random walk model. In what follows, Kumar's analysis is updated using futures contract price data spanning 1989–2004.

Forecasting Framework

The ex post accuracy of crude oil futures prices is assessed by comparing the price of crude oil deliverable k periods ahead with the corresponding spot price. Specifically, the forecast error of a specific WTI contract at time t is given by $F_{t,t+k} - S_{t+k}$, where $F_{t,t+k}$ is the (end-of-month) future price of crude oil for delivery k periods ahead, and S_{t+k} is the (known) spot price for period $t + k$. The analysis is performed in terms of the logarithms of the spot and futures prices so that the forecast errors approximate percentage forecast errors, and then repeated for each month in the 1988:1–2004:6 period (a total of 198 months). This process generates a distribution of forecasting errors for each month in the 24-month forecast horizon, and for the overall sample.

The exercise is repeated for the random walk model, which has a forecast error of $S_t - S_{t+k}$, to provide a benchmark for assessing the marginal contribution of futures prices relative to the last known crude oil spot price.

Forecasting Performance

Forecasting accuracy is assessed using the mean absolute forecast error (MAE), while the variability of the forecast error is measured by

Figure 1.23. Forecasting Crude Oil Spot Prices

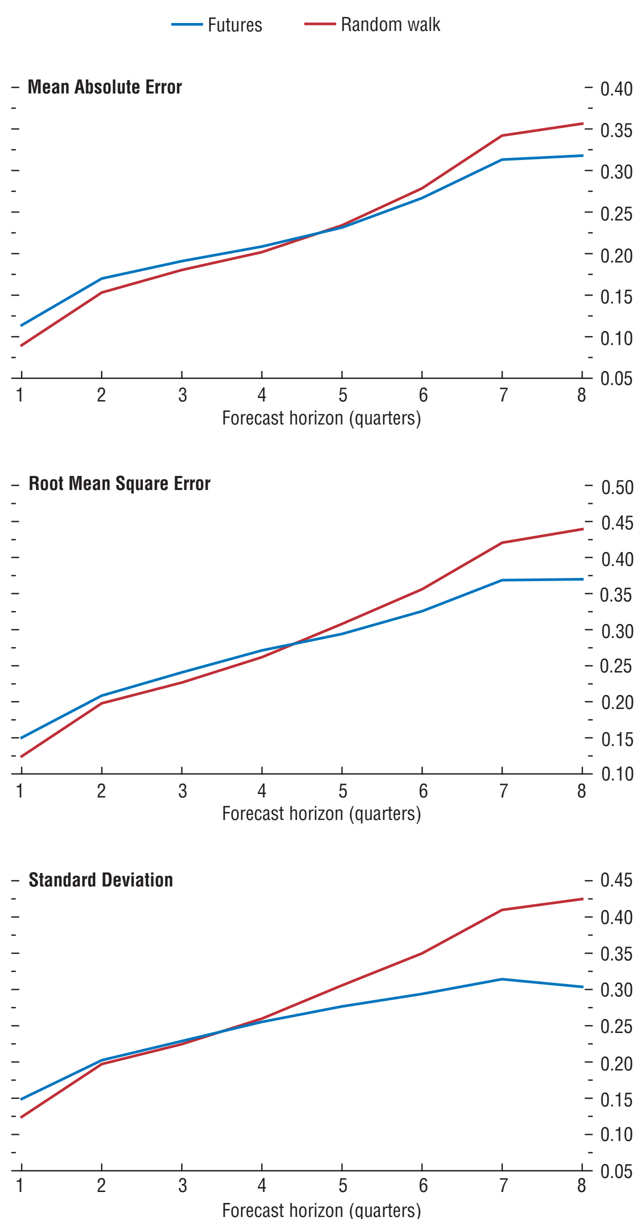


Table 1.14. Relative Forecasting Performance: Futures Versus Random Walk Model

Quarter	Mean Absolute Error	Root Mean Square Error	Standard Deviation of Forecast Error
1	1.27	1.21	1.05
2	1.11	1.05	0.91
3	1.06	1.06	1.00
4	1.03	1.04	0.99
5	0.99	0.95	0.91
6	0.96	0.91	0.87
7	0.92	0.88	0.81
8	0.89	0.84	0.75
Overall	1.01	0.96	0.92

Source: IMF staff estimates.

the root mean square error (RMSE) and standard deviation (SD). The mean absolute forecast error for the overall sample suggests a virtual tie between the random walk and futures model (Table 1.14). Nevertheless, futures-based forecasts appear to yield less volatile error sequences than the random walk model. However, the improvement in forecasting performance is rather slight, amounting to less than 5 percent of the RMSE (8 percent of the SD) of the random walk model, and not significant in a statistical sense. The near-identical performance for the overall sample reflects the fact that spot and futures prices, on average, tend to move together over time.

The analysis for the overall period masks the performance of the two models over specific forecast horizons. As short-term (1–12 month) spot and futures prices tend to react to the same underlying shocks, one might expect the two models to yield similar forecasting performances over the near term, and possibly diverge thereafter. The subperiod analysis confirms that this is indeed the case. Repeating the analysis for each three-month interval (or quarter) in the forecast horizon reveals that the random walk model yields a somewhat lower mean absolute error and root mean square error for the first four quarters (12 months) of the forecast horizon (Figure 1.23). Forecasts based on futures contract prices, however, do better thereafter, producing a lower root mean square error for the crude oil spot

price—one that falls steadily as the length of the forecast horizon increases. Interestingly, the standard deviation of the futures model is also lower than the random walk model after four quarters, suggesting that futures based forecasts are less variable than those derived from the random walk model. In other words, this finding, which is consistent with the results reported in Bowman and Husain (2004) for nonfuel commodity prices, confirms that futures contract prices have some predictive content relative to the random walk model at longer time horizons, underscoring their usefulness for setting medium-term crude oil forecasts in particular.

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