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Assumptions and Conventions

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates will remain constant at their average levels during February 16–March 15, 1999 except for the bilateral rates among the European exchange rate mechanism (ERM) currencies, which are assumed to remain constant in nominal terms; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary polices in industrial countries, see Box 1.1); that the average price of oil will be $12.00 a barrel in 1999 and $13.60 a barrel in 2000, and remain unchanged in real terms over the medium term; and that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 5.2 percent in both 1999 and 2000. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The estimates and projections are based on statistical information available in early-April 1999.

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

. . . to indicate that data are not available or not applicable;

— to indicate that the figure is zero or negligible;

– between years or months (for example, 1997–98 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (for example, 1997/98) to indicate a fiscal or financial year.

"Billion" means a thousand million; "trillion" means a thousand billion.

"Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

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

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

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

The *World Economic Outlook* Database

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

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

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Preface

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

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

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

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

Primary contributors to the current issue include Francesco Caramazza, John H. Green, Peter Sturm, Mark De Broeck, Luca Ricci, Ranil Salgado, Phillip Swagel, Cathy Wright, and Harm Zebregs. Other contributors include Paula De Masi, Esteban Jadresic, Douglas Laxton, and Robert Sharer. The Fiscal Analysis Division of the Fiscal Affairs Department computed the structural budget and fiscal impulse measures. Gretchen Gallik, Mandy Hemmati, Yutong Li, and Anthony G. Turner provided research assistance. Allen Cobler, Nicholas Dopuch, Isabella Dymarskaia, Yasoma Liyanarachchi, Olga Plagie, and Irim Siddiqui processed the data and managed the computer systems. Susan Duff, Caroline Bagworth, and Lisa Marie Scott-Hill were responsible for word processing. James McEuen of the External Relations Department edited the manuscript and coordinated production of the publication.

The analysis has benefited from comments and suggestions by staff from other IMF departments, as well as by Executive Directors following their discussion of the *World Economic Outlook* on March 31 and April 2, 1999. For a summary of their discussion, see the Annex. However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities.

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I

World Economic Outlook and Policy Responses to the Global Slowdown

Since the end of 1998 some significant positive developments in the world economy have been broadly balanced by some important setbacks, so that the global outlook is little changed.

Among the setbacks, the crisis in Brazil that led to the abandonment of its crawling-peg exchange rate arrangement in mid-January was another dramatic episode in the recurrent bouts of instability that have marked global financial markets since mid-1997. Financial contagion from the Brazilian crisis has been limited, and the situation in Brazil itself has stabilized, but it may be several months before the fallout becomes clear. In any event, the crisis has imparted a new contractionary impulse to the global economy. Financial sector fragilities in several emerging market economies, including China, add to the risks of continued turbulence. In Russia, the delay in adopting coherent policies to promote stabilization and reform has postponed improvements in the economy. The conflict in the Federal Republic of Yugoslavia (Serbia/Montenegro) will have severe effects on small neighboring countries and broader adverse consequences for other countries in southeastern Europe. Japan's economy remains weak, and resumption of self-sustaining growth is not yet clearly in sight. Global trade imbalances have been increased by the series of emerging market crises, as well as by the uneven pattern of growth among the United States, the euro area, and Japan. These imbalances may give rise to destabilizing movements in exchange rates and may also increase protectionist pressures.

These setbacks and concerns notwithstanding, the positive developments are also notable. After the deep output contractions in Asia's crisis-afflicted economies, activity has recently turned around in Korea and seems to have bottomed out in Malaysia and Thailand. Investor sentiment toward many emerging market economies has rallied. Conditions in mature financial markets also have improved following the broad-based easing of monetary conditions undertaken partly to address concerns about a credit crunch in the wake of Russia's default last August and the ensuing financial turbulence. The introduction of the euro has proceeded smoothly, with the new currency immediately assuming the role of the second-largest international reserve currency. More generally, most of the advanced economies of North America and Europe, and also Australia, have proved resilient to the crises in emerging markets. Particularly notable has been the continued strong growth of the U.S. economy. In fact, the further downward revisions to the growth projections for Latin America—most markedly for Brazil—in the current IMF staff projections are largely offset by upward revisions for the United States (Table 1.1). Furthermore, inflation has generally remained subdued, including in the United States and other economies that have been operating close to full capacity.

The balance of risks remains on the downside, however, and several hurdles could prevent global growth from returning to potential within two or three years, as in the IMF's baseline scenario. Policymakers, therefore, not only need to be ready to attend to new emergencies, but also should focus on policies required to sustain growth in the short run and over the medium term. (Policy assumptions underlying the projections are summarized in Box 1.1.) In many countries, obstacles to structural reform are a major hurdle preventing the attainment of economic potential. Structural reforms may bring little benefit in the short run in some cases, but in other cases they are needed to make macroeconomic policies effective, and they are often essential to restore and maintain economic dynamism in the longer run.

Economic policies cannot be expected to fully preempt swings in market sentiment, but they can reduce the risk and virulence of adverse shifts in confidence, including those arising from financial contagion. Policy responses to a financial crisis also have a substantial impact on the depth, duration, and social costs of an ensuing recession. And in an increasingly interdependent global economy, it is important that countries not directly affected by crises take timely policy action, when appropriate, to support demand and thus to help smooth the global business cycle; that all countries avoid policies that, while expedient in the short run, carry greater long-term costs or are harmful to trading partners; and that all countries work to strengthen international economic cooperation.

A New Phase in the Global Crisis, and Remaining Risks

The current weakening of world economic growth marks the fourth global economic slowdown in the past quarter-century (Figure 1.1). It began with the

Table 1.1. Overview of the *World Economic Outlook* Projections

(Annual percent change unless otherwise noted)

			Current Projections		Differences from December 1998 Projections[1]	
	1997	1998	1999	2000	1998	1999
World output	**4.2**	**2.5**	**2.3**	**3.4**	**0.1**	**—**
Advanced economies	3.2	2.2	2.0	2.3	0.1	0.4
Major industrial countries	3.0	2.2	1.9	2.0	0.1	0.4
United States	3.9	3.9	3.3	2.2	0.3	1.5
Japan	1.4	–2.8	–1.4	0.3	—	–0.9
Germany	2.2	2.8	1.5	2.8	0.1	–0.5
France	2.3	3.1	2.2	2.9	0.1	–0.4
Italy	1.5	1.4	1.5	2.4	0.1	–0.4
United Kingdom	3.5	2.1	0.7	2.1	–0.5	–0.2
Canada	3.8	3.0	2.6	2.5	0.2	0.4
Other advanced economies	4.2	2.1	2.5	3.4	0.3	0.3
Memorandum						
Industrial countries	3.0	2.5	2.0	2.2	0.2	0.3
Euro area	2.5	2.9	2.0	2.9	—	–0.4
Newly industrialized Asian economies	6.0	–1.5	2.1	4.5	1.1	1.6
Developing countries	5.7	3.3	3.1	4.9	0.2	–0.6
Africa	3.1	3.4	3.2	5.1	–0.2	–0.6
Asia	6.6	3.8	4.7	5.7	0.7	0.1
China	8.8	7.8	6.6	7.0	0.6	—
India	5.5	5.6	5.2	5.1	0.9	0.4
ASEAN-4[2]	3.8	–9.4	–1.1	3.0	0.8	0.1
Middle East and Europe	4.4	2.9	2.0	3.3	–0.5	–0.9
Western Hemisphere	5.2	2.3	–0.5	3.5	–0.3	–2.1
Brazil	3.2	0.2	–3.8	3.7	–0.3	–2.8
Countries in transition	2.2	–0.2	–0.9	2.5	0.1	0.1
Central and eastern Europe	3.1	2.4	2.0	3.7	–0.3	–0.4
Excluding Belarus and Ukraine	3.5	2.6	3.0	4.6	–0.5	–0.4
Russia	0.8	–4.8	–7.0	—	0.9	1.3
Transcaucasus and central Asia	2.4	2.0	1.8	3.1	—	–1.1
World trade volume (goods and services)	**9.9**	**3.3**	**3.8**	**5.8**	**—**	**–0.6**
Imports						
Advanced economies	9.1	4.7	5.0	5.7	0.1	0.3
Developing countries	11.2	–0.7	2.6	6.8	–0.1	–3.0
Countries in transition	9.3	1.2	–0.2	6.2	—	–2.5
Exports						
Advanced economies	10.3	3.2	2.8	5.6	–0.1	–1.0
Developing countries	11.4	2.2	4.6	5.5	–0.6	–0.9
Countries in transition	6.2	4.1	6.4	6.6	0.4	1.1
Commodity prices						
Oil[3]						
In SDRs	–0.2	–31.2	–9.2	13.4	–1.4	–14.1
In U.S. dollars	–5.4	–32.1	–8.3	13.4	–1.6	–16.7
Nonfuel[4]						
In SDRs	2.0	–13.5	–4.9	1.9	1.2	–1.1
In U.S. dollars	–3.3	–14.8	–4.0	1.8	0.8	–3.4
Consumer prices						
Advanced economies	2.1	1.6	1.4	1.7	—	–0.2
Developing countries	9.4	10.4	8.8	7.5	–0.6	–0.2
Countries in transition	28.2	20.8	40.9	12.4	–0.4	11.5
Six-month LIBOR (in percent)[5]						
On U.S. dollar deposits	5.9	5.6	5.2	5.2	0.1	0.1
On Japanese yen deposits	0.7	0.7	0.2	0.3	—	–0.3
On euro deposits	3.5	3.7	3.0	3.1	. . .	–0.3

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during February 16–March 15, 1999. Here and in subsequent tables, shaded areas indicate IMF staff projections

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

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

[3]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil. The average price of oil in U.S. dollars a barrel was $13.07 in 1998; the assumed price is $12.00 in 1999 and $13.60 in 2000.

[4]Average, based on world commodity export weights.

[5]London interbank offered rate.

sharp declines in domestic demand and activity in Thailand, Indonesia, Korea, and Malaysia—economies that have felt the brunt of the Asian crisis. Japan's deepening recession in 1998 was both a factor contributing to the difficulties elsewhere in Asia and a reflection of those difficulties. In most of the rest of the world, activity was relatively well-maintained during 1998, although signs of a slowdown in industrial activity became increasingly apparent, and the growth of world trade slowed sharply to 3¼ percent, the lowest since 1985 (Figure 1.2). During this first phase of the global downturn, the redirection of financial flows toward mature markets and sharp declines in commodity prices were powerful factors offsetting the negative trade effects from Asia. As a result, the United States was able to absorb much of the counterpart to the improvements in external positions in the Asian crisis economies without much impact on its own growth rate, at least through the end of 1998. Growth was also well-sustained in most of 1998 in Europe, where the negative effects of trade adjustment were initially less severe.

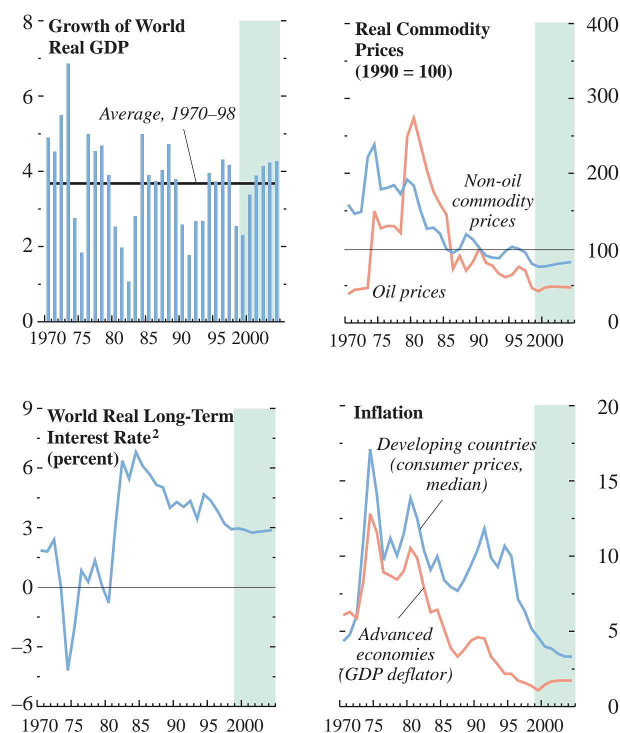
There are growing indications that activity in the Asian crisis economies is close to its trough, but this is unlikely to signal an early reversal of the global slowdown. Indeed, in 1999 new negative forces are contributing to a second phase of the slowdown in the global business cycle—including the repercussions and spillovers from the Russian crisis, and the crisis in Brazil and its spillovers to the rest of Latin America. In addition, many exporters of oil and other commodities are having to step up efforts to adjust to the dramatic loss of export revenue they have experienced since the start of the Asian crisis. (This is despite the pickup in oil prices since mid-March that, if sustained, would ease the pressures on oil producers to some limited extent.) As a result, these countries are also likely to witness significant further slowdowns in domestic demand, imports, and activity in the period ahead. Finally, some of the industrial countries that have seen the most vigorous sustained expansions in recent years—such as the United Kingdom and Norway—have recently witnessed cyclical slowdowns; growth in the U.S. economy is also expected to slow in the period ahead, albeit only moderately; and downward revisions to projections for much of continental western Europe now point to near-term growth somewhat below potential. Overall, world growth in 1999 seems likely to be slightly weaker than last year's rate of 2½ percent, while the expansion of world trade is expected to remain well below the long-term trend growth rate.

Will there be a third phase of the global downturn, which could extend recessionary forces into 2000? The staff's baseline projection assumes that for emerging market economies, financial market conditions will gradually improve further, that the U.S. economy will experience a soft landing, that growth in the euro area

Figure 1.1. Global Indicators[1]

(Annual percent change unless otherwise noted)

The crises in emerging market economies since mid-1997 have led to the fourth global economic slowdown in a quarter century.



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

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

Box 1.1. Policy Assumptions Underlying the Projections for Selected Advanced Economies

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

United States. For fiscal years (to end-September) 1999–2004, the fiscal projections are based on the administration's February 1999 budget proposal (including the Social Security reform proposal). The projections are adjusted for differences between the IMF staff's macroeconomic assumptions and those of the administration. State and local government fiscal balances are assumed to remain constant as a percent of GDP.

Japan. The projections take account of the ¥24 trillion stimulus package announced in November 1998 and the FY 1999 (beginning April) initial budget for the central government. The stimulus measures are assumed to raise public investment by ¥4¾ trillion through FY 1999, after which they are gradually phased out. This assumes that local governments largely offset their share in the stimulus package with cuts in own-account expenditures elsewhere. Of the ¥9.3 trillion in tax cuts, ¥1 trillion is assumed to occur in the first quarter of calendar year 1999, and the bulk of the remainder in FY 1999. No further stimulus measures are assumed, although a "typical" supplementary budget of ¥1 trillion is included in the calculations for FY 2000.

Germany. For 1999, the IMF staff projection of the general government deficit (2.3 percent of GDP) incorporates the draft 1999 federal budget and Financial Planning Council projections for the other levels of government. The difference from the government's 1999 deficit projection (2 percent of GDP) reflects the staff's lower growth forecast. For the medium term, the IMF staff's projections assume unchanged fiscal policies except for the government's income tax reform package, which includes a tax cut, equivalent to 0.3 percent of GDP, from 2002 onward.

France. The IMF staff projections are in line with announced official fiscal targets. For 1999, the projection calls for a slight decline in the ratio of expenditure to GDP and a revenue performance that still benefits from robust activity in 1998. Beyond 1999, the path for the public finances is broadly consistent with the government's Stability Program.

Italy. The projection for 1999 is based on the official budget, allowing for the impact of the IMF staff's macroeconomic forecast and taking into account the estimated budget outturn for 1998. For 2000–01, the projections are based on the IMF staff estimates of the "current services" budget (*tendenziale*), corrected for the measures announced in *Italy's Stability Programme* for those years. It is assumed that these measures are fully implemented and yield the officially estimated amounts. Projections beyond 2001 assume a broadly unchanged primary structural balance.

United Kingdom. The budgeted spending ceilings for FY 1998/99 (April–March) are assumed to be observed. Thereafter, current expenditure is assumed to grow in line with potential output, and capital expenditure in line with the new expenditure plans announced in the November 1998 Pre-Budget Report. For revenues, the projections assume an income elasticity of one over the medium term, but also incorporate previous budgets' tax commitments that are expected to continue during the projection period.

Canada. Federal government outlays for departmental spending and business subsidies are assumed to conform to the commitments announced in the February 1999 budget. Following a recent reduction of 15 cents in the employment insurance premium, the staff assumes further gradual cuts in the rate which would bring it to $2.20 per $100 of taxable employee earnings by 2004. Other revenue and outlays are assumed to evolve in line with the IMF's staff macroeconomic projections. After FY 1998/99, it is assumed that the federal government will be able to maintain budget surpluses which would reach 1 percent of GDP. This would imply that new measures of $1–2 billion (around ¼ percent of GDP) could be introduced each year, aimed at reducing taxes and implementing new spending initiatives. The consolidated fiscal projection for the provinces is assumed to be consistent with their stated medium-term targets.

Austria. The projection for 1999 is based on the official budget, adjusted for the IMF staff projections of lower growth than in the official projections. Beyond 1999, the primary structural balance is assumed to remain constant. In line with the fiscal accounts for 1997, lower levels of government are assumed to run a small surplus of ½ percent of GDP throughout the projection period.

Australia. Projections are based on the Australian Treasury's December 1998 projections of ratios of ex-

penditure and revenue to GDP until FY 2001/02 (July–June), with these ratios assumed to remain constant thereafter. The treasury's projections reflect the impact of the expected introduction of a tax reform package in 2000. For the state and local government sector, the treasury's May 1998 projections were adjusted to incorporate the data released thereafter.

Belgium. Fiscal projections for Belgium are for a deficit slightly below the 1999 budget plan of 1.3 percent of GDP. For 2000 and beyond, the projections incorporate a slight decline in the structural primary surplus, as a result of tax cuts.

Denmark. The assumptions underlying the forecast of general government surpluses for the 1999–2004 period include the ongoing positive effects of recent tax reform measures on revenues and a slowing of the growth rate for expenditures due to a relatively low interest rate environment and a relatively benign outlook for unemployment. In 2000, the general government surplus forecast by the IMF staff is somewhat larger than the official projection, reflecting the staff's projection of slightly stronger economic growth.

Greece. The projection for 1999 is based on the official budget, adjusted to reflect differences in macroeconomic projections, notably somewhat slower growth and lower interest rates. Projections beyond 1999 incorporate the authorities' intention to increase public capital formation (although by less than the amount indicated in the revised convergence program), an unchanged ratio of current primary spending in structural terms, and a trend decline in the current revenue ratio owing to a projected decline in the share of consumption in GDP. The projections, including those for inflation and other macroeconomic variables, include only those indirect tax reductions that have been adopted to date.

Korea. The projection for 1999 is based on the budget passed by the National Assembly in December 1998. The medium-term projections are based on the authorities' stated goal of returning to fiscal balance by 2006. In light of rising social safety net outlays and financial sector restructuring expenditures, it is assumed that offsetting fiscal adjustment measures will be undertaken, along the lines outlined in the authorities' midterm fiscal plan for 1999–2002.

Netherlands. The 1999 projections are based on the 1999 budget and the IMF staff's macroeconomic projections. Projections for 1999–2003 reflect the government's expenditure norm and take into account planned tax cuts.

New Zealand. Fiscal policy assumptions are based on the New Zealand Treasury's December 1998 projections.

Portugal. The fiscal projections for 1999 are based on the budget and the IMF staff's macroeconomic projections. Revised estimates of the budgetary outturn for 1998 are factored into the projections for 1999. For 2000 and beyond, a broadly unchanged primary structural balance is assumed.

Singapore. The government's primary operating balance for FY 1998/99 (April–March) is projected to record a small deficit reflecting a sizable fiscal impulse and a cyclical deterioration in revenues. The primary operating balance is projected in the FY 1999/2000 to reach a deficit of about 3½ percent of GDP, and to generate a further fiscal impulse.

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

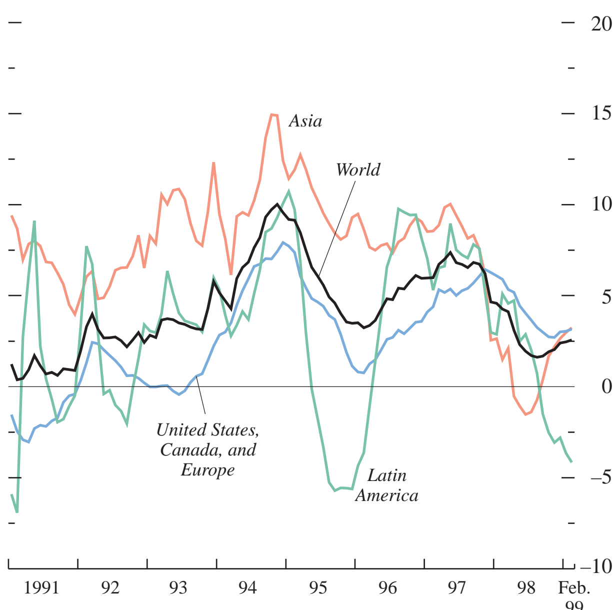
Sweden. The fiscal projections are based on the authorities' policies and projections as presented in the 1998 Fall Budget Bill, which includes the objective of achieving a fiscal surplus of 2 percent of GDP on average over the cycle.

Switzerland. The staff's projection for 1999 is based on official budget plans adjusted for different macroeconomic assumptions. For 2000–01, the projections are in line with present official estimates and incorporate announced fiscal measures to balance the Confederation's budget by 2001. Beyond 2001, the general government's primary structural balance is assumed to remain unchanged.

Monetary policy assumptions are based on the established framework for monetary policy in each country. In most cases this implies a nonaccommodative stance over the business cycle, so that official interest rates will firm when economic indicators suggest that inflation will rise above its acceptable rate or range, and ease when indicators suggest that prospective inflation will not exceed the acceptable rate or range, that prospective output growth is below its potential rate, and that the margin of slack in the economy is significant. On this basis, the London interbank offered rate (LIBOR) on six-month U.S. dollar deposits is assumed to average 5.2 percent in both 1999 and 2000; and the rate on six-month Japanese yen deposits is assumed to average 0.2 percent in 1999 and 0.3 percent in 2000. The rate on six-month euro deposits is assumed to average 3.0 percent in 1999 (30 basis points less than projected in the *Interim Assessment*) and 3.1 percent in 2000. Changes in interest rate assumptions compared with the December 1998 *Interim Assessment* are summarized in Table 1.1.

Figure 1.2. World Industrial Production[1]
(Percent change from a year earlier; three-month centered moving average; manufacturing)

The slowdown in the growth of world industrial production since mid-1997 has been most pronounced in Asia and Latin America but has also been apparent in North America and Europe. There have recently been increasing signs of recovery in Asia.



Sources: WEFA, Inc.; OECD; and IMF, *International Financial Statistics*.
[1]Based on data for 32 advanced and emerging market economies representing about 75 percent of world output. Data through 1994 exclude Indonesia.

will remain reasonably resilient in the face of an unfavorable external environment, and that the Japanese recession will bottom out in 1999 (Box 1.2).[1] In such a scenario, global economic growth should pick up again in 2000 as adjustments in the emerging market economies run their course. However, there is a distinct possibility of a less favorable scenario developing.

- Financial conditions facing many emerging market economies remain more adverse than in most of the 1990s (Figure 1.3), and the deterioration may not be reversed in the way assumed in the projections.
- The slowdown in the U.S. economy may be more abrupt than assumed if inflation picks up, the stock market undergoes a significant correction, or the private sector begins to correct its large saving shortfall more quickly than assumed.
- The recent weakening of growth in the euro area may turn out not to be transitory, as assumed, in spite of the welcome further reduction in interest rates in early April.
- Weakness in the Japanese economy may be further prolonged.

If these risks materialize, the global slowdown could widen and deepen in 1999 and 2000, with recovery being delayed until 2001 at the earliest.

A major risk in the forecast stems from the *uneven pattern of growth* among the three large currency areas since the beginning of the decade, which has resulted in a marked widening of external current account imbalances. These imbalances, which have been exacerbated by the emerging market crises, carry significant risks for the world economy through a potential rise in protectionist pressures (Box 1.3), or excessive and potentially destabilizing movements in exchange rates among the major currencies. They also raise questions about how global growth can be restored to near potential given that domestic demand growth in the United States, which has been running at an unsustainable pace, will need eventually to slow below the rate of output growth in order to allow some narrowing of the U.S. current account deficit. Such considerations highlight the priority that must be attached to policies aimed at generating an early recovery in Asia and at countering and reversing the slowdown in growth that appears to be occurring in continental Europe. For the United States, the strong growth in domestic demand to date has been beneficial from both a domestic and a global perspective, but at some point policies will need to be tightened if domestic demand does not slow in line with current expectations. Over the medium term, in Europe as well as in Asia, de-

[1]The projections also take no account of the computer problems that may arise from the so-called millennium bug, given the considerable uncertainty surrounding them and their economic impact—see Box 1.2.

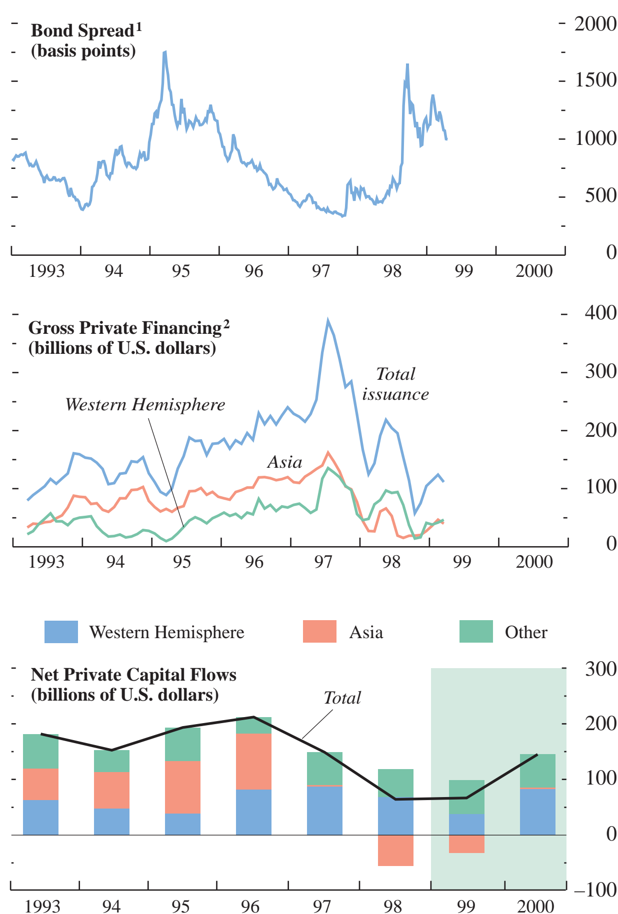
mand growth will need to be sustained at more rapid rates in order to support recovery in the world economy. Adjustments in exchange rates among the major currencies will probably also need to be part of this process, since the present alignment, although broadly appropriate in the current cyclical situation, differs from what seems likely to be warranted in the medium term.

Another key uncertainty in assessing the global outlook is the potential for further financial market turbulence and *contagion,* especially in light of the apparently heightened perception of, and increased aversion to, risk in financial markets. Experience of the Asian, Russian, and Brazilian crises has shown how the severity of contagion depends not only on the importance of economic and financial linkages with the original crisis country, but also on the origins and nature of the initiating crisis—including the degree to which it was anticipated—and the strength of economic fundamentals and policies in the countries potentially subject to attack. Chapter III examines more closely the determinants of contagion and its links to economic fundamentals. The findings help to show how policymakers can prevent further proliferation of the crises suffered since mid-1997. Fiscal and monetary discipline, and the avoidance of large external imbalances and overvalued exchange rates, are important means of fending off contagion. But from an international viewpoint it is also essential to avoid defensive measures—such as excessive depreciations, trade protection, and distortionary exchange restrictions—that may in the short term ease foreign exchange and financial market pressures in the country taking them, but that hurt both its trading partners and its own longer-term welfare.

Recent crises, and broader experience of contagion, have highlighted the *risks that can be associated with pegged exchange rate arrangements*. It is striking that most of the currency crises of the past two years have occurred in countries with pegged exchange rates; and it is clear that the greatly increased—and still increasing—mobility of international capital has made considerably more demanding the macroeconomic and structural policy requirements that countries must meet to maintain a pegged rate. It is therefore not surprising that there has been a trend toward greater exchange rate flexibility among emerging market economies in recent decades, as documented in Chapter IV of the October 1997 *World Economic Outlook*. But it is also clear that flexible exchange rate arrangements do not remove the need for policy discipline and for efficient and robust financial systems. And it is also striking that a number of countries with pegged exchange rates, including several with currency board arrangements, have successfully resisted currency market pressures during the recent episodes of turbulence, and have thereby served as anchors of stability in their regions. It seems likely to remain true that the

Figure 1.3. Financing Conditions for Emerging Markets

Bond yield spreads for emerging market economies have declined somewhat from their recent peaks. Gross capital flows have remained below 1996–97 levels. Net flows are projected to recover partially in 1999–2000.



Sources: Bloomberg Financial Markets, LP; and IMF staff estimates. Shaded area indicates IMF staff projections.

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

[2]Excludes interbank flows. Three-month moving averages; annualized.

best arrangement for any country depends on its circumstances and its economic policies.

Latin America: Addressing the Brazilian Crisis and Meeting Other Adjustment Needs

Most countries in Latin America experienced sharp economic slowdowns during the second half of 1998, as a result of the decline in private capital inflows and the weakening of the prices of commodity exports. Brazil's abandonment of its crawling-peg exchange rate arrangement in mid-January, and associated developments, have added to the adjustment challenges the region faces. A decline in output of ½ of 1 percent is now projected for the Western Hemisphere group of developing economies in 1999—the most significant worsening of the outlook among all regions from the December 1998 *Interim Assessment* of the *World Economic Outlook*—and there is a considerable risk of a more severe contraction (Table 1.2). However, developments in Brazil since early March have been encouraging, financial spillovers have been limited, and the slowdown seems unlikely to be prolonged, provided that there is no further deterioration in the external environment and that countries maintain and, where necessary, strengthen their stabilization and reform efforts.

The pressures that forced *Brazil* to widen and then abandon its crawling exchange rate band in mid-January stemmed largely from growing doubts about the political feasibility of the fiscal adjustment called for by its economic program, which had been put in place in mid-November with international financial support, and from fears that monetary policy was insufficiently tight to stop continued capital outflows. These concerns, which were reinforced by resistance to the fiscal program in the federal legislature and by the threat of default by state governments on their debts to the federal government, increased doubts about the sustainability of the peg and the feasibility of restoring market confidence and achieving sustainable economic growth. Following the abandonment of the peg, the real depreciated to a level in early March that was more than 40 percent below its end-1998 value in terms of the U.S. dollar, with capital outflows continuing, albeit at a slower pace.

Brazil has thus faced the additional challenges of stabilizing the exchange market and containing the effect of the depreciation on the price level. The outstanding accomplishment of the Real Plan was its subjugation of inflation, from an average of about 450 percent a year during 1980–94, and from above 2,000 percent in 1993–94, to 3½ percent in 1998; and the paramount objective must be to preserve the achievement of low inflation and to prevent a rekindling of inflation expectations. To this end, the authorities announced in early February their intention of putting in place an inflation-targeting framework for monetary policy, together with a target of reducing inflation to an annualized monthly rate in the middle single digits by the end of 1999. While the institutional changes necessary for a full-fledged inflation-targeting framework are being put in place, the central bank will adhere to a monetary policy that is consistent with the end-1999 inflation target and ensures the rollover of the government's domestic debt. It will rely on a quantity-based framework, with a target for its net domestic assets consistent with the projected paths of inflation, real GDP, and net international reserves. The target will be modified if need be, depending on the behavior of prices and the exchange rate.

The government recognized the need for a period of distinctly higher interest rates by raising in early March the reference rate for the overnight interbank market from 39 percent to 45 percent, having increased the reserve requirement on time deposits the previous day. Following this monetary tightening and the announcement of agreement with the IMF on a revised economic program, the real recovered to a level in early April that was about 30 percent below its end-1998 value in terms of the U.S. dollar, with the reversal of currency pressure permitting the reference interest rate to fall back to about 39 percent. The impact of the depreciation on inflation has so far been relatively muted. As other crisis situations, including in Brazil itself in late 1997, have shown, determined monetary tightening to stabilize the value of a currency, domestically and externally, and to restore confidence need not be prolonged. For this reason, and to a lesser extent because real interest rates were significantly reduced as a result of the effects of the depreciation on the price level, the increase in the cost of debt service arising from the monetary tightening should not give rise to unstable debt dynamics.

In addition to the impact of higher nominal debt-service costs, the fiscal deficit will be adversely affected by the recession now under way in Brazil as a result of the decline in domestic demand: in the short run, this decline will outweigh the effects on aggregate economic activity of any improvement in net exports resulting from the real's depreciation. Moreover, the depreciation has increased the domestic currency value of the stock of public debt because part of it is linked to the U.S. dollar. Although the resulting deterioration in the public finances should not be exaggerated—and there will be some offsets, notably the revenue gains resulting automatically from the increase in the price level—Brazil's revised program has deliberately incorporated more ambitious targets for the primary balance, to ensure sufficient fiscal adjustment to stabilize the ratio of debt to GDP. This will require progress on structural reforms, including reforms of the social security and taxation systems proposed by the government, as well as further progress with privatization and the maintenance of the revised expendi-

Table 1.2. Selected Developing Countries: Real GDP and Consumer Prices
(Annual percent change)

	Real GDP				Consumer Prices			
	1997	1998	1999	2000	1997	1998	1999	2000
Developing countries	**5.7**	**3.3**	**3.1**	**4.9**	**9.4**	**10.4**	**8.8**	**7.5**
Median	**4.0**	**3.8**	**3.9**	**4.6**	**6.3**	**5.2**	**4.6**	**4.0**
Africa	**3.1**	**3.4**	**3.2**	**5.1**	**11.1**	**8.6**	**8.6**	**6.6**
Algeria	1.1	3.4	3.3	4.3	6.8	6.2	7.0	7.0
Cameroon	5.1	5.0	4.7	5.3	5.2	2.8	2.0	2.0
Côte d'Ivoïre	6.0	5.7	6.0	5.8	5.6	4.5	2.5	2.5
Ghana	4.2	4.5	5.5	6.0	28.8	17.7	7.1	6.5
Kenya	2.1	1.5	3.5	6.0	11.2	6.6	6.0	5.0
Morocco	–2.0	6.3	3.8	4.0	1.0	2.7	2.5	2.5
Nigeria	3.9	2.3	–1.5	5.5	8.5	10.2	13.4	8.0
South Africa	1.7	0.1	0.6	3.2	8.6	7.0	6.8	6.0
Sudan	6.6	5.2	5.5	5.2	46.7	17.0	16.9	9.0
Tanzania	3.5	3.3	5.2	5.9	16.1	12.6	7.8	5.1
Tunisia	5.4	5.1	5.5	6.5	3.7	3.6	3.6	3.5
Uganda	5.2	5.5	7.0	7.0	7.8	5.8	5.0	5.0
SAF/ESAF countries[1]	4.5	4.0	5.5	6.1	8.7	7.6	5.2	4.1
CFA countries	5.2	5.6	5.3	5.5	4.4	3.4	2.4	2.3
Asia	**6.6**	**3.8**	**4.7**	**5.7**	**4.8**	**8.0**	**4.7**	**4.5**
Bangladesh	5.7	4.2	3.4	3.9	4.8	7.9	8.1	7.2
China	8.8	7.8	6.6	7.0	2.8	–0.8	0.5	2.0
India	5.5	5.6	5.2	5.1	7.2	13.0	7.5	7.9
Indonesia	4.6	–13.7	–4.0	2.5	6.6	60.7	28.2	10.0
Malaysia	7.7	–6.8	0.9	2.0	2.7	5.3	3.6	5.0
Pakistan	–0.4	5.4	3.0	3.0	12.5	7.8	7.0	8.0
Philippines	5.2	–0.5	2.0	3.0	6.0	9.7	8.5	6.0
Thailand	–0.4	–8.0	1.0	3.0	5.6	8.1	2.5	4.0
Vietnam	8.8	3.5	3.5	4.5	3.2	7.7	8.0	6.0
Middle East and Europe	**4.4**	**2.9**	**2.0**	**3.3**	**23.1**	**23.8**	**19.7**	**19.4**
Egypt	5.0	5.3	4.9	5.5	6.2	3.8	4.0	4.0
Iran, Islamic Republic of	3.0	1.7	—	2.0	17.3	22.0	15.0	10.0
Jordan	2.2	0.5	2.0	3.0	3.0	5.0	3.5	3.0
Kuwait	2.5	2.2	–1.9	0.7	0.7	0.5	0.9	1.7
Saudi Arabia	1.9	1.2	–0.7	1.2	–0.4	–0.2	2.0	1.0
Turkey	7.6	2.8	2.0	3.6	85.7	84.6	67.5	73.6
Western Hemisphere	**5.2**	**2.3**	**–0.5**	**3.5**	**13.9**	**10.5**	**14.6**	**9.9**
Argentina	8.6	4.2	–1.5	3.0	0.8	0.9	0.6	0.9
Brazil	3.2	0.2	–3.8	3.7	7.9	3.5	. . .	. . .
Chile	7.1	3.3	2.0	4.6	6.1	5.1	4.5	4.2
Colombia	3.1	0.2	—	3.0	18.5	18.7	13.0	12.7
Dominican Republic	8.1	7.0	7.3	6.4	8.3	4.8	6.5	3.1
Ecuador	3.5	0.2	–5.0	1.5	30.6	36.1	73.8	60.5
Guatemala	4.1	4.9	3.9	5.0	9.2	7.5	6.5	5.0
Mexico	7.0	4.9	2.0	3.0	20.6	16.7	16.7	11.2
Peru	7.2	1.5	4.5	6.5	8.5	7.3	4.7	4.5
Uruguay	5.1	4.5	–1.0	3.1	19.8	10.8	7.0	4.0
Venezuela	5.9	–0.4	–3.6	1.8	50.0	35.8	26.1	21.8

[1]African countries that had arrangements, as of the end of 1998, under the IMF's Structural Adjustment Facility (SAF) or Enhanced Structural Adjustment Facility (ESAF).

ture targets. Sustained implementation of the program is essential for credibility to be established and to permit further reductions in interest rates to more moderate levels.

With the Brazilian economy representing roughly one-third of the output of the Western Hemisphere group of developing economies, and with Brazil trading and competing with the other economies of the region—most closely with Argentina, Paraguay, and Uruguay, its partners in the MERCOSUR trade agreement—this year's recession in Brazil will inevitably have a significant regional impact, exacerbated by the depreciation of the real and by any sustained financial market contagion. Thus far, the Brazilian crisis has had only moderate effects on financial markets elsewhere in Latin America, and most economies of the re-

Box 1.2. Potential Macroeconomic Implications of the Year 2000 Computer Bug

As the twentieth century draws to a close, concerns have risen that the Year 2000 (Y2K) problem, also referred to as the "millennium bug," could lead to severe economic disruptions around the world. The Y2K problem is a legacy of a computer programming shortcut used in the 1960s and 1970s to save computer memory, which was then substantially more expensive than today. The shortcut involved the use by software programmers of two digits instead of four (for example, 99 instead of 1999 for the current year) to identify the year in the date field in software code.[1] As a result, many computer programs and systems, as well as communication networks and some equipment or machinery with embedded microprocessors—including those in utilities, transportation, consumer electronics, and industrial control, health, and security systems—may fail or generate errors as they misinterpret "00" as 1900 instead of 2000.

Government agencies and businesses around the world have spent considerable resources, both to assess the extent of the problem in their systems and to fix and test the systems that are vulnerable. Despite these efforts, there is still considerable uncertainty about the extent of the remaining problem, and many governments, public sector entities, and private companies, particularly small and medium-sized enterprises, have not finished—or in some cases, even begun—the remediation process. In addition, it is almost impossible to ensure that systems are fully protected from the "bug" in an era when computer and information systems are extensively interconnected. Because of these uncertainties, and other uncertainties regarding anticipatory behavior—such as the hoarding of goods and currency and the avoidance of travel—estimates of the potential impact of the Y2K problem vary widely and are subject to wide margins of error.[2]

[1]Newer software programs are not necessarily immune to the "millennium bug" because the practice of using two digits instead of four continued even into the 1990s, despite dramatic reductions in computer memory costs, particularly for programs that were upgrades or modifications of older programs.

[2]Some central banks are preparing for the possibility of an increase in demand for currency by building up inventories of currency during 1999. For example, the U.S. Federal Reserve will have an extra $50 billion worth of currency in reserve (compared with a stock of currency in circulation outside banks of approximately $470 billion in March 1999).

Thus, the projections in the *World Economic Outlook* do not attempt to incorporate any estimate of these effects. However, it is possible to speculate in qualitative, rather than quantitative, terms about the potential macroeconomic consequences.

The impact of the "millennium bug" may best be compared with that of a negative supply shock, such as that of a natural disaster, since a portion of the existing capital stock in the form of hardware and software will become temporarily unusable and, in some cases, obsolete. However, the Y2K problem is different from the typical natural disaster in that it has been foreseen and is global in scale. Because it has been foreseen, there has been some time to attempt to reduce its potential impact. However, because it is a global shock, resources and expertise to repair problems could become severely constrained early in 2000.

Some businesses, particularly insurance companies and other financial service firms that make projections about the future, began efforts to make their systems Y2K-compliant more than ten years ago, in part because system failures had already begun to occur. In recent years, repair efforts have intensified and expanded to include other sectors. Because measured GDP does not take into account the depreciation of systems caused by the Y2K problem, these repair efforts have actually boosted measured output to the extent that they have increased spending—for example, as firms have advanced plans to modernize their information technology infrastructure without reducing other expenditures. For the U.S. economy, for example, it is estimated that the impact on real GDP has been several tenths of a percentage point in each of the past few years.[3] In other economies, where the repair effort is not as advanced and reliance on computers is less, the impact on GDP has been correspondingly smaller. Toward the end of 1999, GDP may also be stimulated by stockbuilding of goods by consumers and businesses as a precaution against potential economic disruptions in early 2000.

[3]See, for example, Martin Brooks, Gavyn Davies, and Neil Williams, "Y2K—A Millennium Recession?" *Global Economic and Strategy Weekly* (New York: Goldman Sachs, January 1999).

gion appear relatively well placed to withstand its spillovers—a reflection of the considerable strengthening of the region's economic fundamentals since the mid-1980s. But the risks of further contagion as investors reassess their portfolios, as well as the economic adjustment already required by the adverse developments of 1997–98, call for stringent policy discipline, even in the face of weakening growth, and a reinvigoration of reform efforts. The projected narrowing of external current account deficits in the region this year—totaling $30 billion (equivalent to 1 percent of GDP), with Brazil accounting for the bulk of the improvement—could well be exceeded. In a number of countries, financial sector fragilities require that particular attention be paid to the problems arising for banks and other financial institutions from the more adverse economic environment. These problems will be alleviated to the extent that adjustment takes the form of fiscal consolidation, since this should relieve upward pressures on interest rates both through reduced government borrowing and through improvements in confidence. And in some cases—most notably Colombia, Ecuador, and Venezuela—fiscal consolidation is needed anyway to reduce unsustainable imbalances.

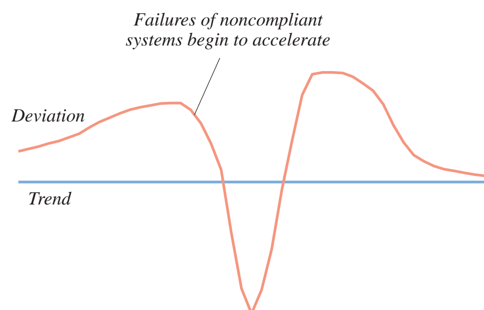
Some disruptions in economic activity are expected in early 2000, to the extent that some firms and government agencies will not have attended to the problem in time. In addition, destocking as the threat of disruptions fades, and lower Y2K-related spending in organizations that already have completed their remediation efforts, may tend to reduce aggregate demand and output early in 2000. However, as unprepared firms and government agencies repair their computer systems and make up for lost output, GDP may be boosted, perhaps starting later in 2000, possibly followed by a small negative impact as the extra spending is unwound. The *figure* offers a stylized depiction of the time profile of the net outcome of those effects in terms of aggregate output: an initial boost to activity resulting from anticipatory expenditures, followed by a drop in output as Y2K takes its main toll, and then a renewed upswing resulting from repair spending.

Similar to other types of supply shocks, the macroeconomic effects could include higher prices or lower profits and lower productivity. Already, wages among COBOL programmers, those most involved with the compliance effort, have risen significantly, and prices may rise to cover these higher wage costs as well as other costs of the remediation effort. Firms that face relatively high costs will realize a reduction in profits.

Perhaps the greatest uncertainties are attached to the possible impact of the Y2K problem in the developing and transition countries. These economies are generally less dependent than the advanced economies on computer-based technology, which might suggest that the potential disruptions would be less serious than in the advanced economies. Moreover, in at least the rapidly growing economies, a larger share of the capital stock is recently installed investment and therefore relatively likely to be Y2K-compliant. On the other hand, because sufficient investment is less likely to have been made in some of these countries to fix the Y2K problem, they may be more vulnerable, particularly to infrastructure failures in such areas as electricity, water, communications, transportation, and health services (which tend to be dependent on older computer systems) and also to failures of government tax collection and statistical systems. In addition, to the extent that these countries have problems, it may take them a longer time to fix their computer and information systems because of financial and human resource constraints. There are also dangers that failures in payment and other financial systems that are not Y2K-compliant could lead to disruptions in international trade and that perceived or actual compliance problems might increase capital flight and affect the cost and availability of external financing, especially in those cases where potential problems might affect production for exports and, therefore, the balance of payments.

Thus the macroeconomic effects of the Y2K problem are potentially significant but extremely difficult to quantify. They should not be exaggerated because experience suggests that economies can quickly recover from temporary shocks. In industries and sectors where compliance problems have been identified, there may still be time to alleviate the problem. But it is unlikely that all problems can be addressed in time.

Impact of Y2K: Stylized Depiction of Deviation of GDP from Trend



Source: Adapted from Filippo Cartiglia, Alex Patelis, and Javier Perez de Azpillaga, “Is the Millennium Bug a Danger? Y2K: A Tremor, not a Quake” (New York: Goldman Sachs, August 20, 1998).

Argentina has the closest trade links with Brazil among the major Latin American economies, and Brazil’s currency depreciation and recession have further worsened Argentina’s external economic environment. This follows a decline in economic activity in the latter part of 1998 as a result of the reduced supply of external financing, after three years of vigorous economic recovery from the Mexican crisis. The best way Argentina can respond to the new challenge it faces is to reaffirm and, where possible, reinforce its already strong commitment to the policy framework, centered on the currency board arrangement, that has served it well since the early 1990s, including at times of international financial turmoil. The fiscal position has improved markedly in recent years, but the widening of the external current account deficit, to 4¼ percent of GDP last year, as well as the volatile external situation, underscores the importance of continued budgetary restraint, despite the current weakness of activity. It will also be important to push ahead with structural reforms that enhance the flexibility of the labor market and the efficiency of the economy, particularly in order to strengthen Argentina’s international competitiveness and increase the scope for re-

Box 1.3. Are There Dangers of Increasing Protection?

The increased turbulence in the world economy since 1997, together with the uneven pattern of growth among the industrial countries, has exacerbated international payment imbalances and given rise to some trade tensions that are likely to continue in 1999. Over the past year, the collapse of demand in Asia, large currency depreciations in the crisis countries, the broader slowdown in economic growth globally, depressed commodity prices, and more difficult external financing conditions for many emerging market economies have intensified competitive pressures in export markets and reduced import demand. These pressures heighten concerns of an increase in protection through trade and exchange restrictions. The spread of the crisis to Russia and more recently to Brazil are likely to contribute to the maintenance of pressures in the trading system in 1999.

The Asian crisis was the main factor slowing the growth of world trade (in volume terms) from about 10 percent in 1997 to only 3¼ percent in 1998. Large declines in import volumes occurred last year in Asia: imports of the "Asia-5"—the five countries most affected by the Asian crisis (Indonesia, Korea, Malaysia, the Philippines, and Thailand)—are estimated to have fallen by 22 percent and those of Japan by 7¼ percent. The United States and the European Union have been the main absorbers of cheaper exports from the crisis countries, which are of course an essential element of their recoveries. Imports by the United States grew by 10½ percent (in volume terms) in 1998, while those of the EU rose by 7½ percent. So far, there is no clear indication of the increase in Asia-5 exports being at the expense of other developing countries. Commodity exporters in Latin America, the Middle East, and Africa have borne the brunt of terms of trade losses from the commodity price decline. The crises in Russia and Brazil have affected trade flows more recently, especially in certain neighboring countries.

Despite these developments, there are no signs of a generalized increase in protection, and most countries remain committed to trade liberalization. One measure of this commitment is provided by movements in the IMF's 10-point index of member countries' aggregate trade restrictiveness.[1] Notwithstanding the usual caveats relating to the use of a single measure to summarize several complex variables, the index is a useful composite measure of restrictiveness and an indicator of significant changes in a country's overall trade policy stance. During 1998, 24 countries of the total of 173 IMF members for which data are available increased their openness sufficiently to result in a movement in the index; 17 of these shifts occurred in the context of IMF-supported programs. By the same measure, only 3 countries increased their overall degree of trade restrictiveness sufficiently to show an increase in the index. As indicated in the *table,* these changes resulted in an overall increase from 79 to 87 in the number of countries whose trade systems could be classified as "open" (an index rating of 1–4), while there has been a decline from 38 to 33 in the number of countries that could be classified as "restrictive" (an index rating of 7–10).

An often-used indicator of protectionist pressures is the evolution of antidumping petitions initiated by World Trade Organization (WTO) members. The *figure* shows total initiations in the six 12-month periods 1992/93–97/98 (July–June) by developing and industrial countries. So far, there are indications of only a moderate upsurge in petitions in 1997/98, and of continuing moderation in the latter half of 1998. While the number of petitions in 1997/98 did increase from the two previous years, these are still below the number experienced ear-

Overall Trade Restrictiveness Ratings

	1997		1998	
Classification[1]	Number of countries	Percent of countries	Number of countries	Percent of countries
Restrictive	38	22	33	19
Moderate	56	32	53	31
Open	79	46	87	50

Source: IMF Trade Policy Information Database.
[1]Countries with index ratings of 7–10 are classified as "restrictive," 5–6 as "moderate," and 1–4 as "open."

[1]The index is made up of key measures of trade restrictiveness, relating to both the pervasiveness of non-tariff barriers and average tariff protection. See Robert L. Sharer and others, *Trade Liberalization in IMF-Supported Programs* (Washington: IMF, 1998).

ducing unemployment, which—despite its recent decline—has recently been about 12 percent. The banking system in Argentina has weathered the recent turmoil well.

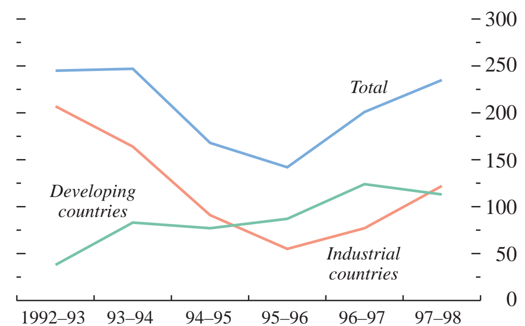
Chile's trade links with Brazil are less significant than those of Argentina, and developments in Brazil have had only a limited impact on Chile's financial markets. A tightening of macroeconomic policies in 1998 was necessary to contain external imbalances as well as to defend the exchange rate, and the current account deficit has begun to narrow since late last year, while inflation has slowed markedly. The health of the Chilean financial system has remained strong, despite a moderate deterioration resulting from increased domestic interest rates and the economic slowdown.

The Brazilian crisis led to another bout of turbulence in *Mexico*'s financial markets in January, but this was short-lived, reflecting the relatively small scale of the economic links between the two countries as well as a prompt tightening of Mexico's monetary policy. The challenges currently facing Mexico stem more from the fiscal and balance of payments reper-

lier in the decade. However, because the application of antidumping measures tends to take time because of the need to prove injury from increased imports, it is too early to draw firm conclusions about the impact of the emerging market crises on actual antidumping activity. Moreover, an absence of petitions to the WTO does not indicate an absence of pressures for protection. Thus, dangers of an upsurge in protection stemming from increased resort to antidumping remain.

The major industrial countries have so far, for the most part, resisted protectionist pressures and reaffirmed their commitment to sustaining the momentum for trade liberalization. Continued growth in most industrial countries except Japan has made it easier to absorb additional imports and adhere to trade liberalization commitments, including the phased implementation of the Uruguay Round agreements and regional initiatives.[2] The most substantial and visible pressures for protection have come from the steel industry in the form of antidumping petitions in Canada, the EU, and the United States; there has in the past been a cyclical pattern of demand for protection in this industry. In the United States, pressures for the introduction of more general safeguards in steel have recently intensified. Other pressures for protection related to fears of globalization and "social dumping" also continue to be present.

Antidumping Investigations Initiated[1]
(Number of investigations)



Source: World Trade Organization; July–June data.
[1]Indications are that this pattern continued in the second half of 1998.

There has been a worrisome increase in pressures for protection in Latin America, although the measures taken so far do not significantly reverse the policy direction of steady (and successful) trade liberalization over the past decade. Protectionist measures have been introduced in response to the impact of declining commodity prices and of the crisis in Brazil on trade flows in the region. A number of oil-exporting countries have increased import tariffs to help address domestic and external imbalances. Venezuela introduced a temporary surcharge of 15 percent on import duties on about 800 products in April 1998. In January 1999, Mexico raised its external tariff by 3 percent and 10 percent on intermediate and nonessential consumer goods, respectively. Ecuador introduced a temporary import surcharge of 2–5 percent in April 1998 until end-December 1998 (which was extended through end-March 1999) and replaced this in February 1999 with a surcharge of 2–10 percent. Recently, trade tensions within MERCOSUR countries have increased. Argentina is planning to introduce a licensing scheme for about a fifth of its imports in response to increased imports from Brazil. Moreover, various refinements in administrative procedures on trade, including revised safeguard and antidumping laws, that can give greater scope for use of these instruments for protection have been introduced over the past year in a number of Latin American countries.

In the countries in transition, although some protectionist measures have been introduced, there has been no major trend toward protection. Russia's anticrisis plan, adopted in October 1998, signaled a shift toward more activist industrial and trade policies—including directed credits, subsidies, and increased protection of domestic industries—representing a setback for trade liberalization. Recent trade measures in Russia have included a 3 percent

[2]The "banana war" has recently increased cross-Atlantic trade tensions. However, this emanates from an old legal dispute about the application of preference systems for developing countries and is unrelated to the emerging market crises.

cussions of the decline in oil prices since 1996; the reduced supply of external financing since 1997; the rise of inflation during 1998 associated with the depreciation of the peso that resulted partly from these developments; and continuing weaknesses in the financial system originating partly from the 1994–95 crisis and its aftermath. The 1999 budget includes new measures to help offset the revenue shortfalls resulting from lower oil prices, but further action may be needed. An early reform of the tax system to reduce the budget's dependence on oil revenues is particularly desirable. Successful implementation of the financial sector legislation passed in December, which promotes bank restructuring, introduces limited deposit insurance, and opens the commercial banking system to foreign competition, is critical for improving the soundness of the banking system, but further recapitalization of problem banks, including through public funds, will also be needed. With inflation having edged down in recent months, and with confidence returning, a sizable reduction of interest rates has been possible, but further fiscal consolida-

Box 1.3 *(concluded)*

import surcharge (subsequently substantially eliminated) and increased export taxes of up to 10 percent for selected products. The declines in import demand in Russia and in its export prices have not so far caused major protectionist reactions in the region, perhaps partly because of the declining importance of Russia as a trading partner for many countries. Protectionist measures have been introduced in Kazakhstan, Lithuania, Romania, and Uzbekistan, but for the most part these do not seem to be closely related to the Russian crisis. Kazakhstan bilaterally negotiated trade restrictions against Russian consumer goods; Lithuania introduced agricultural support guarantees and increased tariffs in the face of general increases in agricultural imports; Romania introduced an import surcharge of 6 percent in October 1998, reportedly for fiscal reasons, but has since agreed to a timetable with the WTO for its elimination; and Uzbekistan increased administrative compression of all imports.

In Asia, trade liberalization has generally continued, although a few countries introduced restrictions on selected products. Hong Kong SAR and Singapore have continued their traditionally open trade policies, and Indonesia and Korea have continued to implement agreed trade liberalization programs. China has increased value-added tax (VAT) rebates for exports, but since these remain at or below the VAT rate, no export subsidy is involved. It has continued to pursue its gradual liberalization, including in the context of WTO accession discussions. The Philippines recently adopted increased tariffs on a number of items for one year, apparently reflecting protectionist pressures, which could be viewed as a setback for its commitment to gradually achieve a uniform tariff rate of 5 percent by January 2004. Malaysia and Thailand introduced selective increases in import duties during 1998, again reportedly for fiscal reasons but possibly also reflecting protectionist pressures.

In Africa and the Middle East, most countries have continued to implement trade liberalization programs in the context of IMF-supported programs or WTO and regional liberalization commitments. Increases in protection have occurred in Nigeria and Zimbabwe. Nigeria has recently raised some tariffs to provide temporary relief to domestic producers affected by the sharp declines in prices on imports from Asia. Zimbabwe has introduced a number of exchange and trade measures, including raising import duties, to deal with mounting foreign exchange pressures.

In sum, while there clearly have been protectionist responses to the turbulent international environment, so far these have been relatively contained, and there has been no major setback to trade liberalization. A key factor in this has been the position of the industrial countries in resisting protectionist pressures. Also, countries increasingly recognize the benefits of open trade and its substantial contribution to economic growth over the past several decades, which also provides counterweight to protectionist pressures. Commitments to the WTO and to regional arrangements—by locking in policy reforms, binding tariffs, and constraining the type of protectionist actions that can be introduced—have also served as an important barrier containing these pressures. The launching of a new broad-based global trade round by end-1999, as proposed by most industrial countries, would also deter protectionist pressures and continue the momentum for trade liberalization. However, some recent signs, especially in Latin America, are worrisome, and there is a danger of further protectionist measures being taken, especially in the form of "temporary" import surcharges and less transparent administrative actions, particularly antidumping and safeguard actions.

The main factors and risks underlying the potential for further protectionist pressures remain. These are related to the pace of recovery of the Asian crisis economies, the slowdown in world economic growth, increased trade deficits in many countries, more restricted access to international finance by many developing countries, deteriorations in competitiveness resulting from currency appreciations, and depressed commodity markets. These are likely to affect adversely the export prospects of many countries. However, the appropriate response to weaker exports or stronger import competition should be appropriate adjustments in macroeconomic or structural policies, not increased trade protection. Protection, once instituted, is difficult to reverse. It would undermine economic efficiency, raise costs and prices to consumers and producers, and adversely affect business confidence, profit expectations (and thus the values of capital assets), with adverse effects on economic activity. Maintenance of open markets is essential to restore broad-based sustainable growth in the crisis countries and in the global economy.

tion is needed for lower interest rates to be achieved on a sustainable basis.

Ecuador and Venezuela also have been suffering from the weakness of oil prices; developments in Brazil have had only a limited impact in both cases. In *Ecuador,* the economy is in deep crisis. The exchange rate was floated in mid-February after a period of heavy pressure related to large fiscal and external imbalances, and following extensive withdrawals of bank deposits, the government declared a bank holiday followed by a partial freeze of loans and deposits. Determined budgetary consolidation and resolution of the difficulties in the banking system are needed to address the country's economic crisis. *Venezuela* also is in recession, and despite significant public spending cuts in 1998, the still unsustainable fiscal position calls for a further, substantial strengthening of the public finances in the near term to bolster confidence, take pressure off interest rates, reduce inflation, and promote sustainable growth. Increased interest rates last year had noticeably adverse effects on the banking system, which experienced a significant increase in

nonperforming loans. The health of *Colombia*'s financial system also deteriorated in 1998 owing to increased interest rates and weak economic activity, which partly reflected a deterioration in the public finances.

Policy Failures in Russia and Effects on Neighboring Countries

In contrast to the success of most other transition countries in escaping serious involvement in the emerging market turmoil, the Russian economy plunged into deep crisis following the devaluation of the ruble and the unilateral restructuring of its domestic debt last August and the subsequent meltdown in its foreign exchange and financial markets. Russia's economic predicament mainly reflects the serious and persistent shortcomings in its structural reform and institution-building efforts, repeated slippages in fiscal adjustment and reform, and an excessive buildup of short-term government debt, including to foreign investors. But its difficulties have been exacerbated by the emerging market crises and their spillover effects, especially on oil and other commodity prices.

There was considerable success in reducing inflation in the period up to August 1998; this was due in part to the pegging of the ruble to the U.S. dollar and a relatively tight rein on monetary policy in the preceding two to three years, but it was also due in part to the suppression of inflationary pressures by the accumulation of budgetary arrears, and domestic (nonbank) and external borrowing. The underlying fiscal and structural problems were reflected in large-scale capital flight, even when Russia's economic performance seemed promising; this meant that the increase in external debt was not matched by higher investment and increased export potential. Widespread graft and a culture of nonpayment—with the government itself, at central and local levels, repeatedly failing to meet its obligations to public sector wage earners, pensioners, and suppliers—have eroded the social fabric. The lack of political consensus and commitment to the reform process caused the situation to deteriorate until the accumulation of debt and erosion of confidence made it untenable.

Russia's economic outlook is subject to considerable uncertainty. With regard to policies, discussions on measures consistent with a framework agreed to with the IMF for a new program are under way. Key elements of such a program would be a tightening of fiscal policy to achieve a primary surplus equivalent to 2 percent of GDP in 1999, and a reinvigoration of structural reform, including the early implementation of a plan for bank restructuring. On the assumption of such policies, IMF staff tentatively project an output contraction of some 7 percent in 1999 followed by a stabilization of activity in 2000 (on an annual average basis), and a decline in inflation, to about 50 percent on a 12-month basis at the end of 1999, with a further reduction in 2000 (Table 1.3, which slows inflation on an annual average basis). In the absence of coherent stabilization and reform policies, however, there would remain a risk of high inflation and continued economic contraction; access to international financial markets would be unlikely to resume; and much of the progress tentatively achieved in some areas during 1991–98 could be lost, setting back the transition process by many years. The importance of arresting and reversing Russia's economic decline is evident, and the international community needs to be prepared to assist a strengthened commitment to reform that can prove to have domestic political backing.

Developments in Russia have had significant adverse effects on near-term growth prospects and balance of payments positions in a number of the neighboring countries in transition. The Russian crisis contributed to currency depreciations in *Belarus, Georgia,* the *Kyrgyz Republic,* and *Moldova* in late 1998, and in *Kazakhstan* in April 1999, and thus to a worsening of near-term inflation prospects for these countries; the near-term growth outlook has deteriorated in much of the region. Additional official financial support has been announced for some of the smaller countries, whose external positions have been particularly affected. In response to the spillovers from Russia, the neighboring countries will need to maintain relatively tight macroeconomic policies to limit the widening of external imbalances and to contain price pressures associated with exchange rate weakness. They also need to maintain their structural reform efforts, and particularly to resist pressures to reverse exchange and trade liberalization as a result of deteriorating balance of payments positions. In *Ukraine,* there have been some efforts in recent months to strengthen the fiscal position and make further progress with structural reforms, but in the absence of further, sustained fiscal and structural adjustment the external position will remain vulnerable.

Japan: Seeking a Turnaround

Japan's recession deepened further in late 1998, with real GDP falling to a level 5¼ percent below its peak of early 1997. Indicators for early 1999 are mixed, and it remains unclear whether activity has stabilized, although survey evidence points toward a modest recovery in business confidence and financial market developments suggest a turnaround in investor sentiment. Unemployment rose to a new postwar peak of 4.6 percent in February. The projections assume that after the boost to demand provided by fiscal stimulus through mid-1999, activity will again weaken before moderate recovery begins in 2000. On that basis, real GDP is projected to decline further—by about 1½

Table 1.3. Countries in Transition: Real GDP and Consumer Prices
(Annual percent change)

	Real GDP				Consumer Prices			
	1997	1998	1999	2000	1997	1998	1999	2000
Countries in transition	**2.2**	**–0.2**	**–0.9**	**2.5**	**28**	**21**	**41**	**12**
Median	**3.4**	**4.0**	**3.2**	**4.3**	**15**	**10**	**9**	**6**
Central and eastern Europe	3.1	2.4	2.0	3.7	37	18	20	9
Excluding Belarus and Ukraine	3.5	2.6	3.0	4.6	39	15	10	7
Albania	–7.0	8.0	8.0	8.0	33	21	7	5
Belarus	11.4	8.3	—	—	64	73	213	30
Bulgaria	–6.9	4.0	3.7	4.1	1,082	22	1	5
Croatia	6.5	2.4	1.5	3.5	4	6	4	5
Czech Republic	1.0	–2.2	0.5	3.0	8	11	5	6
Estonia	11.4	4.0	2.3	6.0	11	8	4	3
Hungary	4.6	5.0	4.3	4.8	18	14	9	8
Latvia	6.5	3.8	4.0	5.0	8	5	3	3
Lithuania	6.1	4.4	2.5	4.5	9	5	2	4
Macedonia, former Yugoslav Rep. of	1.5	5.0	5.0	5.0	2	1	2	3
Moldova	1.3	–5.0	1.0	3.0	12	7	15	3
Poland	6.9	4.8	4.7	5.3	15	12	7	7
Romania	–6.6	–5.5	–2.0	3.0	155	59	46	18
Slovak Republic	6.5	4.4	2.0	5.0	6	7	9	7
Slovenia	3.8	3.9	3.8	4.2	9	8	7	7
Ukraine	–3.0	–1.7	–3.6	–0.1	16	11	28	9
Russia	0.8	–4.8	–7.0	—	15	28	100	20
Transcaucasus and central Asia	2.4	2.0	1.8	3.1	37	15	13	9
Armenia	3.1	5.5	4.0	5.0	14	9	10	7
Azerbaijan	5.8	10.0	6.0	4.8	4	–1	–6	3
Georgia	11.0	4.0	2.0	5.0	7	4	20	5
Kazakhstan	1.7	–2.5	–1.5	1.0	17	7	3	5
Kyrgyz Republic	9.9	2.0	4.6	4.5	26	12	10	6
Mongolia	4.0	3.5	3.5	4.0	37	9	9	6
Tajikistan	1.7	5.3	3.0	4.0	88	43	12	7
Turkmenistan	–25.9	4.5	24.8	15.2	84	17	28	20
Uzbekistan	2.4	2.8	—	2.0	71	29	29	16

percent—in 1999 after a contraction of 2¾ percent last year (Table 1.4).

With the fiscal deficit (excluding social security) projected to reach more than 10 percent of GDP in fiscal year 1999 (beginning April 1), there are clearly limits to further fiscal expansion, as indicated by limited effects of recent fiscal packages on private demand and the rise in government bond yields since November (Table 1.5). But it remains critical to ensure that the fiscal stimulus already planned is implemented in full to provide support to the economy. Furthermore, it will be important to maintain adequate fiscal stimulus until recovery in private demand is under way, and then to proceed gradually with the consolidation of the public finances that is needed over the medium term.

Appreciation of the yen, together with rising long-term interest rates, resulted in a significant tightening of monetary conditions in late 1998 and early 1999. In mid-February, the Bank of Japan lowered the target for the overnight call rate from 0.25 percent to 0.15 percent, and indicated that it would seek to reduce the rate as low as possible through its market operations. Since early March, the rate has been virtually zero, so that the room for reduction of short-term interest rates has been essentially exhausted. These easing actions have partially reversed the earlier tightening of monetary conditions and contributed to a significant improvement in financial market sentiment. But with deflationary pressures persisting, the Bank of Japan will need to continue to implement a stimulative monetary policy through the instruments at its disposal, including open-market operations in private and government debt. Also, to convince markets of its determination to combat deflation, and to guide monetary operations, the central bank might adopt a supplementary operating target—such as for the growth of the monetary base or an interest rate objective for somewhat longer-maturity instruments—which would provide a means of signaling its willingness to ease liquidity until the objective of price stability is ensured.

Macroeconomic policies alone, however, will not be able to reinvigorate the Japanese economy over the medium term. Structural reforms also are needed in

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

	Real GDP				Consumer Prices				Unemployment			
	1997	1998	1999	2000	1997	1998	1999	2000	1997	1998	1999	2000
Advanced economies	**3.2**	**2.2**	**2.0**	**2.3**	**2.1**	**1.6**	**1.4**	**1.7**	**7.0**	**6.9**	**6.9**	**6.9**
Major industrial countries	3.0	2.2	1.9	2.0	2.0	1.3	1.4	1.7	6.7	6.4	6.5	6.6
United States	3.9	3.9	3.3	2.2	2.3	1.6	2.1	2.4	4.9	4.5	4.5	4.7
Japan	1.4	–2.8	–1.4	0.3	1.7	0.6	–0.2	–0.2	3.4	4.1	4.8	4.9
Germany	2.2	2.8	1.5	2.8	1.8	0.9	0.6	1.0	11.4	11.2	10.9	10.4
France	2.3	3.1	2.2	2.9	1.2	0.7	0.5	1.1	12.5	11.6	11.4	11.1
Italy	1.5	1.4	1.5	2.4	1.7	1.8	1.3	1.5	12.3	12.3	12.2	12.0
United Kingdom[1]	3.5	2.1	0.7	2.1	2.8	2.7	2.7	2.4	5.5	4.7	4.6	5.1
Canada	3.8	3.0	2.6	2.5	1.4	1.0	1.2	1.6	9.2	8.3	8.1	8.1
Other advanced economies	4.2	2.1	2.5	3.4	2.5	2.5	1.5	1.7	8.0	8.2	8.3	7.8
Spain	3.5	3.8	3.3	3.5	2.0	1.8	1.8	2.1	20.8	18.8	17.7	17.1
Netherlands	3.6	3.7	2.3	2.6	2.2	2.0	1.6	2.2	6.6	5.3	5.3	4.9
Belgium	3.0	2.9	1.9	2.2	1.6	1.0	1.1	1.4	9.2	8.8	8.7	8.5
Sweden	1.8	2.9	2.1	2.8	0.5	–0.1	0.2	1.0	8.0	6.5	5.9	5.7
Austria	2.5	3.3	2.0	2.5	1.3	0.9	1.0	1.3	6.4	6.4	6.4	6.3
Denmark	3.1	2.9	1.3	2.0	2.2	1.7	1.9	2.1	7.6	6.2	6.4	6.6
Finland	6.0	5.0	3.1	3.5	1.2	1.5	1.5	2.0	12.6	11.4	10.2	10.0
Greece	3.2	3.7	3.3	3.4	5.5	4.8	2.5	2.9	10.3	10.1	10.0	9.9
Portugal	4.0	3.9	3.1	3.2	2.2	2.8	2.3	2.0	6.7	5.0	5.1	5.2
Ireland	9.8	9.0	6.7	6.4	1.5	2.4	2.0	2.0	9.8	7.8	6.8	6.2
Luxembourg	4.8	4.1	3.9	4.4	1.4	1.6	1.7	1.7	3.7	4.1	4.5	4.7
Switzerland	1.7	2.1	1.2	2.0	0.5	—	0.8	1.0	5.2	3.9	3.4	3.2
Norway	3.4	2.0	1.0	1.8	2.6	2.2	2.3	2.5	4.1	3.2	3.6	4.0
Israel	2.3	2.0	2.3	3.0	9.0	5.5	8.3	3.0	7.7	9.2	9.3	8.8
Iceland	5.4	5.1	5.6	4.7	1.8	1.7	3.5	3.2	3.7	3.0	1.7	1.7
Korea	5.5	–5.5	2.0	4.6	4.4	7.5	1.8	2.0	2.7	6.8	8.0	7.0
Australia[2]	3.6	5.1	3.1	3.2	1.7	1.6	1.5	1.6	8.6	8.0	7.5	7.3
Taiwan Province of China	6.8	4.9	3.9	4.8	0.9	1.7	0.8	1.3	2.7	2.8	3.0	2.7
Hong Kong SAR	5.3	–5.1	–1.3	3.1	5.7	2.6	–2.2	—	2.2	4.7	6.5	6.1
Singapore	8.0	1.5	0.5	4.2	2.0	–0.3	–0.1	1.1	1.8	3.3	5.3	4.5
New Zealand[2]	2.1	–0.3	2.7	3.3	1.7	1.5	1.0	1.4	6.7	7.5	7.6	7.4
Memorandum												
European Union	2.7	2.8	1.8	2.7	1.9	1.5	1.3	1.6	10.9	10.2	9.9	9.7
Euro area	2.5	2.9	2.0	2.9	1.7	1.3	1.0	1.4	12.3	11.7	11.3	11.0

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

key areas. Most important, the country's banking sector problems continue to need attention. Recent legislation has put in place a comprehensive framework for dealing with banking problems, including public funds to recapitalize the banking system and address banking sector weaknesses—for example, through the temporary nationalization, public administration, or the sale or liquidation of failed banks. Under this new framework, the Long-Term Credit Bank and Nippon Credit Bank have been nationalized. In late March, 15 of the major banks received injections of public funds amounting to ¥7.4 trillion for recapitalization; these and other major banks also plan to raise ¥2½ trillion from private sources. Although the banks receiving public funds have submitted plans to restructure their operations, these plans do not appear to go far enough in cutting costs or reorienting the banks' business to more profitable areas. It will therefore be important to continue intensifying supervisory pressure to ensure full recognition of the bad loan problem, while using the leverage provided by public capital injections to catalyze restructuring and consolidation of the banking system, including more active disposal of bad bubble-period loans and the shedding of unprofitable business. After many delays, there are signs that a solution to the banking problems is taking shape, but decisive actions along these lines are still needed.

From a medium-term perspective, there is also a complementary need for bold, comprehensive, and coherent structural reforms to facilitate corporate restructuring, reduce inefficiencies, and remove obstacles to new enterprises and activities. This is essential not only to strengthen medium-term growth performance but to ensure a reasonably early return to full employment, especially since the relative importance of the industrial sector is likely to continue to decline, with greater potential for growth in services, as has been the experience of the mature economies of North

Table 1.5. Major Industrial Countries: General Government Fiscal Balances and Debt[1]

(Percent of GDP)

	1982–92	1993	1994	1995	1996	1997	1998	1999	2000	2004
Major industrial countries										
Actual balance	–3.0	–4.2	–3.5	–3.4	–2.7	–1.2	–0.9	–1.2	–1.0	0.4
Output gap	–0.9	–2.8	–2.3	–2.2	–1.4	–0.8	–0.9	–1.2	–1.4	–0.4
Structural balance	–2.6	–2.9	–2.4	–2.4	–2.0	–0.7	–0.4	–0.6	–0.3	0.6
United States										
Actual balance	–2.9	–3.6	–2.3	–1.9	–0.9	0.4	1.2	1.4	1.8	2.1
Output gap	–1.7	–3.2	–2.1	–2.2	–1.2	0.2	1.5	2.1	1.7	0.1
Structural balance	–2.4	–2.3	–1.4	–1.1	–0.5	0.3	0.7	0.7	1.2	2.1
Net debt	39.3	54.2	54.9	54.5	54.1	51.4	48.5	45.7	42.6	30.1
Gross debt	53.5	68.5	67.8	67.9	67.8	65.7	61.9	58.3	54.4	38.4
Japan										
Actual balance	–0.3	–1.6	–2.3	–3.6	–4.2	–3.3	–5.3	–7.9	–8.2	–2.0
Output gap	0.2	–1.3	–2.6	–3.0	–0.2	–1.1	–5.7	–8.2	–8.9	–2.7
Structural balance	—	–1.2	–1.4	–2.6	–4.1	–2.9	–3.1	–4.7	–4.6	–1.0
Net debt	18.4	5.2	7.7	13.3	15.4	18.5	29.5	37.9	46.1	55.8
Gross debt	68.0	75.1	82.2	89.7	94.1	100.1	116.8	130.3	141.6	153.4
Memorandum										
Actual balance excluding social security	–3.3	–4.8	–5.1	–6.5	–6.8	–5.8	–7.5	–9.9	–10.0	–4.4
Structural balance excluding social security	–3.4	–4.5	–4.5	–5.7	–6.8	–5.6	–6.1	–7.8	–7.7	–3.9
Germany[2]										
Actual balance	–2.1	–3.2	–2.4	–3.3	–3.4	–2.7	–2.0	–2.2	–1.7	–0.4
Output gap	–0.9	–2.0	–2.2	–2.5	–3.2	–3.1	–2.5	–3.1	–2.4	—
Structural balance	–1.5	–2.2	–1.2	–2.0	–1.6	–0.7	–0.4	–0.4	–0.3	–0.4
Net debt	22.1	35.2	40.5	48.9	51.5	52.4	52.3	53.0	52.4	46.7
Gross debt	41.3	48.0	50.2	58.0	60.4	61.3	61.2	61.8	61.3	55.5
France										
Actual balance	–2.4	–5.8	–5.7	–4.9	–4.2	–3.0	–2.9	–2.4	–1.9	–1.0
Output gap	0.3	–3.8	–3.0	–2.7	–3.3	–3.2	–2.5	–2.6	–2.1	–0.1
Structural balance	–2.5	–3.3	–3.7	–3.1	–1.9	–0.8	–1.3	–0.9	–0.7	–0.9
Net debt[3]	19.4	34.4	40.2	43.6	46.3	48.1	49.6	51.0	51.6	49.6
Gross debt	31.5	45.2	48.3	52.5	55.4	57.8	59.4	60.7	61.4	59.4
Italy										
Actual balance	–11.0	–9.5	–9.2	–7.8	–6.6	–2.7	–2.7	–2.7	–2.5	–1.4
Output gap	0.3	–2.6	–2.5	–1.1	–1.8	–2.2	–2.6	–2.9	–2.4	—
Structural balance	–11.0	–8.2	–7.9	–7.1	–5.7	–1.6	–1.5	–1.4	–1.4	–1.4
Net debt	77.7	112.8	118.3	118.6	118.0	115.8	112.4	111.3	109.3	98.1
Gross debt	85.1	119.1	124.9	125.3	124.6	122.3	118.7	117.5	115.4	103.5
United Kingdom										
Actual balance	–2.3	–7.8	–6.8	–5.5	–4.5	–1.9	–0.1	–1.0	–1.4	–1.2
Output gap	–1.1	–4.0	–2.2	–1.1	–0.9	0.5	0.6	–1.3	–1.4	—
Structural balance	–1.5	–4.5	–4.5	–4.3	–3.9	–1.9	–0.7	–1.0	–0.6	–1.1
Net debt	41.0	33.8	39.4	42.3	45.7	47.9	48.8	45.9	45.3	42.1
Gross debt	49.1	42.5	48.4	50.5	53.8	54.5	52.4	48.2	47.5	43.9
Canada										
Actual balance	–5.3	–7.6	–5.6	–4.5	–2.2	0.9	1.3	1.6	1.5	1.7
Output gap	–1.0	–3.8	–1.3	–0.9	–1.8	–0.5	–1.0	–0.9	–0.8	—
Structural balance	–4.8	–4.8	–4.5	–3.8	–1.1	1.3	1.8	2.0	1.9	1.7
Net debt	34.6	63.3	66.8	67.8	69.2	65.7	63.2	59.8	56.1	41.0
Gross debt	67.2	96.9	98.0	99.3	99.5	95.0	91.5	87.0	82.3	63.2

Note: The budget projections are based on information available through April 1999. The specific assumptions for each country are set out in Box 1.1.

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

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

[3]Figure for 1982–92 is average of 1984–93.

America and western Europe. Past deregulation initiatives in some sectors have already borne fruit by increasing competition and reducing prices. However, many restrictions and market distortions remain in agriculture, distribution, transportation, and construction that act as impediments to medium-term growth and job creation. Further deregulation in the nontradable goods sector will need to be combined with the removal of nontariff barriers to trade in both goods and services. Further, there is a need for corporate restructuring to proceed more quickly in order to achieve a more efficient allocation of capital and labor. While the "big bang" reforms in the financial sector should help in this regard by setting the stage for more stringent market-oriented discipline on corporate behavior, this needs to be supplemented by reforms of the bankruptcy code and the tax structure to facilitate corporate restructuring and enhance labor mobility.

Asia and the Pacific: Toward Recovery

The economies in Asia that suffered the first wave of the recent emerging market crisis seem close to the bottom of their deep economic slumps. Recovery appears to have begun already in Korea, with an upturn in activity late last year. Among the newly industrialized Asian economies, projected growth in 1999 has been revised upward for Korea and Singapore since the December 1998 *Interim Assessment,* while for the ASEAN-4 group of developing countries (Indonesia, Malaysia, the Philippines, and Thailand) small downward revisions for Indonesia and Thailand have been offset by a larger upward revision for Malaysia, so that projected growth for the group as a whole in 1999 is little changed, still pointing to a bottoming-out of activity in the course of this year. Progress toward economic recovery has been advanced by financial stabilization, with strengthening exchange rates allowing monetary policies to be relaxed further; by supportive fiscal policies; and by improvements in confidence domestically and abroad. Large-scale recoveries in stock markets from their nadirs, and the narrowing of international bond-yield spreads—toward mid-1997 levels in some cases—indicate the improvement in sentiment and financial conditions. At least since mid-1998, the IMF programs with Indonesia, Korea, the Philippines, and Thailand have all remained broadly on track, indicating these countries' progress with stabilization and reform policies. However, to ensure that the nascent recoveries in the Asian crisis economies take hold and develop into a new period of sustainable growth, considerable further progress is needed with the structural reforms that have been initiated and are beginning to take effect.

In *Thailand,* the first Asian economy to suffer crisis in 1997, activity has stabilized in recent months, with the strengthened exchange rate allowing further declines in interest rates to well below precrisis levels. But credit growth has yet to recover: its revival hinges on further progress in bank recapitalization and corporate debt restructuring. The latter has been sluggish, but the passage in March of key legislation on bankruptcy and foreclosure proceedings should facilitate the process. Expansionary fiscal policy remains appropriate for the time being, and measures were announced at the end of March to ensure the desired stimulus, through various tax cuts and timely spending on labor-intensive investment projects and the social safety net. These measures and the progress made in advancing the structural reform agenda should lead to a resumption of growth in the second half of this year. Indeed, modest positive growth is projected for 1999 as a whole. The recovery in *Korea* has also been fostered by financial stabilization and easier macroeconomic policies, as well as by a recovery in investor sentiment. With the output gap still large—as reflected in unemployment close to 9 percent—and upward pressure on the exchange rate, significant foreign exchange purchases by the central bank have been accompanied by further reductions in interest rates. In addition, the budget aims at a deficit of 5½ percent of GDP to ensure stimulus to the economy. The restructuring of the financial sector is on schedule, with recapitalization plans for banks making progress. In the corporate sector, restructuring plans for the top five *chaebol* conglomerates were announced in December, but important decisions on the elimination of excess capacity remain to be made. The genuine restructuring that is needed will require a sea change in the extent to which Korean companies are exposed to market discipline, and it is imperative that the restructuring does not involve government favors to contracting parties.

Indonesia remains behind Korea and Thailand in its stabilization efforts, owing to initial delays and political and social tensions, and while the economy is expected to begin its recovery in the latter part of this year, downside risks remain. Real interest rates have had to remain high to maintain exchange rate stability, but fiscal policy has been providing stimulus since late last year. Progress is being made in bank restructuring, although much remains to be done, especially with regard to the state banks. The corporate restructuring process under the Jakarta Initiative also needs to be revitalized. Modest positive growth is now projected for *Malaysia* in 1999 following the sharp contraction in 1998. External demand appears to be benefiting from the improvement in Malaysia's competitive position vis-à-vis other countries in the region, reflecting the appreciation of their currencies against the U.S. dollar since Malaysia pegged the ringgit to the dollar in September 1998. Despite stimulative monetary and fiscal measures introduced last year, however, domestic demand is expected to strengthen only gradually, and inflationary pressures are expected to remain low. Private sector investment, in particular, is likely to re-

main inhibited by the ongoing financial restructuring of the banking system and corporate sectors, together with the uncertainties regarding the future of Malaysia's capital controls. The *Philippines* has been less severely affected by the Asian crisis; it would probably have experienced positive growth in 1998 if it had not been for a weather-related drop in agricultural output late in the year, and a moderate recovery is projected for 1999. Interest rates have been reduced cautiously as exchange rate stabilization has taken hold, and further gradual easing seems likely to be appropriate in 1999 as inflation declines and the external sector strengthens. There is less scope for fiscal policy to support demand than in the other Asian crisis countries, owing to the Philippines' higher level of public sector debt.

In *China,* growth appears to have been well maintained in 1998, helped by large increases in public investment outlays and cautious reductions in interest rates, but a moderate further slowing is projected for 1999. Net exports have weakened considerably despite measures to bolster exports and limit import growth, but the current account remains in significant surplus, and China's external vulnerability is limited also by its very large foreign exchange reserves, moderate foreign debt, and regulation of capital movements. These factors, together with the recent strengthening of regional currencies, have helped maintain the stability of the renminbi against the U.S. dollar, and this is making an important contribution to the restoration of financial stability in the Asian region. However, there are significant downside risks to projected growth, which could affect the prospects for recovery in the region given the potential spillovers from China to its neighbors. The risks arise from slowing external demand, financial sector weaknesses, concerns about cutbacks in external financing to Chinese companies following the failure of a major international trust and investment corporation, and past overbuilding and excess inventory accumulation. These problems all indicate the need for reforms of both the financial sector and the state-owned enterprises. With regard to the financial sector, the authorities took a welcome step in January by announcing a pilot project to create an asset management company to take over the bad loans of one of the big four state commercial banks. While fiscal policy is providing welcome stimulus to demand, with a further increase in the fiscal deficit in the 1999 budget, interest rate policy needs to remain cautious to avoid a recurrence of exchange rate pressures.

In 1998, the effects of the regional crisis hit the *Hong Kong SAR* economy with full force, despite its strong fundamentals, and output, employment, and asset prices declined significantly. However, the flexibility of domestic wages and prices, shown in falling prices and labor costs, together with the depreciation since last August of the U.S. dollar, especially in terms of regional currencies, has contributed to a significant recovery of international competitiveness. The recession is expected to bottom out in the second half of 1999, but the strength of recovery may be limited by high real interest rates as domestic prices decline. The fiscal position has weakened significantly during the recession, partly on account of supportive measures, but in view of the outlook and the SAR's substantial fiscal reserves, the authorities have appropriately postponed the process of restoring balance until after 1999. The financial position of the SAR's banks remains strong by international standards.

Other economies in the Asia-Pacific region have been more resilient to the financial turbulence in the region. In the case of *India,* this has partly reflected the country's relatively closed economy. Growth is projected to remain close to 5 percent in 1999 and 2000. The main priority for macroeconomic policy continues to be to rein in the public sector deficit, which has widened to almost 10 percent of GDP. The recent budget implies some modest deficit reduction at the central government level, but measures will also need to be taken by state governments and public enterprises to ensure consolidation for the public sector overall. There is also a need to contain rapid monetary growth to reduce risks of a renewed upturn in inflation. But to bring about the sustainable improvement in growth performance that India needs to reduce poverty over the medium term, structural reform efforts will also need to be strengthened. While some progress has been made recently, critical reforms—particularly in the areas of trade liberalization, privatization, and the strengthening of the financial sector—continue to lag. In the case of *Pakistan,* despite debt relief, a resumption of lending by international financial institutions, and the introduction of a number of structural measures, growth in 1999 is unlikely to exceed 3 percent, largely because of severe import constraints, tightened fiscal policy, a wait-and-see attitude by investors, and a poor cotton crop. A rebound in official foreign exchange reserves is allowing a rapid winding down of the trade and payments restrictions introduced during the 1998 crisis.

Singapore's strong fundamentals at the onset of the Asian crisis and its easing of macroeconomic policies have helped to moderate the contractionary forces emanating from the regional downturn, but the economy nevertheless experienced a sharp slowdown of growth in 1998. The substantial easing of fiscal policy in 1998/99 and, prospectively, in 1999/2000, is appropriate given the country's large fiscal and external reserves. The absence of inflation provides some scope for a modest further easing of monetary policy in the near term. Expansion is expected to resume in the course of this year, resulting in modest positive growth for 1999 as a whole.

Growth in *Australia* accelerated in 1998 despite the east Asian recession, with demand boosted by an eas-

ing of monetary conditions, including through depreciation of the Australian dollar. The weakness of commodity markets is expected to take a heavier toll this year as certain export contracts are renegotiated, and growth is projected to slow significantly. Inflation remains low, and there is scope for further modest monetary easing if inflationary pressures remain muted. Demand can also be supported by the operation of the automatic fiscal stabilizers, but high priority must continue to be attached to raising national saving, given Australia's large external liabilities, which precludes discretionary fiscal easing beyond the personal income tax cuts in the tax reform package to be implemented next year.

In *New Zealand,* economic recovery seems to be under way following last year's recession, underpinned by stronger domestic demand and exports. Growth in 1999 should reach 2½–3 percent. Monetary conditions have firmed slightly in recent months, following a substantial easing during 1997–98, and inflation is expected to remain below the midpoint of the authorities' target range of 0–3 percent. The current account deficit, at 6 percent of GDP in 1998, together with the very high ratio of net external liabilities to GDP, point to the need for strengthening national saving over the medium term.

Africa and the Middle East: Uneven Spillovers from Global Slowdown

While limited access to international capital markets has deprived most countries in sub-Saharan Africa of many of the benefits of international financial integration, it has also shielded them during periods of financial turbulence. The direct financial effects of the recent crises on most countries in sub-Saharan Africa have therefore been relatively small. An exception is *South Africa,* which was affected by the turmoil in global markets in early 1998, necessitating a sharp rise in interest rates. More recently, interest rates in South Africa have been declining, reflecting sound monetary and fiscal policies. Nevertheless, real interest rates have remained high, exacerbating the weakness of economic activity: growth was near zero in 1998 and is expected to be below 1 percent in 1999. Cautious fiscal policies will need to be maintained to restore confidence, and accelerated implementation of structural reforms remains essential to improve the medium-term outlook for growth and employment.

For many other African countries the crisis is mainly being felt indirectly, through the impact on commodity prices and export earnings, and the resulting need to tighten budgets. Declining oil revenues have placed particular pressure on the fiscal positions and external accounts of the oil-exporting countries of the region, particularly Angola, Gabon, Nigeria, and the Republic of Congo. In *Nigeria,* associated with improvements in governance, a comprehensive adjustment and reform program was adopted in early 1999, which is being monitored by IMF staff. Some exporters of nonoil commodities have also been hard hit, notably exporters of minerals, such as Botswana and Zambia. Many other African countries appear to be coping reasonably well with the adverse effects of the crisis. This can be attributed in part to reforms implemented over the past decade, together with a primary orientation of trade toward North America and Europe, and the favorable effects of the drop in oil prices on the petroleum importers. Nevertheless, while the effect on growth in Africa as a whole appears to be relatively modest, large terms of trade losses have entailed significant real income reductions in many instances (see Chapter II). This underscores the importance of recent new initiatives to reduce the debt burdens of some of the poorest countries, as well as of improving market access in industrial countries for developing country exports, particularly agricultural products. Also in Africa, severe economic as well as political risks attach to the armed conflicts in Angola, Sierra Leone, and the Democratic Republic of Congo, and between Ethiopia and Eritrea—conflicts that have already set back prospects for economic progress in these countries.

In the Middle East, lower oil prices—in real terms, recently back to the levels prevailing before the first (1973–74) oil shock—have had major consequences for the region's oil exporters. In the six Gulf Cooperation Council countries, oil export earnings fell by one-third in 1998, causing fiscal balances to deteriorate by 5–8 percentage points of GDP. Drawing on reserves and external borrowing can only be a short-term solution to the loss of earnings. Notwithstanding the pickup in prices since mid-March, the risk of a prolonged slump in oil prices and of little improvement in international financial market conditions militates against financing any large share of the shortfall. The large oil exporters are therefore faced with an acute need to adjust, chiefly through reductions in government expenditures, tax measures, and adjustments in the prices of utilities. Other economies in the Middle East and North Africa are generally more diversified. Some have made good progress in financial stabilization and structural reform, which will ease the task of adjusting to lower oil export earnings and reduced remittances from emigrant workers; others, such as Egypt, will need to introduce tighter credit policies and active interest rate management in order to cope with the loss of reserves by the banking sector. Many countries in the region maintain exchange rate pegs vis-à-vis the dollar. In some cases these have come under pressure during the recent turmoil, but such pressures have been manageable in part because of limited exposure to international financial markets. In some instances, however, the exchange rate may need to play a part in the adjustment process.

North America: How Long Can the United States Remain the Main Engine of Global Growth?

The remarkable strength of the U.S. expansion has shown no signs of abating despite the slowdown in most of the United States' overseas markets. Indeed, with a growth rate in domestic demand of 5 percent in 1998 (up from 4¼ percent in 1997), U.S. consumers and investors accounted for almost half of the growth in world demand (and output) last year. The ability of the United States to act as the main engine of global growth can be explained in part by the optimism of consumers and investors engendered by an exceptionally encouraging combination of economic developments—including virtual price stability, low interest rates, low unemployment, and a rising budget surplus—that are testimony to fiscal discipline over several years and to monetary policy that, with considerable agility, has acted to bring about medium-term price stability. Another factor boosting domestic demand, related partly to these developments, has been the buoyancy of the stock market. The stock market corrections and threat of a credit crunch that came in the wake of the Russian default and the near failure of the hedge fund Long-Term Capital Management appeared to signal a slowdown of growth, but the cuts in interest rates by the Federal Reserve quickly restored confidence. In the event, economic growth surged to 6 percent in the fourth quarter of 1998.

There are many reasons to expect growth to moderate in the period ahead. With unemployment at a 29-year low of 4.2 percent, the rate of expansion is increasingly constrained by underlying productivity growth and increases in the labor force, which together point to potential growth of 2¼–2¾ percent. Moreover, there are reasons to expect the growth of demand to slow. After a sharp reduction in the personal saving rate induced in part by increased stock market wealth, the growth in private consumption will eventually need to converge toward the growth in personal incomes, assuming that the stock market stabilizes. U.S. corporations can also be expected to reduce the pace of spending on capital goods as growth prospects diminish. And the bond market again seems to be serving to help stabilize demand: long-term interest rates have risen by about a full percentage point from their trough of last October, as growth has continued to exceed expectations. Given the absence of inflationary pressures that might lead to a tightening of financial conditions, however, it seems quite likely that the slowdown in demand will be gradual and moderate: in short, a soft landing is possible.

However, a harder landing cannot be ruled out given the danger of inflationary pressure and the signs of other, potentially unsustainable, imbalances in the economy. Some of the forces that have helped to keep inflation low, including the declines in oil and other commodity prices since 1996, seem likely at least to lose momentum in the period ahead and may well, like the appreciation of the dollar up to mid-1998, begin to be reversed. Moreover, with resource utilization high, unless growth slows to potential or lower, domestic inflationary pressures seem bound to surface. If inflation prospects did deteriorate, the tightening of monetary policy that would be needed, together with the reaction of the bond market, might trigger a sharp correction in the stock market—a possibility that seems all the more conceivable given the high level of equity prices in relation to current and prospective corporate earnings and historical experience.[2] Such a correction could slow domestic demand quite abruptly, especially taking into account the deterioration in the private sector's saving/investment position that has accompanied the strong expansion: this is unprecedented in recent history and is unlikely to be sustainable (see Chapter II, the section "What Are the Implications of the U.S. Saving-Investment Imbalance?"). Furthermore, the willingness of foreign investors to continue financing the rapidly growing external deficit of the United States at current interest rates may not continue, in which case downward pressure on the dollar might be another cause of higher interest rates. All these factors could give rise to larger and more abrupt adjustments in private sector behavior, and a more abrupt economic slowdown, than envisaged in the baseline.

The possibility of a hard landing poses a considerable challenge for U.S. policymakers and indeed for the rest of the world. As far as U.S. monetary policy is concerned, the Federal Reserve Board appropriately eased monetary conditions significantly during September–November in response to the financial turbulence. Subsequently, with the risks having become more evenly balanced, monetary policy has remained on hold. Looking forward, if growth moderates by more than is projected, monetary conditions may need to be eased further, though not so much as to preempt the slowdown; the goal should be to help ensure a soft landing. If growth does not moderate sufficiently, the Federal Reserve may well need to tighten monetary policy initially. The slowdown in the rest of the world economy may appear to make such a move undesirable, but allowing the imbalances in the U.S. economy to continue building would carry much larger risks for both the domestic economy and the rest of the world.

For fiscal policy, the challenge will be to resist political pressures to "spend" the budget surplus that has resulted from earlier consolidation efforts and the strength of economic activity. (In cyclically adjusted terms, the budget surplus is estimated to be only about ½ of 1 percent of GDP in 1998–99.) A large tax cut, for

[2]See "What Is the Implied Future Earnings Growth Rate That Would Justify Current Equity Prices in the United States?" Box 3.2, *World Economic Outlook and International Capital Markets: Interim Assessment,* December 1998, pp. 48–49.

example, might extend the expansion briefly, but it would also substantially increase the risk of overheating, of a further worsening of the external current account, and hence of a hard landing. Projected budget surpluses need to be maintained to meet longer-term financing needs—particularly those related to Social Security and Medicare—and will also create room for fiscal policy to be used temporarily for stabilization purposes if the need arises.

In contrast with the United States, growth in *Canada* slowed last year reflecting the fallout from developments in Asia and world financial markets, particularly on commodity markets. The Canadian economy seems poised to resume faster growth in late 1999 and 2000, but further instability in global financial markets or weakness in commodity prices, or a sharper than projected slowdown in the U.S. economy, could diminish near-term growth prospects significantly. If the outlook for the economy were to worsen, the benign outlook for inflation, which enabled the Bank of Canada to lower official interest rates by a further 25 basis points at the end of March, indicates that there would be additional scope to ease monetary policy.

Europe: A New Currency and Other Challenges

The goal of European Economic and Monetary Union (EMU) was accomplished successfully at the beginning of the year with the start of Stage 3 of the unification process: 11 member countries adopted the euro, and the European System of Central Banks (ESCB) assumed responsibility for monetary policy in the euro area. The smooth introduction of the euro was due not only to the careful technical preparations that had been made, including through collaboration between the public and private sectors, but also to the substantial convergence achieved by macroeconomic policies in the member countries since the early 1990s. The increasingly sure prospect of EMU during 1997–98 may well have helped to shield Europe from international financial turmoil.

Despite this auspicious start, the ESCB and the governments of the euro area continue to face formidable challenges in making EMU a success. Given the importance of the euro area in the world economy, this will be measured not only in terms of EMU's contribution to financial stability and sustainable growth in the area itself, but also in terms of the contribution of euro-area policies to the achievement of these objectives worldwide.

With regard to *monetary policy,* the European Central Bank (ECB) announced in December that its repo rate would initially be 3 percent, more than ½ of 1 percentage point lower than the average of policy rates in the area in mid-1998. The easing implied by this setting of rates was welcome in view of the absence of inflationary pressures in the area as a whole and the downside risks to growth. And since late last year it has become clear that growth in the area has slowed, owing mainly to the weakening external environment but also to decelerating domestic demand, linked in part to markedly weaker business confidence (Figure 1.4). Monetary conditions, broadly defined, have been eased by the depreciation of the euro, attributable in part to the weakening of growth. But with inflation in the area having recently been below the middle of the target range,[3] and short-term growth prospects remaining weak, the ECB appropriately lowered the repo rate by an additional 50 basis points in early April, to 2½ percent. The staff's projection for growth in the area in 1999 has been revised down since December to 2 percent, below its potential rate, indicating some risk that the downward trend in unemployment since mid-1997 may soon be arrested. And although the projections point to a pickup of growth to almost 3 percent in 2000, the downside risks remain significant, notwithstanding the larger-than-expected recent cut in interest rates.

The cyclical responsiveness of monetary policy contrasts with the very limited room for maneuver in the *fiscal policies* of the euro area's member countries. In spite of the substantial consolidation efforts in the period up to 1997—the test year for the Maastricht convergence process—structural fiscal positions in most euro-area countries still fall short of medium-term requirements. Further progress in meeting these requirements since 1997 has been slow, and budget plans promise little acceleration in the near term. The projected slowing of growth in 1999 will tend to cause some widening of actual deficits this year in some cases unless measures are taken to offset the working of automatic stabilizers. The extent to which deficits should be allowed to increase beyond their budgeted levels varies among countries, depending on how close current budget imbalances and debt levels are to the reference values of 3 percent and 60 percent of GDP, respectively. In several countries, including *Germany, France,* and *Italy,* full operation of the stabilizers could lead to the deficit limit being breached in 2000 if the projected economic recovery does not materialize. However, significant procyclical budget tightening, especially through further hikes in already excessive levels of taxation, would not be desirable either. In these cases, efforts to contain cyclical pres-

[3]The stated primary objective of monetary policy in the euro area is the maintenance of price stability over the medium term, where price stability is defined as an annual increase of prices (as measured by the Harmonized Index of Consumer Prices, HICP) below 2 percent. The ECB has confirmed that negative inflation would be inconsistent with this objective, and it has indicated, further, that because of upward bias in changes in the HICP, the floor of the range is above zero, although it has not been specified. In recent months, HICP inflation has been stable at 0.8 percent.

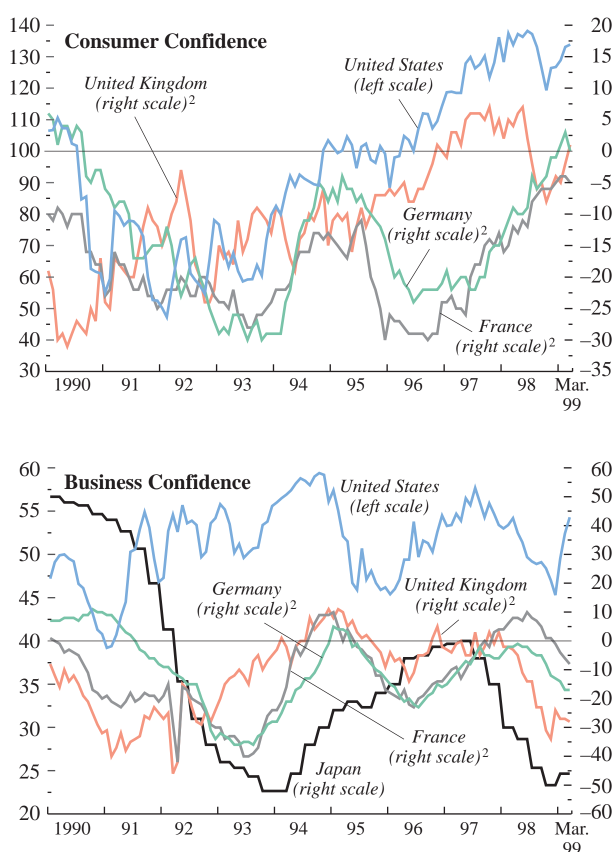
sures on deficits should focus primarily on utilizing contingencies built into budgets and cutting unproductive expenditures. In those countries experiencing strong growth and demand pressures that have been exacerbated by the convergence of interest rates under EMU—such as *Ireland, Portugal,* and *Spain*—strengthened fiscal consolidation efforts would help to damp inflationary pressures as well as serve medium-term fiscal objectives.

The risk of a renewed upturn in cyclical unemployment in much of the euro area in 1999 would be less worrisome if it were not for the large secular rise in European joblessness over the past quarter of a century. Chapter IV of this issue of the *World Economic Outlook* focuses on this major, chronic problem and especially on the *structural policies* needed to address it. In a number of cases—including the three largest member countries of the euro area—labor market reforms have yet to tackle the roots of structural unemployment. And some recent measures that purportedly address the problem—such as legislated reductions in working hours—may at best have little effect but could actually make it worse. A major part of the solution lies in measures to increase the flexibility of labor markets. With the absence of exchange rate adjustment within the euro area, EMU certainly makes such efforts more urgent. What is less clear is whether EMU will provide sufficient incentive to governments, and to the other social partners, to ensure that such efforts are now effectively made, so that the potential benefits of the single currency can be fully harnessed and some of its major risks avoided. Structural reforms that improve the working of labor markets can help monetary policy to be supportive of growth by contributing to the moderation of wage pressures. But also, conversely, structural reforms need to be accompanied by supportive macroeconomic policies that both accommodate the potential growth rate of output and help to reduce the significant portion of unemployment that is cyclical.

Growth in the *United Kingdom,* having exceeded that in the prospective euro area in each of the preceding five years, slowed sharply to below potential during 1998 as a result of the tightening of both monetary conditions and fiscal policy since 1996 and the weakening of external demand. Overheating was thereby effectively forestalled. With inflation close to its target of 2½ percent and with continued weak growth in prospect, the Bank of England has appropriately lowered short-term interest rates since October from their 7½ percent peak to 5¼ percent, which in real terms is close to the average over recent cycles and probably broadly neutral in its influence on demand. Monetary conditions have also been eased by a moderate depreciation of sterling since early 1998. These developments, together with the broadly balanced structural fiscal position—which should allow automatic stabilizers to operate fully—and the relatively strong bal-

Figure 1.4. Selected European Countries, Japan, and the United States: Indicators of Consumer and Business Confidence[1]

Consumer confidence remains strong in France and Germany, but business confidence has weakened significantly, as it has in Japan and the United Kingdom.



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

[1]Indicators are not comparable across countries.

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

ance sheets of the private sector, should help the economic slowdown to be limited and of relatively short duration, with growth beginning to pick up late this year. There is room for further reductions in interest rates in the coming months if warranted by economic developments and the inflation outlook. Labor market conditions call for some caution: unemployment is still close to an 18-year low, and while the growth of labor earnings has weakened since mid-1998, the introduction in April of a national minimum wage is expected temporarily to exert some limited upward pressure on wages and prices.

In Sweden, Norway, and Denmark, monetary policy has been eased in recent months as the growth outlook has weakened. Inflation in *Sweden* remains the lowest in Europe—it has recently been negative on a 12-month basis, well below the 1 percent floor of the official target range—and in late March official interest rates were reduced below 3 percent. In *Norway,* an easing of downward pressure on the krone, following the significant tightening of monetary policy last year in the face of the weak oil market, has allowed official interest rates to be reduced by a full percentage point since the beginning of the year. Although interest rates in Norway are above those elsewhere in Europe, the room for additional easing will depend on prospective inflationary pressures, and particularly on the results of this year's wage round. In *Denmark,* monetary policy is dedicated to the stability of the krone against the euro, within the narrow (±2¼ percent) fluctuation bands agreed with the participants in EMU; given the differential still remaining over euro-area rates, there may be scope for additional easing. In *Greece,* the other participant in ERM2 (with ±15 percent fluctuation bands), inflation has declined appreciably in recent months, helped by indirect tax cuts and other measures, and market confidence in convergence with the euro area has strengthened. A tighter fiscal stance and the implementation of structural measures to address the root causes of inflationary pressures would help to consolidate these gains and allow further gradual monetary easing during 1999. In *Switzerland,* inflation is virtually zero, and interest rates are below euro-area level. Slowing growth, continued economic slack, and a shift to fiscal restraint call for monetary policy to remain accommodative, and the cut in interest rates in early April was appropriate.

In the transition economies of central and eastern Europe, the Brazilian crisis has had no sustained impact on financial markets, with market sentiment remaining quite strong in those countries most advanced in the transition process. *Hungary* and *Poland* have remained among the most successful. Both are estimated to have achieved growth of about 5 percent in 1998—in Poland's case this was the fifth successive year with growth at or above this rate—and only moderately slower growth is projected for 1999 on account of the slowdown of exports to western Europe and Russia. In both countries, annual inflation has recently been reduced to single digits, allowing interest rates to be lowered. Cautious fiscal management, steadfast monetary policy, and commitment to structural reforms have provided the key to successful economic performance in both cases. Current account deficits in excess of 4 percent of GDP partly reflect continued strong capital inflows, but they have recently widened as exports have slowed, contributing to weakness in both countries' exchange rates since the beginning of the year. The external imbalances point to a need for continued fiscal consolidation to reduce vulnerability to adverse shifts in sentiment. The *Czech Republic* remains in recession following the tightening of policies in 1997–98 that was needed to reduce fiscal and external imbalances. Rapid disinflation in recent months has allowed interest rates to be reduced, which has contributed to some weakening of the koruna. This interest rate decline should help to ease banking sector difficulties, but only a slow economic recovery is projected in 1999–2000.

Economic activity in the transition countries of southeastern Europe is expected to be negatively affected by the conflict in the *Federal Republic of Yugoslavia*. A strong influx of refugees is expected to impose a heavy burden on the economies of *Albania* and the *Former Yugoslav Republic of Macedonia,* and the latter will also face a loss of trade with Yugoslavia. Other neighboring countries, *Bulgaria* and *Romania* in particular, will be affected by the disruption of transportation links and by the increased caution among investors toward the region, while *Croatia,* especially, will suffer from the drop in tourism. The IMF and the World Bank, in cooperation with other international organizations and bilateral donors, are assessing the additional financing needs of the countries in the Balkan region.

The Baltic countries have been somewhat more badly affected by the Russian economic crisis. While they have experienced only limited financial market pressures—they have maintained their exchange rate pegs and retained access to international capital markets—the Russian crisis and its economic repercussions have tended to slow growth and to complicate the task of reducing the wide external imbalances in each of the three countries. In *Lithuania,* in particular, where official data show the current account deficit recently close to 12 percent of GDP, adjustments of the policy mix, including tighter fiscal policies, will be needed to promote adjustment. *Estonia,* by contrast, lowered its current account deficit significantly to about 9 percent of GDP in 1998 as the contraction in exports to Russia and other countries in transition was outweighed by the continued rise in exports to western markets and by the impact on imports of tighter macroeconomic policies.

Turkey also suffered significant contagion from the Russian crisis, reflecting its close trade links with

Russia and macroeconomic imbalances reflected in high inflation and large fiscal deficits. In recent months, its international reserves have stabilized, and foreign borrowing has tentatively resumed. But capital flight following the Russian crisis has left a legacy of tight liquidity and markedly slower growth. High real interest rates and large debt-refinancing requirements point to continuing vulnerability, even though some progress has been made in the past year in lowering inflation and strengthening the fiscal position. To reduce its vulnerability decisively and to strengthen its growth on a sustainable basis, Turkey needs to implement strong structural measures to put its public finances on a sound medium-term basis and to establish a monetary framework to cure its chronic inflation problem.