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Asset Prices and the Business Cycle

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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 January 25–February 22, 2000 except for the currencies participating in the European exchange rate mechanism II (ERM II), which are assumed to remain constant in nominal terms relative to the euro; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary polices in industrial countries, see Box 1.3); that the average price of oil will be $24.50 a barrel in 2000 and $19.80 a barrel in 2001, 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 6.8 percent in 2000 and 7.1 percent in 2001. 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 mid-March 2000.

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 the main text, shaded areas of figures and tables indicate IMF staff projections. In the Statistical Appendix, projections are shown in white.

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.

FURTHER INFORMATION AND DATA

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.

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 Tamim Bayoumi, Chief of the World Economic Studies Division.

Primary contributors to the current issue include Luis Catão, Mark De Broeck, John H. Green, Maitland MacFarlan, Peter Sturm, Cathy Wright, Francesco Caramazza, Barry Eichengreen, Luca Ricci, Ranil Salgado, and Torsten Sløk. Other contributors include Eduardo Borensztein, Paul Cashin, Martin Cerisola, Juan Pablo Cordoba, Paula De Masi, Luiz de Mello, Sanjeev Gupta, Benjamin Hunt, Charles Kramer, Douglas Laxton, Carles Pinerua, and Patricia Reynolds. The Fiscal Analysis Division of the Fiscal Affairs Department computed the structural budget and fiscal impulse measures. Mandy Hemmati, Bennett Sutton, Siddique Hossain, Toh Kuan, and Yutong Li provided research assistance. Gretchen Byrne, Nicholas Dopuch, Staffan Gorne, Olga Plagie, Di Rao, and Anthony G. Turner processed the data and managed the computer systems. Lisa Nugent, Patricia Medina, Jemille Tumang, and Marlene George were responsible for word processing. Jeff Hayden and Jacqueline Irving 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 22 and March 24, 2000. 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.

CHAPTER I PROSPECTS AND POLICY CHALLENGES

Global economic and financial conditions have improved dramatically during the past year. The effects of the recent financial crises may be felt for some time, but the emerging economies in Asia have for the most part staged a strong V-shaped recovery, and the transition countries and Latin America have begun to recover from the subsequent turbulence that particularly affected Russia and Brazil. The impressive expansion in the United States is now the longest on record and the outlook has also improved for Europe. The Japanese recovery, however, remains tentative and fragile.

The main themes developed in this issue of the World Economic Outlook *include:*

- *How to achieve a better balanced pattern of growth among the major currency areas and to avoid a disruptive adjustment process.*
- *The interaction between business cycles and asset prices, particularly in equity and property markets, and the associated challenges for monetary, fiscal, and regulatory policies.*
- *The persistence of high levels of poverty across many regions in the world and the need for a broader, more determined effort in the fight against poverty.*
- *Some of the most striking aspects of economic developments in the twentieth century, the lessons to be learned, and key challenges for the new century.*

Evidence of a strong rebound in the global economy has continued to accumulate in recent months and the momentum of recovery from the 1997–98 slowdown has proven much stronger than anticipated (Table 1.1). Global growth is now estimated to have reached 3.3 percent in 1999 compared with a projection of only 2.2 percent prepared at the end of 1998, at the height of financial market turbulence and the low point in the associated confidence crisis.[1] North America and the emerging market countries of Asia account for much of the stronger growth picture but other regions also contribute. In retrospect, the global downturn in the wake of the crises in Asia and other emerging market countries since 1997 now appears to have been relatively mild and brief (Figure 1.1). The world growth projection for 2000 has been raised as well, to around 4¼ percent. Moreover, the risks for the current year now appear to be mainly on the upside, given the continued strong forward momentum in the United States and the possibility that recovery in Europe might be more robust. Indeed, the experience from earlier global business cycle upturns is that they have often turned out to be stronger than anticipated. At the same time, however, considerable uncertainty remains about the sustainability of the expansion in some countries.

The remarkable turnaround from the weak and uncertain outlook that prevailed a year ago is testimony to the policies that have been pursued to address shocks that had the potential to lead to a global recession. The strength of the U.S. economy has played a major role, with subdued inflation allowing the Federal Reserve to maintain an accommodating monetary stance that has supported the exceptionally buoyant growth of domestic demand and promoted easy financial conditions worldwide. In Europe, the authorities have also pursued relatively easy monetary policies, while in Japan both fiscal and

[1]See *World Economic Outlook and International Capital Markets: Interim Assessment* (Washington: International Monetary Fund, December 1998).

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

(Annual percent change unless otherwise noted)

	1998	1999	Current Projections 2000	Current Projections 2001	Difference from October 1999 Projections[1] 1999	Difference from October 1999 Projections[1] 2000
World output	**2.5**	**3.3**	**4.2**	**3.9**	**0.4**	**0.8**
Advanced economies	2.4	3.1	3.6	3.0	0.3	0.9
Major industrial countries	2.5	2.8	3.3	2.7	0.2	0.9
United States	4.3	4.2	4.4	3.0	0.5	1.8
Japan	–2.5	0.3	0.9	1.8	–0.7	–0.6
Germany	2.2	1.5	2.8	3.3	0.1	0.3
France	3.4	2.7	3.5	3.1	0.2	0.5
Italy	1.5	1.4	2.7	2.8	0.2	0.3
United Kingdom	2.2	2.0	3.0	2.0	0.9	0.6
Canada	3.1	4.2	3.7	2.7	0.6	1.1
Other advanced economies	2.0	4.6	4.5	4.1	1.0	0.9
Memorandum						
Industrial countries	2.7	2.9	3.4	2.8	0.3	0.9
Euro area	2.8	2.3	3.2	3.2	0.2	0.4
Newly industrialized Asian economies	–2.3	7.7	6.6	6.1	2.5	1.5
Developing countries	3.2	3.8	5.4	5.3	0.3	0.7
Africa	3.1	2.3	4.4	4.5	–0.4	–0.4
Asia	3.8	6.0	6.2	5.9	0.7	0.8
China	7.8	7.1	7.0	6.5	0.5	1.0
India	4.7	6.8	6.3	6.1	1.1	0.8
ASEAN-4[2]	–9.5	2.5	4.0	4.4	1.1	0.4
Middle East and Europe	2.7	0.7	4.6	4.0	–1.1	1.6
Western Hemisphere	2.1	0.1	4.0	4.7	0.2	0.1
Brazil	–0.1	0.5	4.0	4.5	1.5	—
Countries in transition	–0.7	2.4	2.6	3.0	1.8	–0.1
Central and eastern Europe	1.8	1.4	3.0	4.2	0.7	–0.2
Excluding Belarus and Ukraine	2.0	1.5	3.6	4.6	—	–0.3
Russia	–4.5	3.2	1.5	1.4	3.2	–0.5
Transcaucasus and central Asia	2.3	4.4	4.9	3.7	1.6	2.1
World trade volume (goods and services)	**4.2**	**4.6**	**7.9**	**7.2**	**0.9**	**1.7**
Imports						
Advanced economies	5.5	7.4	7.8	7.1	1.5	1.9
Developing countries	0.4	–0.3	9.8	8.5	–1.4	2.7
Countries in transition	2.9	–5.4	6.1	6.9	–3.0	–2.0
Exports						
Advanced economies	3.7	4.4	7.2	6.8	1.4	1.0
Developing countries	4.5	1.7	9.7	8.3	–0.6	4.2
Countries in transition	6.3	3.9	5.9	5.6	1.2	–1.4
Commodity prices						
Oil[3]						
In SDRs	–31.2	37.6	36.5	–19.4	1.0	26.0
In U.S. dollars	–32.1	38.7	35.1	–19.2	1.0	24.0
Nonfuel (average, based on world commodity export weights)						
In SDRs	–13.5	–7.7	6.0	2.9	1.5	2.1
In U.S. dollars	–14.7	–6.9	4.9	3.2	1.6	0.5
Consumer prices						
Advanced economies	1.5	1.4	1.9	2.0	—	0.1
Developing countries	10.1	6.5	5.7	4.7	–0.9	–0.3
Countries in transition	21.8	43.7	19.5	14.2	–9.2	–2.1
Six-month London interbank offered rate (LIBOR, percent)						
On U.S. dollar deposits	5.6	5.5	6.8	7.1	0.1	0.7
On Japanese yen deposits	0.7	0.2	0.2	0.4	—	—
On euro deposits	3.7	3.0	4.1	4.9	—	0.6

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during January 25–February 22, 2000.
[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 $18.14 in 1999; the assumed price is $24.50 in 2000 and $19.80 in 2001.

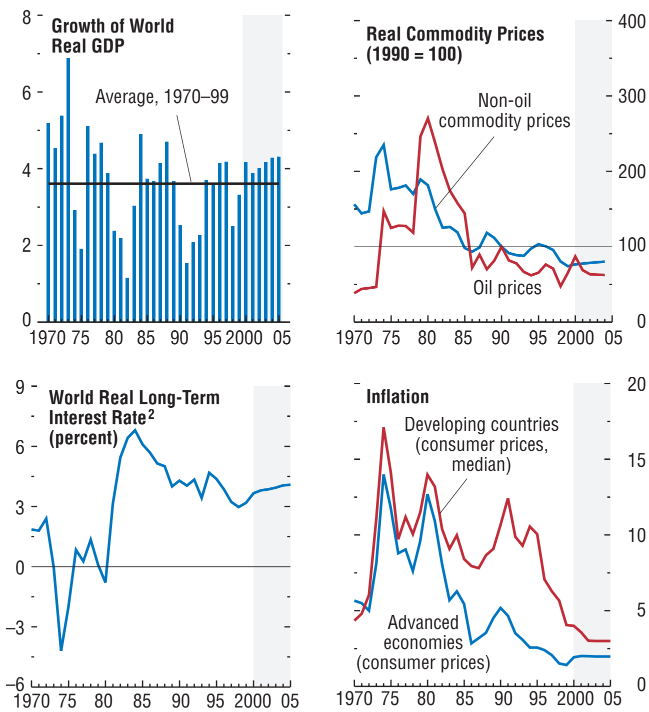
monetary policies have been helping to restart the economy after a severe recession in 1998.

Among the emerging market countries the turnaround is also testimony to the resolute actions by policymakers to deepen adjustment and reform efforts in response to the sharp curtailment of capital inflows in the wake of the recent crises. In Asia, the rapid return of confidence and recovery of activity demonstrate the efficacy of the stabilization strategies that have been pursued. There is no doubt that the region's growth potential remains very strong, provided the institutional and other shortcomings that contributed to the recent crises are adequately addressed through continued reforms. In Brazil, policy reforms have also served to lessen the severity of the downturn and to prepare the ground for recovery in the period ahead. Economic policies have helped to mitigate the effects of the crisis in Russia as well, although much more remains to be done to secure a lasting recovery.

The recovery in global activity has been accompanied by a more than doubling of oil prices since early 1999, mainly due to production curbs by the Organization of the Petroleum Exporting Countries (OPEC) and several other oil producers. To a large extent, the rise in oil prices represents a recovery from exceptionally weak prices in early 1999, and this recovery has brought prices back closer to a long-term equilibrium. With oil having become a less important factor in the world economy since the 1970s, the consequences of the recent price increase for oil importing countries are smaller than they would have been in the past. In addition, the price rise is contributing to significant improvements in external balances and fiscal positions of oil exporters, including Russia, many countries in the Middle East, and some African countries (as discussed later in this chapter), although net global demand will still fall somewhat as oil importers reduce demand more than oil exporters raise it. The production increases agreed by OPEC in March 2000 will probably stabilize oil prices. However, in the relatively unlikely case that prices continue to increase, the benign effects

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

The world economy has continued to strengthen following the relatively mild slowdown in the wake of the emerging market crises.



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

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

on global activity to date could turn more worrisome.

The main concern about the outlook stems from a series of economic and financial imbalances that have been building for several years, including:

- The lopsided pattern of growth among the principal currency areas and the resulting increase in external imbalances, with the U.S. current account in record deficit and persistently large surpluses in Japan and, to a lesser extent, in the euro area (Table 1.2). These imbalances appear unlikely to be sustainable, based on recent and past experience. On a smaller absolute scale, large external deficits also persist in Australia, New Zealand, most of Latin America, and among some countries in transition.
- The seemingly significant misalignments of several key currencies relative to what would be consistent with medium-term fundamentals, notably the strength of the dollar relative to the euro. Such deviations can be explained in part by large capital inflows into rapidly growing economies, and therefore appear justified on cyclical grounds. Nevertheless, combined with the large external imbalances mentioned earlier, there remains a risk of sudden changes in market sentiment, associated shifts in capital flows, and potentially disruptive realignments of exchange rates.
- The very high stock market valuations around the world. These may be justified in part by investors' favorable assessments of the impact of new technologies, but they may also reflect unrealistic expectations of future earnings growth that have been nourished by the now record-long expansion in the United States. Moreover, there are reasons to suspect that the relatively ample growth in global liquidity in recent years—warranted by the need to overcome the effects of financial crises in Asia, Russia, and Latin America, and more recently by concerns related to potential Y2K computer problems—has helped fuel demand for fi-

Table 1.2. Selected Economies: Current Account Positions
(Percent of GDP)

	1998	1999	2000	2001
Advanced economies				
United States	–2.5	–3.7	–4.3	–4.4
Japan	3.2	2.5	2.2	2.3
Germany	–0.2	–0.8	0.2	0.7
France	2.7	2.8	2.6	3.1
Italy	1.8	0.9	0.9	1.1
United Kingdom	–0.1	–1.4	–1.5	–2.0
Canada	–1.8	–0.5	–0.4	0.1
Australia	–5.0	–5.7	–5.1	–4.9
Austria	–2.2	–2.3	–1.9	–1.0
Finland	5.7	5.0	5.4	5.7
Greece	–1.9	–1.3	–1.6	–1.8
Hong Kong SAR[1]	0.8	4.8	4.1	4.2
Ireland	0.9	0.6	–0.4	–0.9
Israel	–0.9	–1.6	–1.2	–1.8
Korea	12.7	6.1	3.0	2.2
New Zealand	–5.1	–7.3	–6.2	–5.2
Norway	–1.5	4.2	7.0	7.5
Singapore	25.4	25.3	23.4	22.0
Spain	–0.2	–2.1	–2.0	–1.7
Sweden	2.9	2.6	2.4	2.2
Switzerland	9.1	12.9	10.0	9.9
Taiwan Province of China	1.3	2.5	2.1	2.3
Memorandum				
Euro area	1.3	0.7	1.0	1.4
Developing countries				
Algeria	–1.9	0.0	10.8	5.6
Argentina	–4.9	–4.3	–4.5	–4.7
Brazil	–4.3	–4.1	–3.5	–2.5
Cameroon	–2.7	–4.3	–2.8	–2.1
Chile	–5.7	–0.1	–2.2	–3.2
China	3.4	1.6	1.6	1.5
Côte d'Ivoire	–4.5	–5.0	–5.9	–4.5
Egypt	–3.4	–3.2	–3.1	–2.9
India	–1.7	–1.2	–1.3	–1.4
Indonesia	4.2	3.6	1.9	0.5
Malaysia	12.9	18.4	13.3	10.4
Mexico	–3.7	–2.9	–3.1	–3.2
Nigeria	–9.1	–10.8	–1.9	–6.7
Pakistan	–2.7	–2.6	–2.5	–2.3
Philippines	2.0	9.1	8.2	8.1
Saudi Arabia	–10.2	–2.8	5.5	–2.4
South Africa	–1.6	–0.4	–1.3	–1.5
Thailand	12.7	9.1	5.8	5.3
Turkey	0.9	–0.5	–1.9	–1.7
Uganda	–2.2	–4.1	–3.1	–2.8
Countries in transition				
Czech Republic	–1.9	–1.0	–1.5	–1.8
Estonia	–9.2	–4.1	–5.5	–6.0
Hungary	–4.9	–4.4	–4.5	–4.3
Latvia	–9.5	–8.7	–7.7	–7.4
Lithuania	–12.1	–10.9	–9.2	–8.4
Poland	–4.4	–7.6	–6.9	–6.6
Russia	0.9	10.8	9.1	4.7
Slovak Republic	–10.4	–4.9	–3.0	–2.8
Ukraine	–3.1	–1.1	–2.9	–2.6

[1]Data include only goods and nonfactor services.

nancial assets in many countries. Property prices have also been rising sharply in some economies. Experience shows that such asset price inflation can be particularly destabilizing because it may encourage households and businesses to over-consume and over-invest, and because of the danger that the financial system may become vulnerable to an eventual downward correction in asset prices.

These imbalances have been present for some time, and concerns about how they might unwind have been discussed repeatedly in recent issues of the *World Economic Outlook*. These assessments have cautioned that the continued strength of domestic demand in the United States, while playing a critical role in alleviating the adverse effects of the recent crises in emerging markets, did not seem sustainable. It might be tempting to conclude that since the perceived imbalances have not given rise to any obvious difficulties so far, they may not be a problem after all. Such a view has more than a few adherants, and could be correct, but if it is wrong such complacency could have severe consequences. The potentially disruptive effects could become much more serious if the imbalances were allowed to increase further while, at the same time, the chances of a benign outcome would probably diminish. As the alternative "harder" landing scenario reported in Box 1.1 illustrates, continued strong growth in the United States in 2000 could lead to higher inflationary expectations and interest rates, lower earnings expectations, and severe corrections in the stock market and the exchange rate. The attendant fall in domestic demand could well lead to a mild recession in 2001 in the United States and more limited output losses in the rest of the world.

It is therefore becoming a matter of urgency to secure a smooth transition to a more sustainable pattern of global growth, as in the current forecast. The priorities in this regard are to contain excess demand pressures in the United States, including the avoidance of a significant relaxation in the fiscal stance, and to promote robust and durable economic expansions in Japan and Europe. Part of the policy challenge needs to be met through asymmetric adjustments of monetary stances. Global financial conditions will naturally tend to tighten with the pickup in growth, and in the short term the bulk of the monetary firming should probably occur in the United States. In contrast, the euro area has more room to maintain relatively easy monetary policies until the recovery is on a sufficiently strong footing. Such a policy stance would foster the absorption of existing slack and help to offset any slowdown in the United States and the effects of the potential realignment of exchange rates that may accompany a slowdown. Similar arguments apply to Japan; indeed, the fragile nature of the recovery and recurrent upward pressure on the yen underscore the need to explore the scope for further monetary easing. Greater progress on structural reforms also remains critical to sustaining and strengthening growth over the medium term in Japan and Europe.

Two data-related issues may have an important bearing on assessments of global economic conditions and prospects. First, the widening global current account discrepancy (see Table 27 in the Statistical Appendix) raises the possibility that export growth may be underestimated, implying a further upside risk to the near-term projections for world growth. Second, recent revisions in national accounts methodologies in the United States, Europe, and elsewhere have had an important impact on the estimated level and growth of GDP, on reported personal saving rates in the United States, and on other economic aggregates (Box 1.2). Particular care is needed with the interpretation and use of national accounts data while the full range of revisions is being phased in.

How Much Longer Will the Expansion in North America Continue?

The U.S. economy continues to expand rapidly. After a brief slowing in the second quarter of 1999, annualized real GDP growth bounced

Box 1.1. An Alternative Scenario

The baseline projections in the *World Economic Outlook* represent a relatively benign scenario with a moderation of growth in the United States to sustainable rates (i.e., a “soft landing”) and sustained recoveries in Japan, Europe, and the emerging market countries. This is an entirely plausible projection, especially in view of the subdued rates of inflation in most economies, but judging the likelihood of this scenario is difficult. Indeed, the margin of error, even for a forecast horizon as short as one year, is very large—typically plus or minus 1 percentage point for individual country forecasts and almost as large for the aggregate of the industrial countries.[1] Experience also shows that growth is much more cyclical in reality than forecasters usually are prepared to project, with upturns often surprising on the upside and downturns on the downside. And finally, it is the shared experience of all forecasters that turning points are notoriously difficult to anticipate. For example, many forecasters, including IMF staff, expected 1999 to mark the trough in the global slowdown of the late 1990s; in reality, 1999 became the first year of recovery.

In considering the risks to the outlook for the next several years, there is a distinct possibility that the global upturn now under way may turn out to be stronger than expected. Moreover, a stronger upturn in 2000 might well give rise to sufficient additional pressures on actual and expected inflation that monetary authorities will need (or be expected) to raise interest rates. Higher actual or expected inflation, tighter monetary policy, and the attendant reconsideration of future prospects for growth and earnings could significantly change currently buoyant investor sentiment regarding equities and the dollar. If investors’ expectations of future returns on equities are revised down while the returns on available substitutes rise, the resulting exodus of funds could trigger a notable correction of equity markets and realignment of exchange rates, leading to a more general erosion of confidence. This would be felt mostly in the United States, where the stock market has helped to sustain exceptionally rapid growth in domestic demand in recent years. However, other countries would probably experience at least a partial correction in their stock prices (this is suggested by the correlations between stock markets analyzed in Chapter III) as well as spillovers through trade and confidence.

The scenario results shown in the table assume that world growth in 2000 would be somewhat stronger than expected in the baseline. This would eventually (some time in the second half of 2000) generate an increase in inflation expectations, a downscaling of earnings expectations, a marked (25 percent) correction in U.S. equity prices, and a depreciation of the U.S. dollar (assumed at almost 20 percent) in response to a reversal of capital inflows. The large negative impact on U.S. domestic demand implied by these assumptions would be partially offset by an improvement in the foreign balance but would still bring U.S. growth almost to a halt in 2001. Because the U.S. financial system remains well capitalized and unlikely to be seriously impaired by a cyclical correction of the magnitude assumed here, the slowdown would be likely to be of relatively short duration (the scenario does not assume any specific countercyclical fiscal action, although automatic stabilizers and normal monetary rules are assumed to operate).

Other countries would be less affected, mainly because the stock market correction in Europe and Japan would be likely to be smaller and have much less impact on domestic demand. Easier monetary conditions would provide support for domestic output, and lead to relatively buoyant domestic demand. Nevertheless, in view of the fragility of the recovery under way in Japan and the limited room for further macroeconomic stimulus, this country would be particularly vul-

[1]Forecast errors of this magnitude are also typical among private sector forecasters. See Michael Artis, “How Accurate Are the IMF’s Short-Term Forecasts? Another Examination of the World Economic Outlook,” *Staff Studies for the World Economic Outlook* (Washington: International Monetary Fund, December 1997).

"Harder Landing" Scenario
(Percent deviation from baseline levels unless otherwise noted)

	2000	2001	2002	2003	2004
World					
Real GDP	0.7	–0.9	–0.7	–0.5	–0.2
United States					
Real GDP	0.5	–2.0	–1.9	–1.3	–0.6
Domestic demand	0.6	–3.7	–4.2	–3.8	–3.0
Net private saving (percent of GDP)	–0.3	1.6	2.2	2.1	1.8
Current account (billions of U.S. dollars)	–5.7	33.9	111.6	160.4	201.9
CPI inflation	0.3	0.8	–0.7	–0.6	–0.2
Short-term interest rate	1.0	0.9	0.1	–0.9	–1.7
Nominal effective exchange rate	1.1	–17.5	–15.3	–13.0	–10.0
Euro area					
Real GDP	0.8	–0.7	–0.3	–0.3	–0.1
Domestic demand	0.7	1.0	1.3	1.3	1.3
Net private saving (percent of GDP)	–0.3	–0.1	–0.6	–1.0	–1.3
Current account (billions of U.S. dollars)	1.1	23.7	3.8	–23.2	–50.9
CPI inflation	0.2	–0.7	–0.5	–0.6	–0.6
Short-term interest rate	0.2	–0.6	–1.1	–1.4	–1.5
Nominal effective exchange rate	–0.3	12.0	10.4	8.5	6.6
Japan					
Real GDP	0.6	–0.6	–0.6	–0.4	0.0
Domestic demand	0.4	0.5	1.0	1.4	1.6
Net private saving (percent of GDP)	–0.1	–0.1	–0.7	–1.3	–1.8
Current account (billions of U.S. dollars)	4.6	23.3	–19.3	–51.2	–73.6
CPI inflation	0.1	–1.1	–0.5	–0.5	–0.5
Short-term interest rate	0.1	–0.3	–0.6	–1.2	–1.3
Nominal effective exchange rate	–0.9	18.9	16.0	12.8	9.6
Developing countries					
Real GDP	0.8	–0.4	–0.4	–0.4	–0.3
Memorandum: Baseline Growth in Real GDP					
World	4.2	3.9	4.0	4.2	4.3
United States	4.4	3.0	3.0	3.0	3.0
Euro area	3.2	3.2	3.0	2.7	2.5
Japan	0.9	1.8	2.4	2.5	2.4
Developing countries	5.4	5.3	5.4	5.9	6.2

nerable to a marked slowdown in the United States and to a further appreciation of the yen.

The emerging market countries would also be adversely affected, but only temporarily. Latin America would appear to be the most vulnerable to a possible firming of global financial conditions and a significant slowdown in the United States, although a depreciation of the U.S. dollar would provide some relief for those countries that peg their exchange rate to the dollar.

back to a remarkable 5¾ percent in the third quarter and over 7 percent in the fourth. While some of this represented Y2K-related stock building, monthly indicators point to continued buoyancy in the opening quarter of 2000. Private domestic demand continues to drive growth, with consumer confidence remaining strong and business investment still increasing rapidly. The growth in housing activity has leveled off somewhat, partly in response to higher interest rates, but remains at a very high level. In 1999 as a whole, real GDP rose by 4.2 percent and real do-

Box 1.2. Revisions in National Accounts Methodologies

Statistical agencies in most Organization for Economic Cooperation and Development (OECD) countries and elsewhere are in the process of introducing comprehensive revisions to their national accounts, based on a number of significant changes in definitions, classifications, data sources, and statistical procedures as suggested in the 1993 System of National Accounts (SNA93).[1] In the European Union (EU), GDP data prepared under the new European System of Accounts (ESA95) have been available for most countries since around mid-1999; in the United States, initial results of the latest benchmark revision of the National Income and Product Accounts (NIPA) were released in October 1999.[2] National accounts data prepared under SNA93 guidelines have also been available in Canada and Australia since the end of 1998, and are expected to become available in Japan later in 2000.The new methodologies, which have a substantial impact on some economic variables, will improve the quality and international comparability of national accounts data. As discussed below, however, particular care will be needed with the interpretation and use of these data while the revisions are being phased in.

Principal Changes

The main methodological changes are the following:

- *A broader concept of capital formation.* In particular, business and government purchases of computer software are now included as fixed capital formation, rather than production inputs or government consumption expenditures. Under ESA95, some military purchases that used to be classified as current expenditures are now included under capital formation, along with literary and artistic works and also mineral exploration (the last-mentioned was already included as investment in the NIPAs). Correspondingly, capital consumption allowances (depreciation) now reflect use of computer software and other new investments.
- *An improved treatment of services.* This includes more detailed coverage of the financial sector. In the United States, for example, there are better measures of bank services, including ATM transactions and electronic fund transfers; and the ESA95 revisions reflect the increasing role in the economy of insurance and pension funds.
- *Reclassification of some social expenditures.* The ESA95 revisions reclassify reimbursable health expenditures, and some other areas of social spending, from private to government consumption.
- *Reclassification of U.S. government employee retirement plans.* Under the NIPA revisions, government contributions to these plans (covering federal, state, and local government employees) are now recorded under personal income rather than as government receipts (of contributions) and expenditures (of compensation). Similarly, interest and dividends paid to plans are included under personal income, while plan benefits are treated as transactions within the personal sector rather than as

[1]The guidelines of SNA93 were developed under a working group consisting of representatives of the OECD, IMF, the United Nations Statistical Division, the World Bank, and the Commission of the European Communities. The changes introduced under the 1995 European System of National Accounts are broadly consistent with SNA93, with more specific interpretation in some areas, and many of the SNA93 guidelines are also incorporated in the latest revisions to the National Income and Product Accounts in the United States.

[2]The European Central Bank's Monthly Bulletins of June, August, and December 1999 (available at: *www.ecb.int*), and the EU Commission's *European Economy,* Supplement A, Economic trends, *No.10/11 October/November 1999* (available at: *http://www.europa.eu.int/comm/economy_finance*), provide detailed reviews on the implications of the switchover to ESA95. In the United States, detailed information and data are available on the website of the Bureau of Economic Analysis (*www.bea.doc.gov*) and in the August, October, and December 1999 editions of the *Survey of Current Business* (Washington: Commerce Department). See also the OECD *Economic Outlook* 65/66, June/December (Paris: Organization for Economic Cooperation and Development, 1999).

transfer payments from government to recipients.

- *More widespread use of accruals principles*. Under ESA95, transactions involving interest payments, taxes, and other items are now recorded on an accruals basis rather than at the time of payment. For example, interest expenses are recorded as accruing continuously over time to the creditor, not when actual cash payments are made.
- *Wider use of chain-linked volume measures*. This allows the impact of relative price changes on volume growth to be reflected more quickly and accurately.

Impact on GDP and Saving Estimates

The new accounting methodologies have tended to raise the reported level of nominal GDP, but with varying effects on real growth. In the European Union as a whole, the transition to ESA95 increased the level of nominal GDP by around 2 percent in the base year (1995), but with quite wide variation from country to country.[3] Of the overall increase, 1½ percentage points came from the wider definition of fixed capital formation. The level of final consumption in the European Union increased by 1 percent, comprising a 7 percent decrease in private consumption and 32 percent rise in government consumption, and this explained slightly more than ½ of a percentage point of the rise in GDP. The revisions to real GDP lowered annual growth rates in the EU by 0.1 to 0.3 percentage points over the 1996–98 period (e.g., from 2.9 to 2.6 percent in 1998), without broadly changing the overall cyclical profile.

The revisions in the United States increased the level of nominal GDP by 2¼ percent on average over 1995–98, mainly because of the inclusion of computer software purchases as investment. The revisions have generally increased through time—for example, nominal GDP was revised up by 2.9 percent (amounting to a rise of almost $250 billion) in 1998. Reflecting this, together with adjustments in price deflators, real GDP growth has also been revised up in most years—by just over 0.4 percentage points on average in 1995–1998, including from 3.9 percent to 4.3 percent in 1998. As in Europe, however, the timing of cyclical peaks and troughs over the revision period (starting in 1959 in the United States) is unchanged. A striking result of the U.S. revisions has been the sizable increase in reported personal saving rates, due particularly to the reclassification of government employee retirement plans. While the long-standing downward trend in personal saving is maintained, the revisions have increased personal saving rates by 2 to 3 percentage points each year since the early 1980s, and from 0.5 percent to 3.7 percent in 1998. The national saving rate has been revised up a smaller amount—by 0.5 to 1.5 percentage points in most years since 1982, the largest increase (from 17.3 to 18.8 percent) coming in 1998.

Words of Caution

As noted, the national accounts revisions will significantly improve the quality of these data in terms of their measurement of key economic concepts and for purposes of international comparison. However, the many revisions to the various components of the national accounts are being phased in at different rates both within and across countries. During this interim period, therefore, more than the usual degree of caution will be required in interpreting data, deriving related concepts, and applying these results to policy development. For example, revised data for the main national aggregates contained in expenditure, household, and government accounts are now available for the United States and most euro area economies, but these revisions are not yet available for Japan and a number of smaller OECD countries. Even among the larger economies, revised capital stock data are not yet widely available, complicating the estimation of potential output and other derived se-

[3]This variation reflects not just the switch to ESA95, but also differences in the rate at which EU members have introduced other changes in sources and methods in recent years—with some introducing many of these changes at the same time as switching to ESA95.

Box 1.2 *(concluded)*

ries, and the program for the full set of revisions—including sectoral and regional breakdowns—stretches several years ahead. A further complication comes from the varying extent of revisions to historical data within and across countries, with many revised series available for only short time spans. For example, ESA95 data for several EU members (including Austria, Greece, the Netherlands, and Spain) are available only for 1995–1998, and for most other countries in the EU the revised series begin in the late 1980s or early 1990s. While data-splicing and other methods can be used to compile longer series, the results should be viewed as rough approximations. Hence, intertemporal comparisons and estimations requiring long runs of data must necessarily be carried out with caution.

mestic demand by 5.1 percent, continuing the pattern seen since 1996 of the growth of demand outstripping that of supply.

To date, the discrepancy between the growth of demand and supply has been mostly reflected in a sharp widening of the external deficit, rather than in inflationary pressures. Rapid growth in demand resulted in a record current account deficit of nearly $400 billion at an annualized rate in the last quarter of 1999, up over $150 billion from the equivalent figure in 1998. At 3.7 percent of GDP, the current account deficit for 1999 as a whole exceeded the previous record of 3.4 percent set in 1985 and 1986. The labor market has tightened further, with the rate of unemployment at about 4 percent, a level last seen in the 1960s, although exceptionally strong productivity gains and moderate wage growth have thus far contained upward pressures on unit labor costs. Rising energy prices have affected CPI inflation, which reached 3.2 percent in February 2000 compared with the year before, but the equivalent increase in the core rate of inflation (which excludes energy and fresh food) was 2.1 percent. It is unlikely, however, that inflationary pressures will continue to be contained in the face of growth above potential, higher oil prices, and strong signs of global recovery.

Even though inflationary pressures have remained quiescent thus far, the falling household saving ratio points to other internal imbalances. Buoyed by rising asset prices, the household saving rate has fallen by about 5 percent of disposable income since the early 1990s, the private investment ratio has increased by over 3 percent of GDP in this period, and private debt is at record levels. In spite of rising profits, private borrowing (defined as the difference between private investment and private saving as a ratio to GDP) is at a postwar record and is of a magnitude that has proved unsustainable in several other advanced countries over recent decades, where such borrowing was also accompanied by buoyant growth, relatively subdued inflation, and strong government finances (Figure 1.2). Private sector balance sheets have remained relatively robust, in a large part because they have been buttressed by rapid increases in asset price valuations, particularly in the stock market. However, a significant vulnerability for the economy is that a rapid reversal in asset prices could leave many borrowers in financial difficulties if asset values fall relative to debt servicing commitments.

The process by which this widening of internal and external imbalances will ultimately be reversed is one of the major uncertainties facing the world economy. Every effort needs to be made to ensure that this occurs in an orderly manner (the so-called "soft landing") rather than in an abrupt and discordant one (a "hard landing"). The forecast assumes that the economy slows fairly early in 2000, still producing year-on-year growth of 4.4 percent before settling at a relatively steady rate of growth of 3 percent subsequently (Table 1.3); that the current account stabilizes at close to its current value; and that there is no rapid stock market correction. Such an outcome would allow the necessary slowing of U.S. activity without seriously disrupting the recovery of world output.

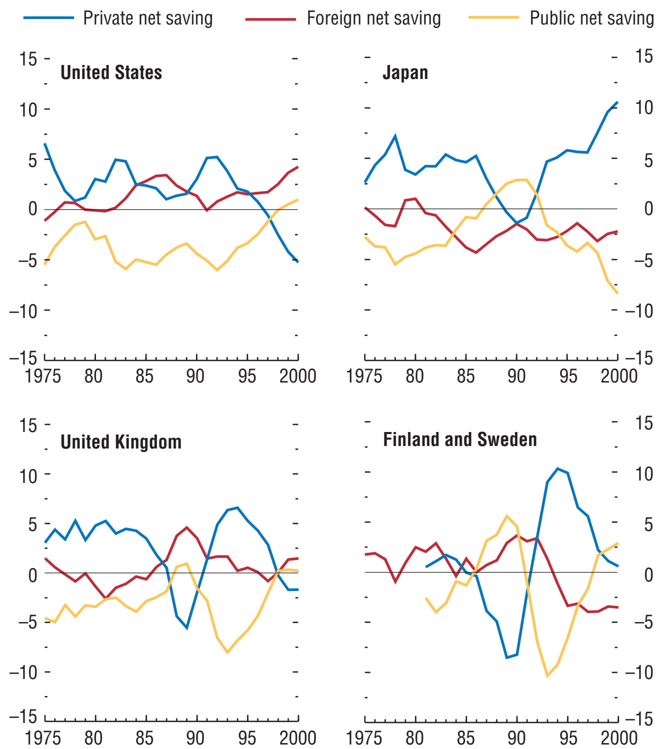
Prudent macroeconomic policies are an important element in ensuring the needed slowdown in activity. With the near-term balance of risks facing the U.S. economy still very much on the upside, the Federal Reserve's decision to raise rates by a further ¼ percentage point in February and again in mid-March was clearly warranted, even after three increases since June 1999 that fully reversed the easing that occurred in the wake of the Russian default and problems at Long-Term Capital Management, a highly leveraged hedge fund. Although the full effects on demand of the 1¼ percentage point rise in short-term interest rates and the rapid increase in oil prices since the summer have yet to be fully seen, there is little evidence of U.S. growth slowing of its own accord or of existing imbalances reversing. Even with considerable short-term volatility, continued high equity valuations and the large share of household wealth held directly or indirectly in equities may complicate the task of achieving the needed slowdown, as they work against the needed recovery in the household saving rate. Very high valuations, particularly in the technology and bio-tech sectors, continue to pose the risk of a large market correction and a sharper economic slowdown later.

The Federal Reserve probably needs to continue to move progressively but prudently to a tighter monetary stance. The money markets anticipate a rise in short-term interest rates of ½–¾ of a percentage point over the next six months, although the eventual extent of any tightening will depend upon changing economic considerations and is difficult to project. A more significant tightening of monetary conditions might well be needed to slow U.S. demand growth to a sustainable pace, avoid a rise in inflationary pressures, and minimize the risk of an abrupt market correction at a later stage and an associated rapid deceleration in growth.

On the fiscal side, it is important to resist proposals to substantially raise spending or cut taxes. Sustained robust growth and prudent fis-

Figure 1.2. Selected Countries: Net Financial Balances[1]
(Percent of GDP)

Private net saving in the United States has fallen to levels that have not been sustainable in other advanced economies in recent years.



[1]Data for 2000 are IMF staff projections. Public net saving is the general government current balance less government net investment, as defined in the national accounts. Foreign net saving is the current account balance, shown with opposite sign. Net private saving is the sum of public and foreign net saving, with opposite sign; it represents household disposable income less expenditure, plus after-tax corporate profits, less investment. The net saving of a sector is also known as its financial balance.

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

	Real GDP				Consumer Prices				Unemployment			
	1998	1999	2000	2001	1998	1999	2000	2001	1998	1999	2000	2001
Advanced economies	**2.4**	**3.1**	**3.6**	**3.0**	**1.5**	**1.4**	**1.9**	**2.0**	**6.7**	**6.4**	**6.0**	**5.8**
Major industrial countries	2.5	2.8	3.3	2.7	1.3	1.5	1.8	1.9	6.2	6.1	5.9	5.7
United States	4.3	4.2	4.4	3.0	1.6	2.2	2.5	2.5	4.5	4.2	4.2	4.2
Japan	–2.5	0.3	0.9	1.8	0.6	–0.3	0.1	0.9	4.1	4.7	4.7	4.6
Germany	2.2	1.5	2.8	3.3	0.6	0.7	1.2	1.3	9.4	9.0	8.6	8.1
France	3.4	2.7	3.5	3.1	0.7	0.6	1.3	1.1	11.7	11.0	10.2	9.8
Italy	1.5	1.4	2.7	2.8	1.7	1.7	2.2	1.6	11.8	11.4	11.0	10.4
United Kingdom[1]	2.2	2.0	3.0	2.0	2.7	2.3	2.0	2.4	4.7	4.4	4.3	4.5
Canada	3.1	4.2	3.7	2.7	1.0	1.7	2.1	2.0	8.3	7.6	6.7	6.6
Other advanced economies	2.0	4.6	4.5	4.1	2.4	1.3	2.3	2.4	8.1	7.3	6.3	6.0
Spain	4.0	3.7	3.7	3.4	1.8	2.2	2.3	2.2	18.8	15.9	14.4	13.2
Netherlands	3.7	3.5	3.8	3.4	2.0	2.0	2.3	3.5	4.1	3.2	2.3	2.0
Belgium	2.7	2.3	3.3	2.9	0.9	1.1	1.7	1.4	9.5	9.0	8.5	8.1
Sweden	3.0	3.8	3.9	3.2	–0.1	0.4	1.4	1.8	6.5	5.6	4.8	4.2
Austria	2.9	2.0	3.1	3.3	0.8	0.5	1.2	1.0	4.7	4.3	4.0	3.9
Denmark	2.7	1.3	1.7	2.1	1.8	2.5	2.3	2.0	6.4	5.6	5.8	6.1
Finland	5.0	3.6	4.1	3.5	1.3	1.3	2.4	2.5	11.4	10.3	9.0	8.2
Greece	3.7	3.5	3.6	3.1	4.5	2.3	2.4	2.7	10.9	10.5	10.2	10.1
Portugal	3.9	3.0	3.4	3.1	2.8	2.2	2.1	1.9	5.0	4.4	4.3	4.3
Ireland	8.9	8.4	7.4	7.2	2.4	1.6	3.5	3.0	7.4	5.6	4.8	4.8
Luxembourg	5.0	5.2	5.1	5.0	1.0	1.0	1.6	1.4	3.3	2.9	2.7	2.3
Switzerland	2.1	1.7	2.1	2.1	0.1	0.8	1.3	1.5	3.9	2.7	2.2	2.0
Norway	2.1	0.8	3.3	2.3	2.3	2.3	2.3	2.0	2.4	3.2	3.5	3.8
Israel	2.0	2.2	3.8	3.5	5.4	5.2	2.9	2.7	8.6	9.3	8.8	8.0
Iceland	5.1	5.6	4.7	3.5	1.7	3.5	3.2	3.0	3.0	1.7	1.7	1.5
Korea	–6.7	10.7	7.0	6.5	7.5	0.8	3.0	3.0	6.8	6.3	4.3	4.2
Australia[2]	5.1	4.4	3.9	3.5	0.9	1.5	4.4	3.2	8.0	7.2	6.7	6.6
Taiwan Province of China	4.7	5.5	6.2	6.0	1.7	0.2	1.8	2.1	2.7	2.9	2.6	2.3
Hong Kong SAR	–5.1	2.9	6.0	4.7	2.8	–4.0	–2.0	4.7	6.1	4.7	3.8	
Singapore	0.4	5.4	5.9	6.0	–0.3	0.4	1.3	1.7	3.2	3.5	2.9	2.5
New Zealand[2]	–0.3	3.0	3.9	3.4	1.6	1.3	2.3	2.0	7.5	6.9	6.6	6.4
Memorandum												
European Union	2.7	2.3	3.2	3.0	1.4	1.4	1.8	1.8	9.7	8.9	8.4	8.0
Euro area	2.8	2.3	3.2	3.2	1.2	1.2	1.7	1.6	10.9	10.1	9.4	8.9

[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.

cal management have contributed to the emergence of a small general government budget surplus in 1999 (Table 1.4). The administration's recent budget proposal for FY 2001 preserves a significant budget surplus for the near-term (Box 1.3). Maintaining such surpluses is necessary to avoid exacerbating existing risks of overheating and to assist monetary policy in achieving the needed slowing of activity in a smooth fashion—indeed, somewhat larger surpluses would in principle be helpful in both respects. There is also a structural reason for running significant budget surpluses at this point in time, since such surpluses are needed to help prepare the government's accounts for the rising tide of unfunded liabilities associated with the aging population. In the event of a sharper slowdown in activity than is currently anticipated, there would then be scope for a temporary fiscal expansion for countercyclical purposes.

In *Canada*, the long period of expansion that began in 1992 has also continued and activity picked up further strength in 1999. Real GDP growth accelerated to a 4.7 percent annual rate in the second half of 1999, and averaged 4.2 percent for the year as a whole. Output growth is projected to remain strong, at around 3.7 percent, in 2000. The recent strengthening in activ-

Table 1.4. Major Industrial Countries: General Government Fiscal Balances and Debt[1]
(Percent of GDP)

	1983–93	1994	1995	1996	1997	1998	1999	2000	2001	2005
Major industrial countries										
Actual balance	–3.8	–4.2	–4.1	–3.4	–1.9	–1.3	–1.2	–1.1	–0.6	0.6
Output gap	–0.9	–2.2	–2.3	–1.8	–1.4	–1.5	–1.3	–0.5	–0.3	—
Structural balance	–3.3	–3.1	–3.1	–2.6	–1.3	–0.6	–0.6	–0.8	–0.5	0.5
United States										
Actual balance	–4.9	–3.8	–3.3	–2.4	–1.2	–0.1	0.5	1.0	1.2	1.9
Output gap	–1.6	–2.7	–3.2	–2.8	–1.8	–0.7	0.3	1.3	1.0	–0.1
Structural balance	–4.3	–2.8	–2.2	–1.5	–0.6	0.1	0.3	0.5	0.8	1.8
Net debt	46.0	60.1	59.6	59.2	57.3	54.0	50.6	46.6	43.1	29.8
Gross debt	60.1	72.8	72.9	72.8	70.6	67.2	62.4	57.4	53.1	36.8
Japan										
Actual balance	0.1	–2.3	–3.6	–4.2	–3.4	–4.3	–7.1	–8.4	–6.7	–2.0
Output gap	0.3	–1.6	–1.7	1.3	0.9	–3.4	–4.5	–4.6	–4.0	–0.1
Structural balance	0.3	–1.8	–3.1	–4.7	–3.7	–3.1	–5.4	–6.6	–5.2	–2.0
Net debt	18.2	7.7	13.0	16.4	17.9	30.4	37.7	46.1	51.6	60.7
Gross debt	69.0	82.2	89.7	94.4	99.2	114.0	125.1	136.1	141.5	147.6
Memorandum										
Actual balance excluding social security	–3.0	–5.1	–6.5	–6.8	–5.9	–6.4	–9.0	–9.6	–7.6	–3.2
Structural balance excluding social security	–3.1	–4.8	–6.1	–7.2	–6.1	–5.6	–7.8	–8.4	–6.7	–3.2
Germany[2]										
Actual balance	–2.0	–2.5	–3.2	–3.4	–2.6	–1.7	–1.1	–0.7	–1.0	–0.4
Output gap	–1.3	—	–0.3	–1.6	–2.2	–2.2	–2.8	–2.1	–1.0	—
Structural balance	–1.6	–2.3	–2.9	–2.3	–1.1	–0.3	0.6	0.5	–0.4	–0.4
Net debt	22.0	40.6	49.4	51.1	52.2	52.0	52.4	49.9	48.1	41.5
Gross debt	41.8	50.2	58.3	59.8	60.9	60.7	61.1	58.6	56.8	50.2
France										
Actual balance	–2.0	–5.5	–5.5	–4.2	–3.0	–2.7	–1.8	–1.5	–1.0	—
Output gap	0.3	–3.0	–2.7	–3.3	–3.1	–1.9	–1.6	–0.5	0.1	—
Structural balance	–2.0	–3.5	–3.7	–2.0	–1.0	–1.5	–0.8	–1.2	–1.0	—
Net debt	21.6	40.5	45.9	48.1	49.4	49.6	49.0	48.4	48.3	42.9
Gross debt	32.7	48.5	54.6	57.1	59.0	59.3	58.6	58.1	57.4	52.6
Italy										
Actual balance	–10.9	–9.1	–7.6	–7.1	–2.7	–2.8	–1.9	–1.5	–1.1	—
Output gap	0.1	–2.5	–1.1	–2.0	–2.3	–2.7	–3.3	–2.6	–1.9	–0.1
Structural balance	–10.9	–7.9	–7.0	–6.2	–1.6	–1.6	–0.5	–0.4	–0.3	0.1
Net debt	79.8	117.2	116.6	115.7	113.4	110.1	108.8	104.9	101.5	88.9
Gross debt	87.1	123.8	123.2	122.2	119.8	116.3	114.9	110.7	107.2	93.9
United Kingdom										
Actual balance	–2.4	–6.8	–5.8	–4.4	–2.0	0.2	0.3	0.2	0.2	–0.5
Output gap	–0.9	–1.9	–1.2	–0.8	0.4	0.5	0.1	0.7	0.5	—
Structural balance	–1.8	–4.7	–4.7	–3.7	–1.8	–0.1	0.1	—	–0.2	–0.5
Net debt	33.0	33.0	39.1	41.6	43.3	44.6	41.1	39.8	37.6	33.8
Gross debt	49.4	51.4	54.9	56.2	54.8	51.0	47.1	45.6	43.2	38.5
Canada										
Actual balance	–5.7	–5.6	–4.3	–1.8	0.8	0.9	2.8	2.3	2.0	1.7
Output gap	–1.9	–4.3	–4.0	–4.7	–3.2	–2.6	–0.9	0.4	0.6	0.4
Structural balance	–4.6	–2.9	–2.0	0.8	2.5	2.3	3.3	2.1	1.7	1.5
Net debt	38.2	68.7	70.2	69.8	65.5	62.3	56.7	51.3	47.0	32.8
Gross debt	70.4	99.4	102.2	101.8	97.7	95.8	88.1	80.9	75.4	56.7

Note: The budget projections are based on information available through March 2000. The specific assumptions for each country are set out in Box 1.3.

[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 balance 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 1987–93. Beginning in 1995, the debt and debt-service obligations of the Treuhandanstalt (and of various other agencies) were taken over by general government. This debt is equivalent to 8 percent of GDP, and the associated debt service to ½ to 1 percent of GDP.

Box 1.3. Economic Policy Assumptions Underlying the Projections for Selected Advanced Countries

The short-term fiscal policy assumptions used in the *World Economic Outlook* are based on officially announced budgets, adjusted for differences between national authorities and IMF staff regarding macroeconomic assumptions and projected fiscal outturns. The medium-term fiscal projections incorporate policy measures that are judged likely to be implemented. These projections and policy assumptions are generally based on information available through February 2000. In cases where the IMF staff have insufficient information to assess the authorities' budget intentions and prospects for policy implementation, an unchanged structural primary balance is assumed, unless otherwise indicated. Specific assumptions used in some of the advanced economies follow (see also Tables 14–16 in the Statistical Appendix for data on fiscal and structural balances).

United States. The fiscal projections are based on the Administration's FY 2001 Budget released in February 2000. The projections are adjusted for differences between the IMF staff's and the Administration's macroeconomic assumptions. State and local government fiscal balances are assumed to remain constant as a percent of GDP.

Japan. The projections take account of the FY 1999 supplementary budgets and the FY 2000 initial budget. The ¥18 trillion stimulus package announced in November 1999 includes additional public investment of ¥6.8 trillion (headline figure) through FY 2000, most of which would take place in the first two quarters of CY 2000. Local governments are projected to largely offset their share in the stimulus package with cuts in own-account expenditures elsewhere. A typical supplementary budget of ¥1 trillion, to cover routine budgetary overruns, is included in the calculations for FY 2000. The use of public funds to resolve problems in the banking sector is assumed to decline sharply in 2001, which is the main factor behind the improvement in the fiscal balance in that year.

Germany. The projections assume implementation of the government's fiscal consolidation and tax reform measures for the year 2000 and beyond, which were announced in June 1999 and approved by parliament in December 1999. The projections further incorporate the effects of the recently proposed income tax reform package for 2001–2005. The relevant draft legislation was approved by Cabinet in February 2000.

France. The staff's projections for France are in line with the authorities' official fiscal targets. For 2000, the projections incorporate tax cuts that will be included in the 2000 supplementary budget. For the medium term, the projections are broadly consistent with the government's Stability Program, adjusted for the better-than-expected 1999 outturn.

Italy. The fiscal projections are based on the authorities' estimates for 1999, on the 2000 budget approved in December by parliament, and on the medium-term fiscal plan covering the period 2000–2003 released in May 1999 and updated in September 1999. Official projections are adjusted for differences between the staff's and the authorities' macroeconomic assumptions. The fiscal measures included in the 2000 budget are assumed to be implemented fully, and to have the impact as indicated in the government's fiscal plan (the government's medium-term plan does not envisage, at this stage, additional measures for 2001 and beyond). However, the staff's revenue projections are somewhat more pessimistic than the authorities', as recent estimates on the 1999 outturn seem to indicate lower collection than anticipated at the time the official projections were developed; and the staff's expenditure projections include primary expenditure slippages that have emerged in 1999 but have not been accounted for in the official projections.

United Kingdom. The budget projections are based on the pre-budget report announced by the Chancellor in November 1999, adjusted for a slightly different assessment of potential output. The staff's estimates also include ongoing expenditure savings that the pre-budget report did not take into account for reasons of budgetary prudence. For revenues, the medium-term projections incorporate the effect of tax changes introduced in the current and previous budgets.

Canada. The fiscal outlook prepared by the staff assumes tax and expenditure policies in line with those outlined in the February 2000 budget, adjusted for the staff's economic projections. It is expected that the federal government will continue to target a balanced budget on an ex ante basis, with any unspent portion of the contingency reserve allocated to reducing federal government debt. On this basis, the staff assumes that the federal government budget will be in surplus by Can$3 billion a year (the full amount of the contingency reserve) over the medium-term. The consolidated fiscal position for the provinces is assumed to evolve in line with their stated medium-term targets.

Australia. The fiscal projections through FY 2003 are based on the *Mid-year Economic and Financial Outlook*, which was published by the Australian Treasury in November 1999. For the remainder of the projection period, the staff's projections incorporate announced future policy measures that are judged likely to be implemented.

Netherlands. In line with the authorities' fiscal framework, the staff's projections assume annual real expenditure growth of less than 1 percent for the period 2000–2002. For subsequent years, for which no framework has been established, annual real growth of 1.2 percent is assumed. Nominal expenditure is derived using the staff's projected deflator. The projections for revenues are based on the authorities' framework, including the effects of planned tax cuts in conjunction with a major tax reform package planned for 2001 but reflect the staff's real GDP growth projection, which is significantly higher than was assumed by the authorities. Beyond 2002, the projections assume a further gradual reduction of the revenue ratio of about 0.3 percent of GDP annually.

Portugal. The fiscal projections for 2000 are based on the staff's projections for the forthcoming budget. The exact components of the budget (revenues, expenditures, etc.) were not known at the time these projections were prepared, but the deficit target of 1.5 percent of GDP had been released. For 2001–2005, a constant structural primary balance is assumed.

Spain. The projections are in line with the authorities' official targets as expressed in their Stability Program. Projections for the outer years are consistent with the trends established in the Stability Program.

Sweden. The fiscal projections are based on the authorities' policies as presented in the 1999 fall budget bill. The authorities have the objective of achieving a fiscal surplus of 2 percent of GDP on average over the cycle. Since this objective has already been achieved, the staff assumes that the surplus will remain at about 2 percent of GDP through 2002, when the economy is projected to reach full employment.

Switzerland. The projections for 2000 are based on official budget plans adjusted for different macroeconomic assumptions. For 2001–2003, projections are in line with the official financial plan that incorporates announced fiscal measures to balance the Confederation's budget by 2001. Beyond 2003, the general government's 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 6.8 percent in 2000 (70 basis points more than projected in the October 1999 *World Economic Outlook*) and 7.1 percent in 2001. The

Box 1.3 *(concluded)*

projected path for U.S. dollar short-term interest rates reflects the assumption that the Federal Reserve will raise the target federal funds rate by around 60 basis points over the next six months, which is consistent with market expectations in early April. The rate on six-month Japanese yen deposits is assumed to average 0.2 percent in 2000, with the current accommodative policy stance being maintained, and 0.4 percent in 2001. The rate on six-month euro deposits is assumed to average 4.1 percent in 2000 and 4.9 percent in 2001. The projection for 2000 reflects a further 75 basis point rise in short-term rates by the end of the year, in line with market expectations. Changes in interest rate assumptions compared with the October 1999 *World Economic Outlook* are summarized in Table 1.1.

ity has been driven both by strong external demand—particularly from the United States and from the global pickup in demand for commodities—and by robust domestic sales.

Underpinning the economy's strong performance have been the sound macroeconomic and structural policies pursued through most of the past decade. The general government budget has been in surplus since 1997 and is projected to remain so, contributing to a rapid fall in the debt-to-GDP ratio; inflation is very low, expected to remain well within its target range of 1–3 percent; interest rates are currently below those in the United States; and unemployment has fallen to an 18-year low. Nevertheless, given the current and projected strength of activity, and uncertainty about how much slack remains in the economy and about the outlook for the United States, Canada may need to gradually introduce a moderately tighter monetary stance to contain inflation pressures. Ongoing fiscal restraint is also important, with surpluses used primarily for further debt reduction and for income tax reforms.

Reenergizing the Japanese Recovery

The recovery of the Japanese economy from recession remains halting. After falling through much of 1997 and 1998, real GDP rebounded in the first half of 1999, with private sector demand being buoyed by government spending. In the second half of the year this process went into reverse, however, with a decline in government investment being associated with a fall in private domestic spending. The economy contracted in the second half of the year at an annualized rate of almost 4 percent, as private consumption remained depressed by falling real earnings and uncertainty about employment prospects, although private business investment rebounded strongly in the fourth quarter. Recent indicators provide some positive signs, including improvements in corporate profitability and a pickup in industrial production and business confidence (Figure 1.3). Deflationary pressures have eased but have not completely dissipated, as shown by the sharp drop in the GDP deflator in the fourth quarter. Real growth was 0.3 percent in 1999 and is projected at 0.9 percent in 2000, partly reflecting the base effects of the sharp decline in output in the second half of 1999.

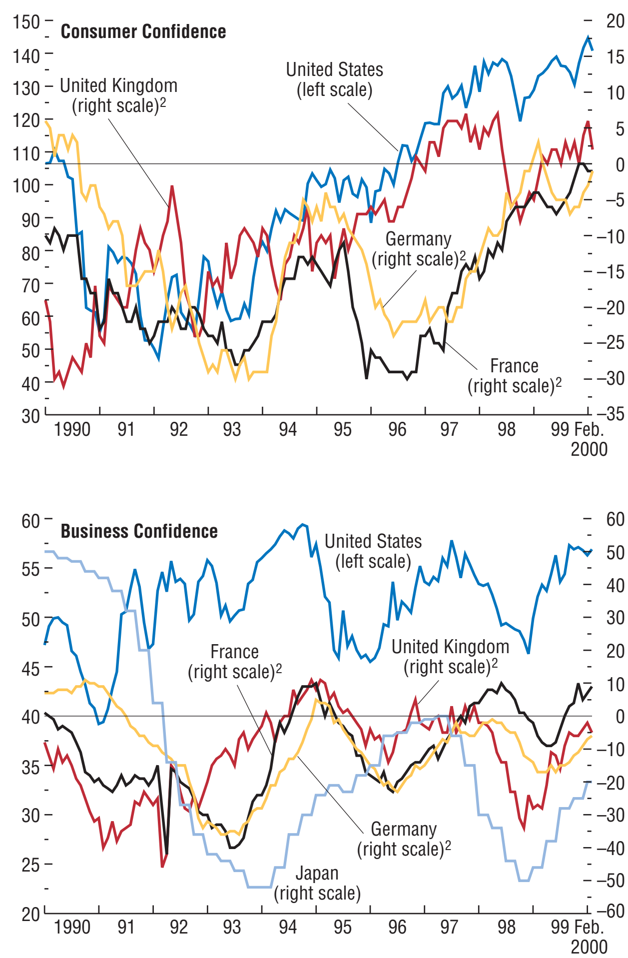
The chief macroeconomic goal remains a self-sustaining recovery, which in turn will provide a supportive environment for restructuring. The recent setback in activity underlines the continuing dependence of domestic demand on fiscal stimulus. Despite its depreciation since the beginning of the year, the yen has risen by over 10 percent in nominal effective terms between July 1999 and mid-March 2000, and this rise will tend to reduce external demand. In these circumstances, monetary and fiscal policies need to continue to be directed toward encouraging a lasting recovery in domestic demand. The FY 2000 budget, together with the November 1999 stimulus package, implies an almost unchanged fiscal stance on both a calendar and fiscal year basis although, to avoid a sharp drop in public investment beyond mid-year, a further supplementary budget is likely to be necessary. At the same time, with the government debt ratio continuing to spiral upwards, fiscal policy is rapidly reaching its limits. While current circumstances warrant an expansionary fiscal stance, the authorities need to begin designing reforms that will facilitate medium-term fiscal consolidation as economic conditions improve. High levels of government and private sector debt also underline the potential costs of significant price deflation.

Growing concerns about the fiscal situation, the need to prevent deflation, and the continued strength of the yen despite its recent fall (and its effect on overall monetary conditions) underline the need to keep monetary policy as accommodative as possible. The Bank of Japan is continuing to follow the "zero interest rate" policy, which has been in place since early 1999. With the recovery looking fragile, however, additional steps to ease liquidity seem appropriate to provide further support to activity.

The key to a lasting recovery remains structural reform. Without thorough financial and corporate restructuring, the dismal growth record of the 1990s is likely to continue into the new century. Bank restructuring, continues under the framework established in late 1998, and recently announced bank mergers, together with "Big Bang" reforms, may help catalyze a needed further reduction in capacity and improvement in core profitability. But more needs to be done to address remaining weaknesses, particularly with regard to smaller banks and the life insurance sector, and to avoid delays in the reform process—such as the recent decision to delay by a year the return to partial deposit insurance that had been planned for early 2001. Similarly, while corporate restructuring has begun in earnest, it still has a long way to go to address sizable excess capacity and excess debt burdens. It is particularly important for the authorities to provide a supportive environment for financial and corporate restructuring and to encourage

Figure 1.3. Selected European Countries, Japan, and the United States: Indicators of Consumer and Business Confidence[1]

Consumer confidence strengthened further in the latter part of 1999; business confidence remains strong in the United States, but it appears hesitant in other major industrial countries.



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.

labor mobility. Priorities include the early introduction of plans for consolidated corporate taxation and easily portable defined contribution pension schemes, and comprehensive reform of the social security system and the Fiscal Investment and Loan Program. Wide-ranging regulatory reform is also needed to increase competition and reduce market distortions, and little progress has been made recently in other important areas such as land use reform, particularly with regard to agricultural land.

Recovery and Divergence in Europe

Recent data suggest that the projected recovery in the euro area is on track. Real GDP growth accelerated to 4 percent (annual rate) in the second half of 1999, and the forward momentum seems to have been maintained into 2000. Moreover, buoyant business confidence and survey data point to further gains ahead. Consumer confidence has returned to its earlier peaks, boosted in part by a fall in the area-wide unemployment rate to below 10 percent and rising stock and property prices. The euro continues to be extremely weak—below parity with the U.S. dollar—apparently due in large part to the continuing differences in cyclical conditions between the euro area and the United States and to the attendant capital flows from the former to the latter. Much of this effect could be rapidly reversed if market participants revise their assessment of the medium-term prospects for the euro area. Although rising oil prices and a depreciated currency have resulted in an increase in annual headline inflation to 2.0 percent in February 2000, the core inflation rate remains at a subdued 1.2 percent over the same period. Growth is now forecast to pick up from 2.3 percent in 1999 to 3.2 percent in 2000; supportive macroeconomic policies, a highly competitive exchange rate, and buoyant global activity may well produce an even stronger upswing.

Monetary policy appropriately remains accommodating, particularly taking into account the weak exchange rate. The European Central Bank (ECB) cut short-term interest rates by ½ of a percentage point in April 1999, amid concerns about deflation and hesitant activity in the euro area coming from weak import demand in Asia and international financial tensions. With these concerns having dissipated, in part thanks to this more accommodative stance, the ECB moved on November 4 to fully reverse the earlier cut in rates, and recently nudged short-term rates a ¼ point higher in early February and again in mid-March on fears over inflation. Recently, markets have been factoring in a further rise of ½ of a percentage point over the next six months. Higher energy prices will temporarily affect headline inflation in the short term, but inflationary pressures should remain subdued due to the large output gap (projected at about 1¼ percent in 2000) and increased competitive pressures caused by the deregulation and restructuring across the area. While the ECB needs to maintain a strong anti-inflationary stance, and a gradual shift to a less accommodative stance is to be expected as slack is absorbed, inflation prospects remain benign and it is important currently to avoid holding back the ongoing recovery through a rapid tightening of policy. Any assessment of the need for further interest rate adjustments also needs to take into account the likelihood of a stronger euro as the relative cyclical situation improves.

This overall picture continues to mask significant differences in the momentum of activity across the euro area. Among the three largest economies, growth remains quite strong in France, and recovery is also now under way in Italy and Germany. However, it is not yet clear that the cyclical positions of this group of countries have begun to converge. Moreover, the momentum of activity seen in the larger economies continues to differ markedly from the much more rapid expansion in the smaller euro area countries, mostly in the periphery, in particular Ireland, Spain, Portugal, and Finland. Growth in the periphery has been generally associated with rapid increases in asset prices, particularly for property, raising questions about whether current price levels are sustainable (see Chapter III). Some increases in asset prices are probably justified by fundamentals, including the lower interest rate premia resulting both from the disappearance of exchange rate risks and from stronger growth prospects associated with the single market and structural reforms. But a significant speculative element may well also be present.

The substantial fiscal retrenchment associated with the Maastricht treaty criteria for entry into the Economic and Monetary Union (EMU) and the low growth experienced by many entrants over the past few years have inevitably led to adjustment fatigue and pent up pressures for further government spending. Available indications are that the relatively unambitious fiscal objectives for 1999 were met, while targets for 2000 imply little change in the structural budget position of the area as a whole despite more ambitious fiscal targets and spending reductions adopted in Germany, Belgium, and Finland. It is particularly unfortunate that fiscal policies are not being more restrained in the dynamic economies on the European periphery as, with monetary policy being made on a euro-wide basis, fiscal policy is the remaining macroeconomic tool to address overheating concerns in individual countries. More generally, while most of the adjustments required to achieve structural balance have been achieved, more ambitious medium-term goals still need to be set. Current plans imply that a small structural deficit will endure through 2003, while macroeconomic prudence would point to a target of structural balance or surplus by that point.

The biggest challenge for fiscal policy, however, is to lower high levels of taxation by reducing excess levels of government expenditures. Compared with the dynamism of the U.S. economy, many economies of the euro area seem hamstrung by their very high tax rates, which are likely to have negative effects on incentives and thereby impede growth. Medium-term fiscal programs would therefore benefit from more ambitious spending restraint to allow tax levels to be reduced significantly from current levels while maintaining fiscal prudence. Policymakers in France, Germany, and Italy have recently announced plans to cut tax rates, and the German government's recent decision to bring forward to 2001 a personal income tax cut equivalent to ½ percent of GDP and to implement further cuts during 2003–2005 is encouraging. However, additional spending restraint will be needed to avoid generating a pro-cyclical fiscal impulse.

Structural reform of labor and product markets also remains central to enhancing medium-term growth and employment prospects. While progress has been made in some countries, particularly the Netherlands and Ireland (and Denmark, which could join the euro zone in 2002, pending a new referendum to be held on September 28), poor labor market performance continues to impose a heavy burden on the region as a whole. Decisive measures are needed, even in some of the faster reformers, to remove obstacles to job creation, labor mobility, and disincentives for those not employed to enter the workforce, as incremental reforms appear to have had generally little impact. Striking a better balance between the legitimate objective of strong safety nets and the desire to avoid creating poverty traps or disincentives to work is particularly important. On the product and service market side, existing progress with privatization, liberalization, and deregulation needs to be continued through promoting market access in still-sheltered sectors and further reducing government involvement in commercial activities. Given the complementarities between reform efforts, a comprehensive approach to product and labor market reforms is needed. Actions to address existing high profile and difficult issues could boost investor confidence and enhance recovery prospects. Conversely, actions perceived as inconsistent with a move toward more flexible, market-oriented policies have the potential to undermine confidence.

Economic activity in the *United Kingdom* has picked up substantially following the slowdown in late 1998. As in the United States, the expansion that began in 1992 is now the longest on record. GDP increased by 2 percent in 1999, with buoyant private consumption supported by rising asset prices and robust employment growth—on a claimant count basis, the unemployment rate fell to 4 percent in February 2000, the lowest level in 20 years. Economic momentum is expected to increase further in 2000, taking GDP growth up to around 3 percent. The low inflation rate achieved during a period of high resource utilization is testimony to the successful management of monetary policy since the Bank of England gained operational independence in May 1997. The risks to inflation are mainly on the upside, however, given the ongoing strength of private demand and some signs of tightening in the labor market. As a result, some additional firming of macroeconomic policy settings may become necessary. The Bank of England reversed policy direction in September 1999 and by February 2000 had increased the policy rate by 100 basis points to 6 percent as the economy strengthened. Further upward adjustments may be needed to contain inflationary pressures. It is important for fiscal policy not to add to these pressures. In this regard, the recently announced budget for 2000/2001 appears to be regrettably pro-cyclical.

Sweden also grew more rapidly than expected in 1999, with GDP increasing by around 3¾ percent. Growth is projected to pick up further, to about 4 percent in 2000, supported by robust expansion in private domestic demand and exports. Inflation remained subdued in 1999—well below the 2 percent midpoint of the central bank's target zone—and in 2000 is projected to remain comfortably within the zone. However, with excess capacity being rapidly absorbed, monetary policy will need to become less expansionary. The Riksbank raised its policy interest rate by 50 basis points in February and further adjustment may well be needed.

Economic growth in *Denmark* and *Switzerland* slowed to around 1½ percent in 1999 and to under 1 percent in *Norway*, among the lowest rates in western Europe. The slowdowns in Denmark and Norway were in part the intended outcome of policy measures designed to reduce macroeconomic imbalances. In Denmark, declines in both cyclical and structural unemployment and fiscal reforms introduced in 1998 have produced a budget surplus and assisted in further lowering gross public debt to around 50 percent of GDP at the end of 1999 compared with more than 80 percent at the end of 1993. In Norway, a sharp drop in investment in the energy sector was a major factor behind slower growth while, in Switzerland, lower export growth and a broad-based weakening in domestic demand produced the slowdown. In 2000, growth in Denmark and Switzerland is projected to pick up slowly, reaching 1¾ to 2 percent, supported by stronger exports, firmer household spending in Denmark, and a pickup in investment in Switzerland. A stronger rebound to more than 3 percent growth is projected for Norway, underpinned by a recovery in oil revenues. As the projected strengthening in growth takes hold over the next few years, all three countries will need to maintain firm fiscal policies. This stance would help to contain potential upward pressures on interest rates and the exchange rate over the medium term and, in Norway, would support more rapid growth in non-energy sectors of the economy.

Recovery in Latin America: Emerging But Still Vulnerable

Following a difficult year for many Latin American countries in 1999, a broadening recovery is expected to emerge in the region in 2000 (Figure 1.4). The recovery is generally being led by stronger domestic demand, including a turnaround in investment after a sharp contraction in 1999, and by a pickup in exports supported by earlier exchange rate depreciations in most countries and the general strengthening in the regional and global economy. The contribution of rising export volumes to growth is not expected to be as strong as in the Asian recovery, given the less open character of most Latin American economies and the commodity concentration of exports. Nevertheless, increases in commodity prices—including rebounds over the past year in the prices of oil and metals, and projected improvements in food and beverage prices—are playing an important role in the recovery, both in supporting domestic demand and in easing external financing conditions.

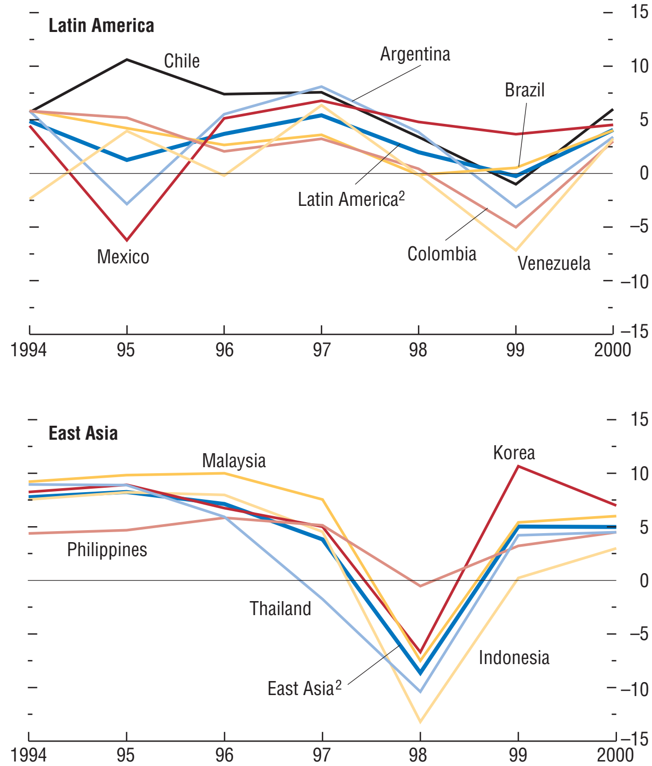
Access to international finance remains the principal vulnerability of the region (see Chapter II). As a result, the costs and volume of global capital flows—including the extent of further adjustment required in U.S. interest rates—could have an important bearing on the strength and resilience of the regional recovery. The combined current account deficit of the four largest countries in Latin America (Brazil, Mexico, Argentina, and Colombia) is projected to be $55 billion in 2000, compared with a combined surplus of $36 billion in the four Asian economies most directly affected by the 1997 crisis.[2] When debt repayment and amortization are also considered, the gross external financing requirement of these Latin American countries is projected to be around $160 billion in 2000; in several countries, including Argentina and Brazil, the financing requirement is equivalent to over 90 percent of merchandise exports.

Most governments in Latin America have appropriately focused on reducing their fiscal deficits as the key measure needed to build investor confidence and contain the risks associated with the high external financing requirements. Budget plans for 2000 suggest that substantial further progress will be made in this regard in most countries, including the largest four. In addition to tight expenditure controls and revenue measures designed to achieve rapid deficit reductions, governments are taking important steps to ensure durable improvements in public finances through reforms to the structure of spending and taxes and through the strengthening of public sector governance. Firm monetary policies have been maintained in most

[2]The four Latin American countries are ordered according to GDP-purchasing power parity weights. The Asian economies included in this comparison are Indonesia, Korea, Malaysia, and Thailand. For all emerging market economies in the Western Hemisphere, the current account deficit in 2000 is projected to be $57 billion, while the overall current account surplus is projected to be over $80 billion in the newly industrialized and developing countries in Asia.

Figure 1.4. Selected Latin American and Asian Economies: Real GDP Growth[1]
(Annual percent change)

The crisis-hit Asian economies have made strong V-shaped recoveries from the recessions of 1998, and ongoing recoveries are also projected for Latin America after milder-than-expected downturns.



[1]Data for 2000 reflect IMF staff projections.
[2]Weighted average of the countries shown in the figure.

countries in the region, another significant departure from the past. Reflecting this, exchange rates have stabilized in several economies following sharp depreciations in early 1999, with some currencies again appreciating, and inflation is generally projected to decline in 2000. The maintenance of cautious macroeconomic policies, together with the improvements projected in external earnings, should contribute to a steady improvement in investor sentiment toward Latin America, helping to lower interest rates and promoting further recovery in domestic economic confidence.

At the same time, economic developments and prospects are quite diverse across individual countries and appear particularly fragile in several cases. Of most concern, *Colombia*, *Ecuador*, and *Venezuela* experienced particularly severe output contractions in 1999—from 5 to more than 7 percent (Table 1.5). The downturn in Colombia appears to have bottomed out in the second half of the year, with tentative signs of recovery emerging. A broader-based increase in output of 3 percent is projected for 2000 but, to be sustained, growth will need to be supported by measures to strengthen the fragile banking system, combined with further fiscal restraint and progress with privatization. In Venezuela, hard-hit by devastating floods and mudslides in December 1999, the rebound in international oil prices has been particularly significant in boosting export earnings and funding a projected increase in public spending (largely because of reconstruction costs). GDP is expected to rise by 3 percent this year, supported by rising domestic demand, and the fiscal deficit is projected to decline. However, while inflation is coming down, it remains one of the highest rates in the region. Overall, the sustainability of recent economic trends and Venezuela's vulnerability to a sharp decline in energy prices are of concern. The economic situation in Ecuador deteriorated further in early 2000, and little or no growth is now projected for this year. A collapse in the exchange rate and rapid monetary growth have fueled a rapid increase in inflation, while severe difficulties in the financial sector and with foreign debt servicing have also contributed to uncertainties about the future course of economic policies. Priority needs to be given to restoring monetary and fiscal discipline, so that the deep-seated financial and structural problems in the economy can be tackled under more stable economic conditions. For the policy of official dollarization of the economy (announced in January 2000) to succeed, it will need to be accompanied by substantial fiscal and structural adjustment in the economy (Box 1.4).

Brazil has recovered more rapidly than expected from the economic crisis of early 1999. Its economy is estimated to have grown by ½ of a percent in 1999, despite projections at the onset of the crisis of a significant output decline, and is projected to grow by 4 percent in 2000. Leading this recovery have been increases in agricultural output, industrial production (including higher import substitution), and exports—the latter two areas being supported by the lower exchange rate and improving regional prospects. Also contributing to improved macroeconomic stability and confidence has been the modest impact of the exchange rate depreciation on inflation, with consumer price inflation under 9 percent at the end of 1999 and projected to fall again in 2000. The terms of trade are expected to rise in 2000 following their deterioration in 1999. This, along with higher export volumes, is projected to lead to a trade surplus and a lower current account deficit, which should be fully covered by foreign direct investment inflows. As discussed in Chapter II, significant progress has been made in tackling the fiscal problems that were at the root of the crisis, with the authorities pursuing a range of measures directed at putting the medium-term fiscal position on a sound footing. These measures include reforms to public administration and to the public sector pension scheme, and a wide-ranging privatization program. Effective implementation of these and other reforms, together with successful application of the new inflation targeting framework, should improve Brazil's access to international finance and hence support the recovery through lower interest rates.

Table 1.5. Selected Developing Countries: Real GDP and Consumer Prices
(Annual percent change)

	Real GDP				Consumer Prices[1]			
	1998	1999	2000	2001	1998	1999	2000	2001
Developing countries	**3.2**	**3.8**	**5.4**	**5.3**	**10.1**	**6.5**	**5.7**	**4.7**
Median	3.6	3.5	4.3	4.5	5.7	4.0	4.0	3.6
Africa	**3.1**	**2.3**	**4.4**	**4.5**	**9.2**	**11.0**	**9.6**	**6.1**
Algeria	5.1	3.4	4.2	4.2	5.8	2.6	4.0	3.0
Cameroon	5.0	4.4	4.2	5.3	2.8	0.0	2.0	2.0
Côte d'Ivoire	4.5	4.3	4.8	5.0	4.5	0.7	2.5	2.5
Ghana	4.6	5.5	6.0	6.0	19.3	12.4	11.4	5.7
Kenya	2.1	1.8	2.3	3.3	6.6	3.5	5.0	4.5
Morocco	6.3	0.2	5.2	3.3	2.9	0.8	3.0	2.5
Nigeria	1.9	1.1	3.9	4.5	10.0	6.6	5.8	7.3
South Africa	0.6	1.2	3.8	4.0	6.9	5.2	4.7	5.9
Sudan	5.0	6.0	6.5	5.5	17.1	16.0	12.0	7.5
Tanzania	3.3	5.3	5.2	5.6	12.6	7.9	5.7	4.5
Tunisia	5.0	6.5	6.0	6.0	3.1	3.1	3.0	3.0
Uganda	5.4	7.8	7.0	7.0	5.8	–0.2	5.0	5.0
PRGF countries[2]	5.0	5.2	5.4	5.7	7.4	4.0	4.8	3.7
CFA countries	4.7	3.3	4.6	4.9	3.0	0.2	2.3	2.4
Asia	**3.8**	**6.0**	**6.2**	**5.9**	**7.6**	**2.5**	**2.6**	**3.0**
Bangladesh	4.7	4.3	4.5	4.5	8.0	7.2	5.8	6.3
China	7.8	7.1	7.0	6.5	–0.8	–1.4	1.0	1.4
India	4.7	6.8	6.3	6.1	13.2	5.0	4.6	5.3
Indonesia	–13.2	0.2	3.0	3.5	58.4	20.5	3.5	4.8
Malaysia	–7.5	5.4	6.0	5.8	5.3	2.7	2.5	3.2
Pakistan	3.3	3.1	4.0	4.5	7.8	5.7	4.0	5.0
Philippines	–0.5	3.2	4.5	4.5	9.7	6.7	5.5	5.0
Thailand	–10.4	4.2	4.5	5.0	8.1	0.3	3.0	3.0
Vietnam	3.5	3.5	4.5	5.5	7.7	7.6	6.0	4.5
Middle East and Europe	**2.7**	**0.7**	**4.6**	**4.0**	**26.0**	**20.3**	**16.2**	**9.4**
Egypt	5.3	6.0	5.6	5.0	4.7	3.8	4.0	4.0
Iran, Islamic Republic of	1.9	2.6	5.0	5.0	22.0	15.0	10.0	8.0
Jordan	2.2	2.0	2.5	3.5	4.5	1.9	2.8	2.4
Kuwait	2.0	–2.4	0.8	2.0	0.5	1.9	1.5	1.8
Saudi Arabia	1.6	–2.3	2.2	2.0	–0.2	–1.2	1.1	1.9
Turkey	3.1	–4.3	4.5	4.8	84.6	64.9	46.5	17.0
Western Hemisphere	**2.1**	**0.1**	**4.0**	**4.7**	**9.8**	**8.8**	**7.7**	**6.4**
Argentina	3.9	–3.1	3.4	3.7	0.9	–1.2	0.6	0.8
Brazil	–0.1	0.5	4.0	4.5	3.2	4.9	7.0	5.0
Chile	3.4	–1.0	6.0	6.5	5.1	3.3	2.9	3.2
Colombia	0.4	–5.0	3.0	4.8	18.7	10.9	9.0	8.7
Dominican Republic	7.3	8.3	6.5	6.0	4.8	6.5	4.2	3.5
Ecuador	0.4	–7.0	1.5	4.0	36.1	55.1	36.2	17.6
Guatemala	5.2	3.3	3.0	3.0	6.6	5.3	9.3	9.2
Mexico	4.8	3.7	4.5	5.3	15.9	16.6	10.1	9.0
Peru	0.3	3.5	4.0	6.0	7.3	3.5	3.9	3.5
Uruguay	4.5	–2.5	2.0	4.0	10.8	5.7	4.4	3.0
Venezuela	–0.1	–7.2	3.2	3.1	35.8	23.6	18.6	16.3

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes as is the practice in some countries.
[2]African countries that had arrangements, as of the end of 1999, under the International Monetary Fund's Poverty Reduction and Growth Facility (formerly the Enhanced Structural Adjustment Facility, or ESAF).

Economic activity in *Mexico* has held up relatively well throughout the regional economic slowdown, with real GDP increasing by an estimated 3½ percent in 1999 and projected to rise by 4½ percent in 2000. Supported by the ongoing strength of the U.S. economy, export volumes have grown rapidly—especially non-oil exports. With the terms of trade also improving,

Box 1.4. The Pros and Cons of Dollarization

Dollarization—the adoption of the U.S. dollar (or other foreign currency) as the domestic legal tender—is the latest alternative to emerge in the search for stable and credible monetary and exchange rate regimes. In January 2000, Ecuador announced the intention to adopt the U.S. dollar as the domestic legal currency, maintaining only a minor role for the sucre which will circulate in denominations smaller than one U.S. dollar, and this policy is now being implemented. A year before, dollarization was being discussed in Argentina, where a currency board already has tied the peso to the U.S. dollar on a one-to-one exchange rate since 1991. One spur for this recent interest in dollarization has been the wave of speculative attacks against even the hardest pegs, such as Argentina's currency board. Another is the adoption of a common currency by 11 countries in the European Economic and Monetary Union. Moreover, there is some empirical work suggesting that the use of a common currency by itself has a large effect in stimulating trade and economic integration, especially by reducing transaction costs and exchange rate uncertainty.

The economic arguments presented for adopting a common currency have shifted over time. The traditional analysis found benefits of using a common currency for countries that, by virtue of sharing similar economic structures, formed an "optimal currency area" (OCA). Most of the current analysis, in contrast, focuses on financial stability and external creditworthiness. Especially for emerging economies, benefits in these areas may dwarf any disadvantages resulting from not fulfilling the OCA conditions.

What are the pros and cons of dollarization? It is useful to compare the merits of dollarization to those of its nearest "competitor"—the currency board. This permits an analysis of the implications of giving up the domestic currency, as opposed to the more general implications of the choice of floating versus fixing the exchange rate.[1]

[1]See Andrew Berg and Eduardo Borensztein, "The Pros and Cons of Full Dollarization," IMF Working Paper 00/50 (Washington: International Monetary Fund, 2000).

Risk premiums. An immediate benefit from the elimination of the risk of devaluation would be a reduction of country risk premiums and thus lower interest rates, which would result in a lower cost of servicing the public debt and also in higher investment and economic growth. While the part of the interest premiums attributable to devaluation risk would disappear with dollarization (as devaluations are no longer possible), the part attributable to sovereign risk would not. The key question, then, is what effect dollarization would have on the overall cost of dollar-denominated borrowing.

The presence of devaluation risk might increase default risk for several reasons. First, governments attempting to avoid a currency crisis may impose currency controls that force a suspension of payments on foreign debt. Second, default risks could rise with a devaluation owing to the higher cost of servicing dollar-denominated debt. And third, a devaluation could cause heavy losses in the financial sector, and governments may end up bearing most of the cost. Not all default risks arise from the risk of currency crises, however. Sovereign defaults may result from an unsustainable fiscal position or political turmoil, and dollarization cannot prevent this sort of crisis. Although data show that sovereign risk and devaluation risk move together, this does not establish a causal link from devaluation risk to sovereign risk (or vice versa). For example, a general "flight to quality" (unrelated to fears of devaluation) would raise both the measured risk of default and the risk of devaluation. Evidence from Panama, a dollarized economy since 1904, suggests that, indeed, the observed comovements in sovereign risk and devaluation risk reflect common factors. That is, the absence of currency risk in Panama does not isolate that country's sovereign spread from swings in international market sentiment (see figure).

Stability and integration. Speculative attacks and currency crises are costly not only because their possible emergence widens risk premiums but also because they have dire consequences for the domestic economy when they occur. Of course, dollarization would not completely eliminate the risk of external crises; indeed, Panama has had several crises in recent decades. Nevertheless, dollarization holds the promise of at least reducing the frequency and scale of crises and the extent of contagion. And, in addition to promoting financial integration, dollarization may contribute to trade integration with the United States to an extent that would not be likely otherwise.

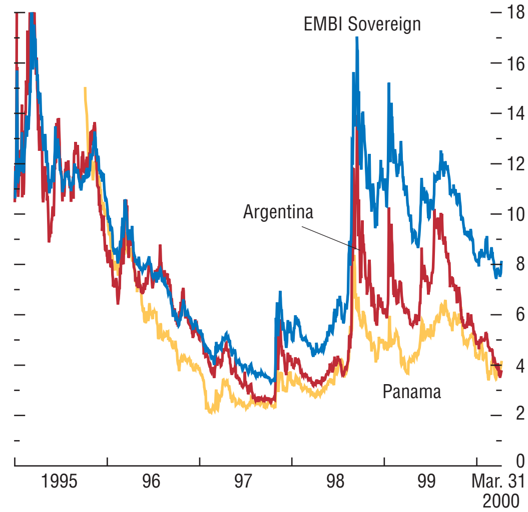
Seigniorage. A country adopting a foreign currency as the legal tender would lose the income from seigniorage. First, the country would have to purchase the stock of domestic currency held by the public (and banks) and pay them with dollars from its international reserves or borrowed funds. Second, the country would give up future seigniorage earnings stemming from the flow of new currency printed every year to satisfy the increase in the demand for money. These increases are likely to become smaller over time, however, as financial development results in a reduced need for currency to effect transactions.

The costs of losing seigniorage can be significant. In Argentina, for example, domestic currency in circulation is equivalent to roughly $15 billion (5 percent of GDP), and the annual increase in currency demand has averaged roughly $1 billion (0.3 percent of GDP) in recent years. The lost seigniorage would accrue to the United States. For this reason, it has been suggested that the United States share this seigniorage with dollarizing countries according to some agreed-upon formula (seigniorage-sharing arrangements exist in the euro and the South African rand areas).

Exit option. Countries with flexible exchange rate regimes can adjust to severe overvaluation by allowing the currency to depreciate. With dollarization or fixed rates, the real devaluation must be achieved through a *fall* in nominal wages and prices (or at least slower increases in these compared with their trading partners). Experience has shown that these declines are often achieved only at the cost of economic recessions, because resistance to nominal wage and price reductions can be strong. Countries with currency boards have already eliminated much of their choice with regard to the exchange rate. But what distinguishes such countries from dollarized economies is that, in extreme cases, the former could in principle devalue. In fact, dollarization's key distinguishing feature is that it would be permanent, or nearly so. It would presumably be much more difficult to reverse dollarization than to modify or abandon a currency board arrangement. Reversing dollarization implies introducing a new national currency to displace a strong and convertible foreign currency, and acceptance of the new currency would likely not be immediate.

Departures from the gold standard in the interwar years and the devaluation of the CFA franc in 1994 suggest that an exit option may indeed be valuable in the presence of extreme shocks. During the Great Depression, countries abandoned the fixed exchange regime of the

Sovereign Bond Spread[1]
(Percentage points)



Sources: Bloomberg Financial Markets, LP; and IMF staff calculations.
[1]J.P. Morgan's Emerging Market Bond Index (EMBI) spread relative to U.S. zero-coupon yield curve, and secondary market yield spreads on U.S. dollar-denominated Eurobonds.

Box 1.4 *(concluded)*

time—the gold standard. Argentina suspended convertibility in 1929 and followed an active policy to sterilize the monetary impact of capital outflows, which contributed to the relatively minor impact of the Depression on Argentina. More recently, when countries of the CFA franc zone in west and central Africa faced a prolonged worsening of their terms of trade and a steep rise in their labor costs, combined with a nominal appreciation of the French franc against the U.S. dollar, they decided to depart from their firm-peg regime, which had lasted since 1948, and devalue the CFA franc in 1994. This exchange rate realignment led to a significant economic turnaround during 1994–97 and little inflation pass-through.

Despite those experiences, many countries might not benefit from an exit option even when the currency is overvalued. Where policymakers have little credibility, or where the dollar is in practice already the unit of account, a nominal devaluation may rapidly lead to an inflation that would undo the devaluation's positive effects. As observed in a variety of recent currency crises, large depreciations in a context of weak banking systems and large foreign exchange exposure in the private sector damage the financial health of banks and businesses, sharply disrupting economic activity. This implies that devaluation may be so costly a policy option in some cases that moving to full dollarization would not entail the loss of an important policy tool.

Lender of last resort and dollarization. As lenders of last resort, central banks stand ready to provide liquidity to the banking system in the event of a systemic bank run. The central bank does this essentially by using its ability to create liquidity—something that it would not have in a dollarized system. Currency boards face a similar constraint, because they can create base money only to the extent that they accumulate reserves. Currency board arrangements can, however, retain some flexibility to create money that is not fully backed by reserves, so as to be able to address banking crises. During the 1995 "tequila" crisis, the central bank of Argentina was able to partially accommodate the run on domestic deposits by temporarily reducing the reserve coverage of the monetary base. Following some episodes of liquidity crunch in 1997, the Hong Kong Monetary Authority also introduced a discount window to provide short-term liquidity to banks.

In any case, the importance of a curtailment of the lender-of-last-resort function should not be exaggerated because the cost of a financial crisis is ultimately a fiscal problem that can be addressed by other means. Dollarization may, moreover, make a bank run less likely. Indeed, without significant currency mismatches in the banks' positions, depositors may have more confidence in the domestic banking system. If large foreign banks play a dominant role in the banking system, which presumably would be encouraged by dollarization, this would also reduce the danger of a weakened lender of last resort.

It is impossible to make a blanket generalization about the net benefits of full dollarization. But the analysis can at least shed some light on which countries are likely to benefit most. A traditional group of candidates is formed by countries that are highly integrated with the United States (or the European Union for "euroization") in trade and financial relations (and are candidates to form what the economics literature calls an optimal currency area). Yet most countries in Latin America are quite different from the United States in their economic structure and would probably not benefit greatly from dollarization from this perspective, unless it took place in the context of deep market integration (in European Union style). The most relevant case deserving consideration is that of a different group: emerging market economies exposed to volatile capital flows but not necessarily close, in an economic sense, to the United States. For this group, the more the U.S. dollar is already used in their domestic goods and financial markets, the smaller the advantage of keeping a national currency. For an economy that is already extremely "dollarized" in this sense, seigniorage revenues would be small (and the cost of purchasing the remaining stock of domestic currency also would be small), the exposures of banks and businesses would make devaluation financially risky, and the exchange rate would not serve as a policy instrument because prices would be "sticky" in dollar terms. In such cases, dollarization might offer more benefits than costs.

The balance of costs and benefits also depends on how far along a country is in "supportive" structural reforms. In principle, it would be desirable to adopt dollarization as the result of a well-planned process and after having achieved fiscal consolidation, more flexible labor markets, and a stronger financial sector. In practice, countries may adopt dollarization as a response to crisis, as with Ecuador, without time to prepare or fulfill prerequisites. In such cases, dollarization may "raise the stakes" and thus force the political system to undertake necessary reforms, but it may also make failure to enact those reforms even more painful.

the current account deficit declined to under 3 percent of GDP in 1999, largely financed by inflows of foreign direct investment. Private investment also grew strongly in 1999, and later in the year there were signs of a broader-based pickup in domestic spending. Indeed, a range of indicators point to a general improvement in financing conditions and economic confidence. For example, domestic interest rates have declined significantly; equity prices almost doubled in U.S. dollar terms in the year to December; and the currency has appreciated by 6 percent against the dollar. These improvements have been underpinned by, and need to receive continued support from, firm macroeconomic policies (see Chapter II). There is also scope for additional reforms to improve the medium-term fiscal outlook, such as measures to broaden the tax base and improve the targeting of social spending. With the banking system still fragile, policy emphasis should be on implementing a tighter regulatory and legal framework and providing sufficient incentives to strengthen the system's financial fundamentals and foster conservative banking practices.

Prospects for economic recovery in *Argentina* have improved, with several of the influences that led to the 3 percent contraction in GDP in 1999 weakening or turning around. The stronger outlook projected for Brazil should support a pickup in export growth; reductions in regional financial market tensions should also contribute to lower interest rates and support investment (which fell by 9 percent in 1999); and the terms of trade are expected to begin to recover as a result of higher international food and oil prices. Overall, GDP is projected to increase by 3½ percent in 2000, with inflation remaining very low and unemployment declining modestly. Progress is needed in two key policy areas to support these improving economic prospects. First, following a larger than expected expansion in the public sector deficit in 1999, rapid progress is needed with fiscal consolidation. Tax and spending reforms introduced by the new government have been an important step forward in this regard. Second, implementation of a range of labor market reforms is also needed, directed in particular at lowering non-wage costs, increasing the flexibility of bargaining and contracting arrangements, and improving external competitiveness.

Another encouraging development is that *Chile* and *Peru* appear poised to attain relatively healthy growth of 6 and 4 percent, respectively, in 2000, supported by last year's exchange rate depreciations, lower interest rates, and a pickup in commodity prices (e.g., copper prices in the case of Chile). Underpinning the improved outlook for both countries are their relatively strong fiscal positions, moderate public debt, and low inflation. Holding on to these strengths would provide key support for a resumption of sustained growth and, in Peru, for the required strengthening of the banking sector.

Recovery in Asia-Pacific: The Momentum Increases

The momentum of economic recovery in Asia increased significantly in 1999, with growth exceeding—by a wide margin in some countries—earlier expectations. Among the crisis-hit countries, the pickup has been strongest in *Korea*, where GDP increased by a remarkable 10½ percent in 1999, and in *Malaysia* where growth was 5½ percent. *Thailand* also grew solidly by 4¼ percent in 1999, and even in *Indonesia*—the hardest hit economy in the region—real activity was broadly stable for the year as a whole, a notable turnaround from the 13 percent contraction in 1998 and the Consensus Forecast at the beginning of 1999 of a further 3 to 4 percent decline in output. This recovery is projected to continue in 2000 and to become more evenly balanced across most of the advanced and developing countries of the region. Growth in Korea is expected to moderate somewhat to around 7 percent, roughly the same as in *Hong Kong SAR*, Malaysia, *Singapore*, and *Taiwan Province of China*, while the economies of Indonesia, the *Philippines,* and Thailand are projected to strengthen by 3 to 5 percent.

The driving forces of recovery have been generally similar among the crisis-affected economies. With initial support provided by fiscal stimulus and a rebuilding of inventories, the upturn has been driven more recently by a faster-than-expected improvement in the volume and value of exports. This has been supported by real devaluations compared with pre-crisis values and export market growth, the latter reflecting continued strength in the United States along with recoveries in Europe and, to a lesser degree, in Japan. A significant sectoral trend has been the rebound in the electronics industry—an important sector for the Philippines, Singapore, and Taiwan Province of China, and also of growing significance in Malaysia and Thailand. In response to this stronger external performance, the severe import compression and destocking that followed the financial crisis came to an end in 1999. For example, import volumes last year surged upwards by around 30 percent in Korea and over 25 percent in Thailand; similarly, a strong pickup in import growth is projected for Indonesia in 2000 as the economy gathers strength.

As reflected in the import surge, final domestic demand has also played an important role in the recovery. Public consumption and investment continued to support economic activity in all the crisis-affected economies in 1999, and this is projected to continue in 2000. Private consumption has also increased, particularly in the countries more advanced in recovery, as incomes and wealth pick up and household confidence returns. The contribution from private fixed investment to recent and projected growth has been less buoyant, as might be expected given the over-investment that preceded the recent economic crisis and subsequent excess capacity. Nevertheless, investment has picked up more rapidly than expected in Korea as business activity increases and profitability improves. Influenced by the same trends, a steady increase in investment is also expected in other countries in the region.

Fiscal policy has, as noted, provided important support for the recovery in Asia, and should continue to do so where necessary until growth is firmly established. As recoveries strengthen, however, some tightening of fiscal and monetary policies will clearly be required to reduce risks of overheating. These pressures may be apparent relatively soon in Korea, where the process of fiscal consolidation has begun in 2000, but may be some distance away in Thailand and other regional economies where output gaps still appear to be large. When firmer policies do become necessary, relatively rapid progress with fiscal consolidation would help to reverse unfavorable public debt dynamics and reduce the extent of adjustment required in interest rates. Low rates of consumer inflation—under 3 percent in most of the crisis-hit economies in 1999—have helped to hold down interest rates, and hence have lowered debt servicing costs arising from the extensive bank recapitalization and corporate debt rescheduling. But, with inflation expected to pick up over the medium term as spare capacity is absorbed, interest rate pressures may raise substantially the financial costs of restructuring, especially in Indonesia and Thailand, where short-term or floating-rate debt has been widely used for this purpose.

The strong export-led expansions and resulting current account surpluses in Asia have allowed the crisis-hit countries to rebuild official foreign exchange reserves that were depleted during the crisis period. In Korea, for example, usable gross reserves have increased from $9 billion at the end of 1997 to $83 billion at the end of March 2000. With economic recovery now well under way, there is scope for further appreciation of some regional currencies—a trend that would help to moderate risks of overheating and consequent inflation pressures.

While major steps have been taken regarding financial and corporate sector restructuring, progress remains mixed and much remains to be done (see Chapter II). In Korea, for example, the restructuring of Daewoo has provided an important signal of the authorities' resolve to pursue far-reaching changes in traditional business arrangements, and the other large *chaebol* (industrial conglomerates) have made substantial progress in reducing their debt–equity ratios. However, further efforts are needed to strengthen management and operations among all the *chaebol*. More rapid progress with bank and corporate restructuring is needed in Thailand, supported by improved bankruptcy and foreclosure procedures. Indonesia faces the most severe challenges regarding economic restructuring, and full implementation of the new government's ambitious and wide-ranging program of reforms is needed. Policy priorities are to complete the bank recapitalization program and to step up the recovery and restructuring of corporate debt, including strengthening the state institutions involved in the reform process.

Turning to the largest economy in developing Asia, *China* grew by 7 percent in 1999. Economic activity has been supported by a sharp pickup in exports, reflecting in part the rebound in the regional economy, and by an additional fiscal stimulus package that took effect late in the year. These influences helped to offset continued weakness in private domestic demand during 1999 and, together with some recovery of private investment spending, are expected to underpin growth of around 7 percent again in 2000. While consumer prices fell by a further 1½ percent in 1999 as a whole, deflation pressures appeared to be abating in the second half of the year and prices may increase marginally in 2000. The authorities' emphasis on interest rate liberalization and broader financial market reforms is appropriate, given that there is limited scope for further interest rate reductions to support activity.

Recent developments suggest a decline in the external vulnerability of China during 1999. The real effective exchange rate has continued to depreciate from its peak reached in early 1998 as a result of domestic price deflation and recoveries in other regional currencies, reducing short-term pressures for a nominal depreciation and supporting export growth. And net capital inflows have resumed (mainly reflecting a reduction in outflows), offsetting a decline in the current account surplus and contributing to a further increase in official reserves to almost $160 billion.

China's prospective membership in the World Trade Organization is likely to add momentum to the structural reform process. Anti-smuggling efforts in 1999 produced a notable rise in recorded imports, as well as a welcome boost to customs revenues. Nevertheless, given China's emerging medium-term fiscal sustainability problems, growth cannot be sustained through fiscal stimulus indefinitely. Rather, continued financial and operational restructuring of state-owned enterprises needs to be pursued vigorously through, among other moves, active participation of the new asset management companies in the reorganization of businesses in which they have become owners or creditors. Closely related to this and the associated financial market reforms, the scope for private sector initiative and enterprise needs to expand, and the authorities' reiteration in January 2000 of their intention to strengthen the role of the private sector is encouraging.

Growth in *India* accelerated to an estimated 6¾ percent in 1999, as a pickup in industrial production that began during 1999 helped offset the slowdown of agricultural output in midyear, and growth is projected to continue at over 6 percent in 2000. Wholesale price inflation has fallen sharply with easier agricultural supply conditions, but is projected to rebound to around 5½ percent in 2000. Exports also have strengthened, and continued robust export growth over the medium term is expected to help contain the current account deficit to under 2 percent of GDP.

However, even stronger economic growth is needed over the longer run for meaningful progress to be made in addressing India's poverty problem, and sustaining current growth rates may be difficult without significant policy action (see Chapter IV, Box 4.2). The foremost challenge is to make prompt and credible progress in reducing the fiscal deficit. With budgetary slippages having occurred at both central and state government levels, the consolidated public sector deficit is now expected to have risen to around 11 percent of GDP in the 1999/2000 fiscal year, over 2 percentage points higher than initially budgeted. India's large fiscal imbalances have pushed public debt up to 80 percent of GDP, are crowding out private investment, and are constraining the scope for the monetary authorities to ease interest rates—which are high in real terms—without jeopardizing recent gains on the inflation front. Although the central government budget for 2000/2001 contains some commendable structural measures, it envisages disappointingly modest fiscal adjustment in the coming year, and fiscal sustainability remains a serious concern. Moreover, while the new government has signaled its intention to reestablish the momentum of structural reforms, important challenges still need to be addressed, including further deregulation and privatization, measures to increase labor market flexibility, and reform of the agricultural sector.

Despite political instability, economic growth in *Pakistan* reached over 3 percent in 1999, supported by good cotton and wheat crops and a pickup in manufacturing output. Also contributing to recent improvements in macroeconomic performance and confidence have been a fall in inflation, a rebound of exports to east Asia, a much greater degree of exchange rate stability following the rapid depreciation in previous years, and the substantial progress made in restructuring Pakistan's foreign debt. Implementation of a range of reforms would consolidate and extend recent gains. These include fiscal measures designed to broaden the tax base and improve the targeting of social expenditures on poverty alleviation; increased private sector participation in the energy sector, along with financial restructuring and privatization among other public enterprises and banks; and further price deregulation in the energy and agricultural sectors. A similar reform agenda needs to be pursued vigorously in *Bangladesh* to sustain higher growth than the 4 to 6 percent achieved during most of the 1990s. As in India and Pakistan, a stronger performance is necessary if substantial inroads are to be made on poverty.

Growth in *Australia* is projected to slow slightly to just under 4 percent in 2000, and *New Zealand*, gaining further strength after the brief downturn in 1998, is also expected to grow at around this rate. An important contribution to recent and projected growth is coming from a continuing recovery of export volumes and some commodity prices as markets strengthen following the economic crisis in east Asia. The rather strong pickup expected in the "headline" inflation rate in Australia, to over 4 percent, is associated in part with the introduction of the new goods and services tax (GST); excluding GST, inflation is projected to rise to around 2½ percent, as in New Zealand, compared with 1½ percent in each case in 1999. Both countries continue to experience high current account deficits that, while projected to decline from their 1999 levels, are expected to be 5 percent of GDP in Australia and 6¼ percent in New Zealand in 2000 as a whole. As discussed in the October 1999 *World Economic Outlook*, the risks surrounding these imbalances are mitigated by the sources and structure of capital inflows and

Table 1.6. Countries in Transition: Real GDP and Consumer Prices
(Annual percent change)

	Real GDP				Consumer Prices			
	1998	1999	2000	2001	1998	1999	2000	2001
Countries in transition	**–0.7**	**2.4**	**2.6**	**3.0**	**22**	**44**	**20**	**14**
Median	3.7	2.7	4.0	4.2	10	8	8	5
Central and eastern Europe	**1.8**	**1.4**	**3.0**	**4.2**	**19**	**21**	**19**	**12**
Excluding Belarus and Ukraine	2.0	1.5	3.6	4.6	17	11	11	7
Albania	8.0	8.0	8.0	8.0	21	—	3	2
Belarus	8.3	3.0	—	2.0	73	294	250	148
Bosnia and Herzegovina	18.0	8.0	14.0	14.0	10	5	3	3
Bulgaria	3.5	2.5	4.0	4.5	22	—	7	3
Croatia	2.3	–2.0	2.5	3.5	6	4	3	3
Czech Republic	–2.3	–0.5	1.6	2.7	11	2	4	5
Estonia	4.0	–1.3	4.0	6.0	8	3	5	3
Hungary	4.9	4.1	4.5	4.6	14	10	8	5
Latvia	3.6	0.8	4.0	6.0	5	3	3	3
Lithuania	5.1	–3.3	2.1	4.0	5	1	2	2
Macedonia, former Yugoslav Rep. of	2.9	2.5	6.0	5.0	–1	—	3	2
Moldova	–8.6	–5.0	2.0	4.0	8	39	29	10
Poland	4.8	4.1	5.2	5.5	12	7	8	6
Romania	–5.4	–3.9	1.3	4.0	59	46	39	20
Slovak Republic	4.4	1.0	2.0	3.9	7	11	10	6
Slovenia	3.9	3.8	4.0	4.6	8	6	6	4
Ukraine	–1.7	–0.4	0.5	3.0	11	23	23	10
Russia	**–4.5**	**3.2**	**1.5**	**1.4**	**28**	**86**	**20**	**16**
Transcaucasus and central Asia	**2.3**	**4.4**	**4.9**	**3.7**	**13**	**15**	**16**	**18**
Armenia	7.2	4.0	6.0	6.0	9	1	3	3
Azerbaijan	10.0	7.4	4.6	7.9	–1	–9	2	3
Georgia	2.9	3.0	4.0	5.0	4	19	8	5
Kazakhstan	–2.5	1.7	3.0	3.5	7	8	12	9
Kyrgyz Republic	2.3	2.2	2.4	3.2	12	37	28	12
Mongolia	3.5	3.5	4.2	4.5	9	8	6	4
Tajikistan	5.3	3.7	5.0	6.5	43	28	15	7
Turkmenistan	5.0	16.0	18.9	2.2	17	23	24	55
Uzbekistan	4.4	4.1	3.0	2.0	29	29	30	39

by each country's highly credible macroeconomic policies. Nevertheless, to reduce longer-term vulnerabilities, policies need to be directed at maintaining public sector surpluses and fostering higher levels of private saving.

Russia and the Commonwealth of Independent States (CIS): Growth, But Uncertain Prospects for Sustained Recovery

Following widespread weakening in the wake of the Russian crisis, growth in the transition economies generally improved in 1999 and is expected to strengthen further in 2000 (Table 1.6). But economic performance and prospects vary widely among these countries, depending crucially on the extent of stabilization and restructuring. Overall, reform efforts in Russia and most other countries of the former Soviet Union continue to lag significantly behind those in the better-performing transition economies that have been accepted for the European Union (EU) accession process. The divergence in outcomes between these two groups appears likely to widen in the period ahead.

Russia's macroeconomic performance in 1999 was, in many dimensions, substantially better than had been anticipated. Compared with projections in the previous *World Economic Outlook,* for example, GDP picked up more rapidly—increasing by over 3 percent rather than remaining flat; and the fiscal position was stronger, inflation lower, and the current account surplus larger than expected. These improvements, however, have been built on a narrow and not necessarily sustainable base including higher prices of energy exports, ongoing import compression, and, associated with this, increases in industrial production driven mainly by import substitution. Unlike in Asia and Latin America, export volumes have yet to show a sustained increase in response to the fall in the real exchange rate since 1998, and export values even declined in 1999. Furthermore, the current account surplus of $18 billion was largely offset by continuing high outflows of private capital, reflecting an ongoing lack of confidence in economic policies and prospects. Hence, gross reserves increased by only $1.6 billion in 1999. The effects of military operations in Chechnya and of the eventual reconstruction efforts on the fiscal position and outlook are unclear.

Looking ahead, the scope for further economic expansion through import compression and substitution is declining, and prospects for a broader-based pickup in private sector activity depend on a recovery of domestic demand. While there are some signs of a revival in consumption and investment, accompanied by continued vigorous growth in industrial output, prospects remain uncertain as to whether growth can be sustained at the same level as in 1999.

For a durable recovery to emerge, significant progress would need to be made in tackling the fiscal and structural difficulties that have undermined growth prospects since the start of transition. Some improvements have been apparent over the past year—for example, public revenues have increased as a share of GDP, partly because of better tax compliance, and a higher proportion of taxes is being paid in cash. Further reforms in the tax structure and administration are now needed to consolidate and extend these gains. Robust fiscal progress would also reduce pressures for central bank financing of the deficit and would thereby contribute to further disinflation and stronger confidence in the ruble. Determined progress is also needed with banking sector reforms, supported by the implementation of a stronger legal framework to facilitate public intervention in troubled banks and, if necessary, their closure. Particular attention needs to be given to determining the future role and structure of state-owned banks. More generally, much remains to be done to develop the institutional and legal underpinnings of a market economy and hence to provide a reliable framework for improving governance, strengthening the rule of law, reducing corruption, and attracting the long-term capital needed for deep restructuring and sustained growth.

In other countries of the CIS, there are mixed prospects for durable recoveries. In *Ukraine,* despite the slowdown in the contraction of GDP in 1999 and growth in early 2000, the economic situation remains difficult, although prospects for restructuring a substantial portion of the heavy debt service payments due in 2000 and 2001 appear to be good. Further adjustment efforts and progress in structural reforms in the area of privatization, public administration, and restructuring the key agriculture and energy sectors are needed to ensure a sustainable output recovery. In *Belarus*, economic conditions remained difficult in 1999, undermined by a rapid rate of monetary growth and, correspondingly, by accelerating inflation and rapid depreciation of the exchange rate in all segments of the foreign exchange market. Firm commitment to significant monetary and fiscal tightening, together with extensive liberalization and restructuring, would be needed to turn economic prospects around. In contrast, the outlook has strengthened in *Kazakhstan*, with growth of 3 percent projected for 2000. While higher agricultural output and oil prices are contributing to this recovery, growth prospects are underpinned by what appears to be a clear commitment of the authorities to ongoing stabilization and adjustment measures. These include a medium-term strategy of fiscal consolidation; monetary policy clearly focused on lowering inflation; and further structural reforms directed at promoting private-sector-led growth, strengthening the social safety net, and securing macroeconomic objectives (e.g., through improvements in tax policy and administration).

Countries on the European Union Accession Track

The decision at the European Union's Helsinki summit in December 1999 to widen the accession process to 13 applicant countries provided a significant incentive and challenge for the countries concerned to push ahead with the economic, legislative, and other adjustments required to prepare them for full European Union membership. For example, progress in many areas of structural reform, including financial sector development, business restructuring, and privatization, is still quite mixed among these economies. Even the countries most advanced in the reform process have a legacy of problematic sectors and regions that so far have been largely left behind in the adjustment to modern market-based economies. Specific policy attention in this regard needs to be given to improving the climate for the creation and growth of small- and medium-sized enterprises, allowing support for nonviable businesses to be steadily withdrawn; and assisting labor market adjustment both through housing and infrastructure development and through well-targeted social support and training programs.

Economic activity in the more advanced transition economies of central Europe and the Baltics is generally expected to strengthen in 2000. In *Hungary* and *Poland*, GDP growth is projected to pick up to 4½ to 5 percent in 2000 following mild slowdowns in 1999. Hungary's fiscal and current account deficits declined in 1999, despite signs of weakening early in the year. Supported by continued firm macroeconomic policies, a further decline in the fiscal deficit is projected for 2000. In Poland, a particular source of concern has been the significant increase in the current account deficit, which reached over 7½ percent of GDP in 1999 and contributed to a period of downward pressure on the currency. A modest decline in the external deficit, to around 7 percent of GDP, is expected in 2000, together with a fall in the fiscal deficit. A long-awaited recovery is expected in the *Czech Republic* after three years of very weak economic performance, and stronger growth of around 2 percent is also projected for the *Slovak Republic*. The economic vulnerability of these two countries appears to have declined as a result of substantial reductions in their current account deficits and renewed, but overdue, efforts to restructure the bank and enterprise sectors, although a great deal of structural adjustment still lies ahead. Activity in the Baltic countries is also picking up again following sharper-than-expected slowdowns in the wake of the Russian crisis, which led to a significant deterioration in their fiscal positions and higher unemployment. *Estonia* and *Latvia* appear to be recovering quite rapidly while a more muted pickup is projected for *Lithuania*, which experienced particularly severe economic and fiscal difficulties in 1999.

A key contribution to the stronger outlook for these countries is coming from an upswing in exports to western Europe as growth in this area also strengthens. But also important is a recovery in the investment climate and in overall confidence following the uncertainties brought on by the financial crisis in Russia. Sustaining these improvements will require prudent policy management on a number of fronts. In almost all of the advanced transition economies, some rebalancing of the macroeconomic policy mix would be desirable, and this is already under way in some countries (notably the Baltics). This rebalancing would generally involve a faster rate of fiscal consolidation to contain pressures on inflation and interest rates that could arise from the projected pickup in economic activity. Such an approach would help to hold down the costs of bank and enterprise restructuring, encourage investment, and lower the risk that strong capital inflows could resume and put pressure on exchange rates and competitiveness. In most countries, fiscal restraint over the medium-term needs to be supported by measures to improve the efficiency of the tax regime, including broadening the tax base, lowering direct tax rates, and placing relatively more emphasis on indirect taxes. And further support would come from reforms to the funding and delivery of health care, pensions, and other social services to improve the quality and sustainability of these programs, where public spending pressures have tended to be the greatest. Wage moderation, in both public and private sectors, would also contribute to improving fiscal positions, lowering inflation and interest rates, enhancing competitiveness, and raising employment.

Growth in *Bulgaria* slowed to 2½ percent in 1999 under the impact of poorer external trading conditions and rapid domestic restructuring but, with activity already picking up, the economy is expected to grow by 4 percent in 2000. Bulgaria's relatively robust performance since its financial crisis in 1997 is attributable to a prudent fiscal stance and low inflation, underpinned by the currency board and complemented by widespread structural reforms—including further privatization, enterprise restructuring, and firm wage restraint imposed on poorly performing state enterprises and monopolies. These reform efforts need to be maintained to consolidate recent economic progress. In *Romania*, large corrections in the fiscal accounts and the exchange rate brought about massive external adjustment in 1999, but at the cost of a further decline in output and higher inflation. The current account deficit more than halved and official reserves were replenished following large debt repayments at midyear, while real GDP contracted by an estimated 4 percent in 1999 (implying a decline of about 15 percent since 1996). A modest turnaround to around 1½ percent growth, together with lower inflation, is projected for 2000, but the outlook is fragile and ongoing international financial support will be required. Sustained recovery will need to be supported by a lasting commitment to fiscal reforms and lower deficits, underpinned by wage restraint, rapid progress with bank restructuring, and much stronger financial discipline in public and private enterprises.

Following the 4½ percent contraction in GDP in 1999, *Turkey* is projected to rebound in 2000. Contributing to this turnaround are an expected recovery in exports and tourism receipts, post-earthquake reconstruction, lower real interest rates, and a general improvement in confidence. But underpinning the strong medium-term outlook is an ambitious IMF-supported program of reforms that should lead to sustainable improvements in the fiscal position, a more credible exchange rate regime, and a rapid reduction in inflation to rates not seen since the 1970s (see Chapter II, Box 2.1). Fiscal measures, most of which have already been enacted, include a significant strengthening in the pension system, reforms to contain the cost of agricultural support programs, and privatization of public utilities and other state enterprises. Anchoring the expected reduction in wage and price inflation is a firm, pre-announced crawling peg for the exchange rate, backed by strict rules regarding domestic base money creation. With Turkey now accepted for the EU accession process, full implementation and consolidation of the reform agenda is now required to secure the improvements in economic strength and stability that such membership would demand.

Middle East and Africa: Stronger But Narrowly Based Growth

The economic prospects of most countries in the Middle East, and several of the larger countries in Africa, have improved significantly over the past year, particularly as a result of higher international oil prices. Although OPEC production quotas have restrained growth in oil output and export volumes, the rapid increase in prices has made a major contribution toward reducing fiscal and current account imbalances in oil-producing countries and has supported a general strengthening of domestic confidence, asset prices, and demand.[3] At the same time, the fluctuations in economic conditions over recent years have again highlighted the need to push ahead with reforms for economic diversification and liberalization in order to promote private-sector-led growth in non-oil areas of their economies. The same reforms are required in non-oil producing countries, many of which are being hit not just by higher prices of oil imports but also by continued weaknesses in export prices of primary goods and other non-fuel commodities.

In the Middle East, relatively strong growth is expected in *Egypt*, underpinned by an environment of low inflation. The external accounts have, however, been under pressure over the past year, reflecting, in part, rapid growth of domestic credit. A tightening of macroeconomic policies, combined with an expected further strengthening of tourism receipts, would help ease these pressures. For Egypt's high rate of growth to be sustained over the medium term, the structural reform effort needs to be reinvigorated. Key reforms should include wide-ranging privatization, trade liberalization (partly under the impetus of the EU partnership agreement and World Trade Organization commitments), tax reform, and a range of measures to improve the business and investment climate. The government of the *Islamic Republic of Iran* has announced a further five-year program of structural reforms, including measures to diversify the economy, support private sector activity, and strengthen the social safety net. Though politically difficult, such reforms are required to reduce macroeconomic imbalances and increase growth to the much higher rates needed to substantially boost living standards and reduce unemployment. *Saudi Arabia* and *Kuwait* are expected to grow by 1–2 percent in 2000, as the recent fiscal and external pressures brought on by low oil prices dissipate. In these countries also, stronger and more robust growth over the medium term would need to be underpinned by measures to boost the non-oil sectors of the economy, especially by expanding the scope for private initiative and investment. Implementation of privatization plans in each country would be an important step in this regard.

Economic growth in Africa is projected to recover to over 4 percent in 2000 after slowing to under 2½ percent in 1999. A rebound of activity in three of the largest economies, *Algeria*, *Nigeria*, and *South Africa*, is expected to lead this recovery, but also significant is the continuing strong performance projected for many of the smaller countries (including *Ghana*, *Tanzania*, *Tunisia*, and *Uganda*). Although past experience points to the risk of policy slippages, several positive factors account for the improved regional prospects. The stronger growth projected for Europe—the major market for many African countries—and for the global economy more broadly is expected to support growth in the volume and prices of African exports. Oil-producing states such as Algeria and Nigeria are benefiting from higher oil prices, while rising non-fuel commodity prices are also helping to reduce imbalances and support activity in a number of countries. Higher metals prices, for example, are contributing to stronger growth in South Africa. However, not all commodity prices are increasing. For example, prices of coffee, tea, and cotton are expected to remain relatively weak, limiting export earnings and growth in many countries, including *Kenya* and Uganda. Agricultural activity in these two countries and others in sub-Saharan Africa was also affected by poor rainfall in 1999, and the torrential rains and flooding that hit *Mozambique* in early 2000 appear likely to lead to slower growth after several years of very strong economic performance.

Underpinning the improved economic prospects for many African economies is the progress that has been made with macroeconomic stabilization, structural adjustment, and political reforms. In South Africa, for example, the fiscal deficit has declined more rapidly than

[3]See Chapter II of this *World Economic Outlook* and Box 1.4 of the October 1999 *World Economic Outlook* for estimates of the impact of higher oil prices on activity, trade, and government revenues of selected oil exporting countries, as well as the effect on growth and inflation among oil importers.

expected, monetary risks have been reduced, and interest rates have fallen, providing a favorable context for the introduction of the planned inflation targeting framework. More broadly, many African countries—with the exception of the conflict-affected regions in the sub-Sahara—have had notable success over recent years in lowering inflation and improving public sector finances. For example, inflation in 2000 is projected to be around 6 percent or less in many countries in the region (see Table 1.5), and only 2 to 3 percent in *Cameroon*, *Côte d'Ivoire*, *Morocco*, and Tunisia. Most of the countries listed in Table 1.5 have also adopted wide-ranging structural adjustment programs, with support from the IMF, World Bank, and regional institutions. These programs typically include the privatization of public enterprises; reductions in subsidies and price liberalization more generally; and the opening up of international trade, including reforms introduced under a range of recent bilateral and multilateral trade agreements (see the October 1999 *World Economic Outlook*). Encouraging political developments include the restoration of a democratically elected government in Nigeria, the consolidation of democratic reforms in South Africa, and the government's efforts in restoring stability in Algeria.

However, with many African economies still facing significant institutional and structural impediments to growth, and continuing to be heavily dependent on agriculture and/or single-commodity exports, reform efforts need to be sustained and expanded in order to broaden the base of economic development and promote private sector initiative and investment. Continued conflicts in the Democratic Republic of the Congo, Angola, and other countries in sub-Saharan Africa, and political uncertainty elsewhere, add to the difficulties of these countries—and probably of the region as a whole—in attracting capital and laying the groundwork for stronger growth. The economic and political challenges facing Africa, particularly to reduce persistently high levels of unemployment and poverty, are discussed further in the following section on Poverty and Globalization, and in Chapter IV on "How Can the Poor Catch Up?" Illustrating these challenges, in South Africa—the largest and arguably the strongest economy—unemployment is currently close to 40 percent (including "discouraged" workers, who have given up looking for work); in Algeria, the second largest economy, it is nearly 30 percent.

Poverty and Globalization

The arrival of the year 2000 is an appropriate time to reflect both on the successes and failures of the past century and on the main challenges lying ahead. Somewhat unusually for a *World Economic Outlook*, Chapter V provides such a long-term view of past and prospective economic developments. A core issue in this regard—and perhaps the most striking exception to the otherwise remarkable economic achievements of the twentieth century—has been the persistent failure to break the cycle of stagnation and poverty in the poorest countries. The global income distribution across countries is somewhat less skewed today than 25 years ago when weighted by population, largely on account of rapid growth in China, as well as in India. But this is no consolation for the large number of very poor (living on a dollar or less per day) that has remained stubbornly high in the range of 1.2 to 1.3 billion—about one-fifth of the world's population. Moreover, per capita incomes have been regressing in absolute terms in a large number of countries during the past 25–30 years. As a result, the world is entering the twenty-first century with the largest divergence ever recorded between rich and poor. The widening income gaps within many countries and the gulf between the most affluent and most impoverished nations are, in the words of the then Managing Director of the IMF, morally outrageous, economically wasteful, and potentially socially explosive.[4]

[4]See Michel Camdessus, "Development and Poverty Reduction: A Multilateral Approach," Address at the Tenth United Nations Conference on Trade and Development, Bangkok, February 13, 2000.

The reasons for poverty are complex and differ from country to country. However, common and often mutually reinforcing causes found in many cases include misguided economic policies, weak institutions, political instability, and recurrent civil unrest and armed conflicts. External factors often contribute to the problem through frequent negative terms-of-trade shocks in commodity exporting countries and a shortage of foreign capital. Also important has been the legacy of support provided during the Cold War era to nonreformist, unaccountable, and often corrupt political leaders. The applications of medical advances, including vaccinations and improvements in water supplies and hygiene, made possible partly through foreign assistance, have played key roles in raising life expectancy in even the poorest countries, although the AIDS pandemic is rapidly reversing these gains in some. In too many cases, however, even generous levels of foreign aid have been unable to put the recipients on a sustainable growth path. Indeed, in some cases aid may even have been counterproductive, to the extent that it may have reduced the incentives for the recipient countries to deal with their problems effectively and allowed governments to divert scarce resources into unproductive areas.

At the same time, experience has shown that flows of foreign aid (including concessional lending) into countries with weak supportive policies often fail to produce positive results. This may be due to a lack of complementary reforms to help make investment projects viable, a propensity of donor countries to favor projects that benefited their own exporters of goods and services more than they met the needs of the recipients, or a propensity of recipient countries to spend on prestigious “white elephant” projects. As a result of the large scale of unprofitable investments as well as loans for unproductive purposes—for example, to finance military purchases—many of the poorest countries have accumulated large debt burdens to official creditors, which they are unable to service. Even with recurrent debt restructurings, these countries have therefore been caught in an unsustainable debt spiral, which has become an obstacle to reform and a barrier to private capital inflows.

On the other hand, where the policy environment is strong, reforms are consistently implemented, and there is a sense of domestic ownership of the reform process, foreign assistance does often play a key supporting role in enhancing growth and reducing poverty and human misery.

The virtual absence of foreign direct investment and other private capital flows into the poorest countries and their apparent inability to compete in increasingly contested world export markets might be interpreted as indications that these countries are casualties of the process of globalization that has marked the final quarter of the twentieth century. The globalized economy has the potential to penalize policy shortcomings very strongly, and this aspect of globalization increases the risk that a poor country becomes (or feels) excluded from the global economic system. As a result, a country’s leaders might stop trying to create the domestic preconditions for economic takeoff, ensnaring the country in a spiral of decline or stagnation. The growing income gap has probably also contributed to cultural and nationalistic backlashes against globalization and the “western” values that are often perceived to be the ideology behind it. Countries that choose to turn their back on the outside world may also consider that they are victims of globalization.

Such rejections of globalization principles are quite rare at a national level, however. These views are not shared, for example, by the many emerging market countries in east Asia and elsewhere that have successfully integrated their economies into the global trading system. Even among countries that are less well integrated, the overall trend in most cases is toward a greater rather than lesser degree of trade and financial liberalization. Rather, the most vocal critics of globalization are often found among advocates of developing countries who come from the advanced countries.

Retreats from globalization are very costly and are especially harmful for the poor. This is clearly suggested by the experience of the twentieth century. When world trade and cross-border investments spiraled downward in the 1930s, all regions, including those comprising developing countries, suffered badly. Similarly, in the 1970s and 1980s, much of Latin America and Africa paid a high price through resource misallocation, hyperinflation, financial instability, and mediocre growth as a result of inward-oriented, protectionist economic policies. In contrast, during the past 40 years, outward-oriented, growth-oriented policies have transformed much of east Asia from one of the poorest areas in the world to the most dynamic. This success would have been unthinkable without access to, and progressive integration with, world markets. The recent financial crises in no way change this conclusion; they have only underscored that globalization both increases a country's economic opportunities and adds to demands on its economic policies and institutions to contain the risk and impact of external shocks.

Rather than being a problem, globalization—through the opportunities it offers—is an indispensable part of the solution. Indeed, when poor countries do begin to seriously tackle their institutional and policy deficiencies they, too, have the potential to benefit from foreign direct investment, higher export growth, and from an easing of financing constraints that will allow them to grow at higher and more robust rates. Recent examples of poor countries that bucked the trend, at least for a period, include Botswana, Côte d'Ivoire, Mauritius, Mozambique, Senegal, Uganda, and Vietnam.

Sustained progress has, however, eluded many countries, and much stronger efforts are required by the poorest countries themselves and also by the international community. The policy priorities among the poorest countries include the mutually reinforcing objectives of:

- Fostering macroeconomic stability through prudent fiscal and monetary policies and the adoption of sustainable exchange rate regimes;
- Harnessing market forces for development by liberalizing external trade and payments; removing price controls, subsidies, and other distortions in domestic markets; subjecting public enterprises to market discipline; strengthening financial and legal systems; and combating corruption;
- Improving the quality of government by reducing wasteful public sector outlays; raising expenditures on basic education, health care, and essential infrastructure; putting in place tax and transfer systems that are efficient and equitable; and promoting transparency and accountability in government operations; and
- Promoting domestic ownership of the reform agenda through closer involvement of unions, employers' organizations, and other representatives of civil society in the design of reforms.

For the international community, a priority task is to address the debilitating debt problem with greater resolve. Moreover it is essential to quickly reverse the downward trend in some advanced countries' official development assistance and to ensure that development aid is used more effectively—for example, by strengthening incentives for reform in the recipient countries.

The advanced countries also need to reform their trade policies in areas that discriminate against the poorest countries. This particularly concerns import restrictions on agricultural products and textiles, and agricultural subsidies in various forms that lead to recurrent problems of overproduction. These production distortions have added to the downward pressure on world food prices, eroded the competitiveness of many farmers in the poorest countries, reduced the scope of these countries for exporting food, and made many of them excessively dependent on food imports. A solution to these distortions is long overdue, with the advanced countries needing to introduce new ways to support agricultural incomes at home that do not jeopardize the global fight against poverty. Similar considerations apply to trade in textiles and other products in which poor countries often have a comparative advantage but where trade liberalization remains incomplete and market access limited.

As part of its contribution to the global antipoverty effort, the IMF has replaced its concessional facility, the ESAF, with a broader focused Poverty Reduction and Growth Facility (PRGF). The new facility seeks to strengthen the mutually reinforcing relationship between macroeconomic stability and structural reform on the one hand, and growth and reduction of poverty and inequality on the other. It emphasizes the need for the poorest countries to assume ownership of their poverty reduction strategies. At the same time, the enhanced initiative for the Heavily Indebted Poor Countries (HIPCs) will provide large-scale debt relief to eligible countries that adopt the needed reforms. The new approach is based on the closest possible collaboration between the IMF and the World Bank.

It is encouraging that eliminating the excess debt burden of the poorest countries is now widely acknowledged to be a necessary condition to strengthen prospects for robust growth and to alleviate poverty. However, it would be a serious mistake to believe that this would be a cure-all for these countries' problems. And it would be particularly dangerous to think that simply removing the debt burden would automatically ensure that social needs, such as improving health care, education, and social safety nets, will be much better met. Rather, if these improvements are to be realized, comprehensive reforms still need to be adopted, as emphasized above, combined with adequate flows of well-targeted foreign aid. The crucial difference is that with meaningful debt reduction, undertaken in a strong policy framework with the support of civil society, these reforms and higher levels of foreign aid stand a better chance of success.

Moreover, many elements of the reform strategy that needs to be pursued in the poorest countries are also relevant for other emerging economies—for example, in south Asia and Latin America—where per capita incomes are higher on average, but where a sizable proportion of the population is still enmeshed in poverty. While these countries may not be eligible for the latest debt reduction initiative, they would nevertheless benefit substantially from other forms of support from advanced countries, notably reductions in trade protection and increased development assistance. But, as in the poorest countries, the key conditions that are needed to make significant and sustainable inroads on poverty lie within the ambit of *domestic* policies. These include macroeconomic stability, trade liberalization, removal of distortions in domestic markets, improvements in the quality of government, and measures directly aiming at improving income distribution. In strengthening the economic foundations needed for sustained growth, such measures would also provide these countries with greater scope for meeting social needs and alleviating extreme poverty.