# CHAPTER I PROSPECTS AND POLICY CHALLENGES

Since the publication of the October 2000 *World Economic Outlook*, the prospects for global growth have weakened significantly, led by a marked slowdown in the *United States*, a stalling recovery in *Japan*, and moderating growth in Europe and in a number of emerging market countries. Some slowdown from the rapid rates of global growth of late 1999 and early 2000 was both desirable and expected, especially in those countries most advanced in the cycle, but the downturn is proving to be steeper than earlier thought. Given the rapid policy response by the U.S. Federal Reserve and a number of other central banks, and with most advanced countries—with the important exception of Japan—having considerable room for policy maneuver, there is a reasonable prospect that the slowdown will be short-lived. However, the outlook remains subject to considerable uncertainty and a deeper and more prolonged downturn is clearly possible. Against this background, macroeconomic policies—particularly on the monetary side—will need to be proactive to guard against the possibility of a steeper than expected downturn.

Given the strength of activity in early 2000, and with the signs of greater than expected weakening coming late in the year, global output in 2000 grew an estimated 4.8 percent, very close to the projection in the last *World Economic Outlook* (Table 1.1 and Figure 1.1). However, activity in 2001 will slow markedly, with global growth now projected at 3.2 percent, 1 percentage point lower than earlier expected. Within this, GDP growth in the United States has been revised downward by 1.7 percentage points to 1.5 percent, the lowest level for a decade. Growth projections have also been marked down significantly in the other major currency areas. Activity in Europe should nonetheless remain reasonably robust, but in Japan growth is projected to fall to 0.6 percent. In emerging markets, the revisions to the outlook vary, depending in part on the closeness of linkages with the United States. Growth has been marked down substantially in emerging *Asia* and *Latin America*—although activity in *China* and *India* is expected to remain relatively well sustained, providing an important source of stability. In contrast, most countries in the *Middle East, Central and Eastern Europe, the Commonwealth of Independent States* and *Africa* have been less affected, although growth in *Turkey* is likely to decline sharply as a result of the recent crisis.

Some slowdown in global growth from the very high rates of late 1999 and early 2000 had been long anticipated by most forecasters. By the end of 2000, activity—particularly in the United States—was clearly weakening significantly (Box 1.1). This was in part the result of the appropriate earlier tightening of monetary policy in the United States to address rising demand pressures; and during most of the second half of the year policies appeared broadly on track to achieve this through a moderation in the pace of economic advance. As experience over the past several decades has shown, however, soft landings are not easy to achieve. In the event, a series of shocks—including higher energy prices; a reassessment of corporate earnings prospects, accompanied by a sharp fall in equity markets, particularly of technology stocks, and slowing growth in the technology sector; and a tightening of credit conditions—appear to have combined to generate a marked slowdown in domestic demand growth, and a sharp weakening in consumer and business confidence (Figure 1.2).

The further setback to the already fragile recovery in Japan is an additional source of concern. Following very strong growth in the first quarter of 2000 (partly due to temporary factors), activity appears to have stagnated, weighed down by weak consumer confidence, slowing business investment, and weakening external de-

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

*(Annual percent change unless otherwise noted)*

| | | | Current Projections | | Difference from October 2000 Projections[1] | |
|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 2000 | 2001 |
| **World output** | **3.5** | **4.8** | **3.2** | **3.9** | — | **–1.0** |
| Advanced economies | 3.4 | 4.1 | 1.9 | 2.7 | –0.1 | –1.3 |
| Major advanced economies | 3.0 | 3.8 | 1.6 | 2.4 | –0.1 | –1.3 |
| United States | 4.2 | 5.0 | 1.5 | 2.5 | –0.2 | –1.7 |
| Japan | 0.8 | 1.7 | 0.6 | 1.5 | 0.3 | –1.2 |
| Germany | 1.6 | 3.0 | 1.9 | 2.6 | 0.1 | –1.4 |
| France | 3.2 | 3.2 | 2.6 | 2.6 | –0.3 | –0.9 |
| Italy | 1.6 | 2.9 | 2.0 | 2.5 | –0.2 | –1.0 |
| United Kingdom | 2.3 | 3.0 | 2.6 | 2.8 | –0.1 | –0.2 |
| Canada | 4.5 | 4.7 | 2.3 | 2.4 | — | –0.5 |
| Other advanced economies | 4.8 | 5.2 | 3.0 | 3.8 | 0.1 | –1.2 |
| *Memorandum* | | | | | | |
| European Union | 2.6 | 3.4 | 2.4 | 2.8 | — | –0.9 |
| Euro area | 2.6 | 3.4 | 2.4 | 2.8 | –0.1 | –1.0 |
| Newly industrialized Asian economies | 7.9 | 8.2 | 3.8 | 5.5 | 0.3 | –2.3 |
| Developing countries | 3.8 | 5.8 | 5.0 | 5.6 | 0.1 | –0.7 |
| Africa | 2.3 | 3.0 | 4.2 | 4.4 | –0.5 | –0.2 |
| Developing Asia | 6.1 | 6.9 | 5.9 | 6.3 | 0.2 | –0.7 |
| China | 7.1 | 8.0 | 7.0 | 7.1 | 0.5 | –0.3 |
| India | 6.6 | 6.4 | 5.6 | 6.1 | –0.3 | –0.9 |
| ASEAN-4[2] | 2.8 | 5.0 | 3.4 | 4.7 | 0.5 | –1.6 |
| Middle East, Malta, and Turkey | 0.8 | 5.4 | 2.9 | 4.6 | 0.5 | –1.2 |
| Western Hemisphere | 0.2 | 4.1 | 3.7 | 4.4 | –0.2 | –0.8 |
| Brazil | 0.8 | 4.2 | 4.5 | 4.5 | 0.2 | — |
| Countries in transition | 2.6 | 5.8 | 4.0 | 4.2 | 0.6 | –0.2 |
| Central and eastern Europe | 1.8 | 3.8 | 3.9 | 4.4 | — | –0.7 |
| Commonwealth of Independent States and Mongolia | 3.1 | 7.1 | 4.1 | 4.1 | 1.1 | 0.1 |
| Russia | 3.2 | 7.5 | 4.0 | 4.0 | 0.5 | — |
| Excluding Russia | 2.7 | 6.3 | 4.2 | 4.4 | 2.4 | 0.3 |
| **World trade volume (goods and services)** | **5.3** | **12.4** | **6.7** | **6.5** | **2.4** | **–1.1** |
| Imports | | | | | | |
| Advanced economies | 7.9 | 11.4 | 6.7 | 6.5 | 1.1 | –1.2 |
| Developing countries | 1.6 | 16.9 | 8.8 | 7.9 | 6.9 | –0.3 |
| Countries in transition | –7.3 | 13.3 | 8.6 | 6.9 | 0.9 | 0.2 |
| Exports | | | | | | |
| Advanced economies | 5.0 | 11.4 | 6.2 | 6.2 | 1.5 | –1.4 |
| Developing countries | 4.1 | 15.7 | 7.1 | 7.0 | 6.8 | — |
| Countries in transition | 0.6 | 14.9 | 4.6 | 5.1 | 4.8 | –1.4 |
| **Commodity prices** | | | | | | |
| Oil[3] | | | | | | |
| In SDRs | 36.5 | 62.6 | –7.7 | –11.9 | 10.6 | 5.3 |
| In U.S. dollars | 37.5 | 56.9 | –9.6 | –11.8 | 9.4 | 3.7 |
| Nonfuel (average based on world commodity export weights) | | | | | | |
| In SDRs | –7.8 | 5.5 | 2.6 | 4.4 | –0.9 | –2.2 |
| In U.S. dollars | –7.1 | 1.8 | 0.5 | 4.5 | –1.4 | –4.0 |
| **Consumer prices** | | | | | | |
| Advanced economies | 1.4 | 2.3 | 2.1 | 1.8 | — | — |
| Developing countries | 6.7 | 6.1 | 5.7 | 4.8 | — | 0.6 |
| Countries in transition | 43.9 | 20.1 | 15.3 | 10.0 | 1.6 | 2.5 |
| **Six-month London interbank offered rate (LIBOR, percent)** | | | | | | |
| On U.S. dollar deposits | 5.5 | 6.7 | 4.5 | 4.3 | –0.2 | –2.9 |
| On Japanese yen deposits | 0.2 | 0.3 | 0.3 | 0.5 | 0.1 | –0.1 |
| On euro deposits | 3.0 | 4.6 | 4.4 | 4.1 | — | –0.7 |

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during February 19–March 16, 2001.
[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 $28.21 in 2000; the assumed price is $25.50 in 2001 and $22.50 in 2002.

mand, while deflation has persisted. Activity in 2001 will be helped by policy initiatives, including the November 2000 fiscal stimulus package and the recent shift to a new monetary framework, as well as the depreciation of the yen since late 2000, but business investment and exports appear to be weakening and there is as yet little sign of a pickup in consumer confidence, which is essential to underpin a sustained recovery, or in bank lending. Moreover, with limited room for policy maneuver and continued fragilities in the financial and corporate sectors, the economy remains vulnerable to additional shocks.

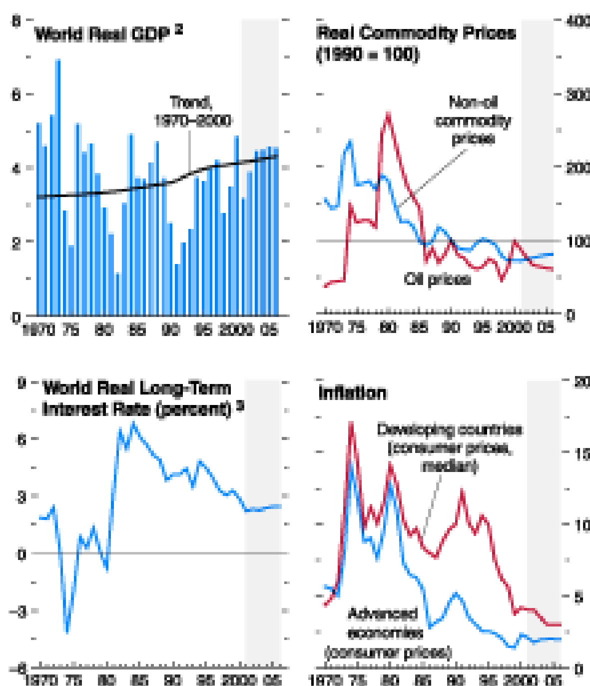
In an environment of slowing global growth, commodity prices are expected to weaken (Appendix I). Oil prices have retreated from their late 2000 high, and—while their continued volatility remains a concern and much continues to depend on the production decisions of the Organization of the Petroleum Exporting Countries (OPEC) in coming months—the risks may now be on the downside. Nonfuel prices are expected to remain broadly unchanged, in part reflecting the continued strength of the dollar; however, if global demand slows more than expected, prices would likely weaken, adversely affecting commodity producers, including many poor countries. As oil prices fall back, headline inflation in most industrial countries has begun to stabilize and—with wage increases moderate—underlying inflation remains generally subdued. Inflation remains a concern in some faster growing European countries and in a number of developing and transition countries, but, in general, inflationary risks do not materially circumscribe policymakers' freedom of action at this stage.

In financial markets, after a respite in January 2001 the fall in U.S. equity markets accelerated through early April in the face of continued weak earnings reports, with additional sharp declines in the technology sector and in broader market indices, although sentiment has since stabilized and, as the *World Economic Outlook* went to press, equity prices rebounded in the initial aftermath of the latest cut in U.S. interest rates. Weakness in U.S. equity markets has been mirrored in other mature markets, and broader eq-

**Figure 1.1. Global Indicators**[1]

*(Annual percent change unless otherwise noted)*

Global growth is projected to slow markedly in 2001, while inflation remains subdued.




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

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

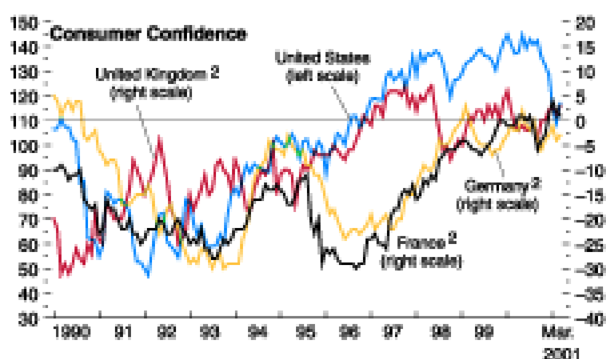
[3]GDP-weighted average of 10-year (or nearest maturity) government bond yields less inflation rates for the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada. Excluding Italy prior to 1972.

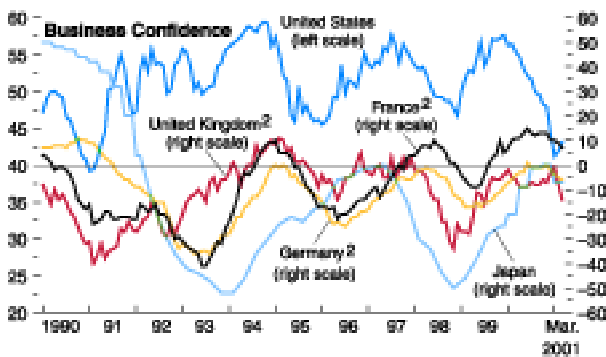
uity indices have fallen back significantly from earlier peaks (Figure 1.3). Increased expectations of a U.S. slowdown, along with tightening bank lending standards, falling corporate profits, the global downgrading of the technology sector, and a pickup in default rates, have also reduced investors' appetite for risk taking. Although long term government bond yields have fallen—in part also reflecting buybacks and expected Federal Reserve interest rate easing—corporate credit spreads have widened since last summer, and there is much greater differentiation in spreads between risk classes, notably in the high yield market (although high yield rates have fallen back somewhat following the cuts in U.S. interest rates). In currency markets, the euro has strengthened only modestly against the U.S. dollar since its low in October 2000, and still appears undervalued in terms of medium-term economic fundamentals (see Chapter II). As concerns about the sustainability of the Japanese recovery have intensified, the yen has weakened significantly to about its mid-1999 level.

As a result of developments in mature markets, the environment faced by emerging markets has changed for the worse.[1] As technology valuations in mature markets declined, emerging equity markets fell back sharply, in a number of cases also reflecting increased investor concerns about domestic and external risks. In tandem with developments in U.S. high yield paper—widely regarded as a competing asset class—spreads on emerging market bonds widened in the last quarter of 2000, and financing conditions tightened markedly, exacerbated by crises in Argentina and Turkey. Following the cuts in U.S. interest rates in January, emerging equity markets initially strengthened and financing conditions improved, permitting a number of countries to cover a substantial proportion of their annual public sector external financing requirement. However, in parallel with developments in mature markets, equity prices subsequently fell back

**Figure 1.2. Selected European Union Countries, Japan, and United States: Indicators of Consumer and Business Confidence[1]**

Confidence has fallen back markedly in the United States; in Europe, business confidence has also weakened, although consumer confidence remains reasonably well-sustained.




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; and 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.

[1]See the IMF's February 2001 *Quarterly Emerging Markets Financial Report* (*http://www.imf.org/external/pubs/ft/emf/index.htm*) for a more detailed discussion.

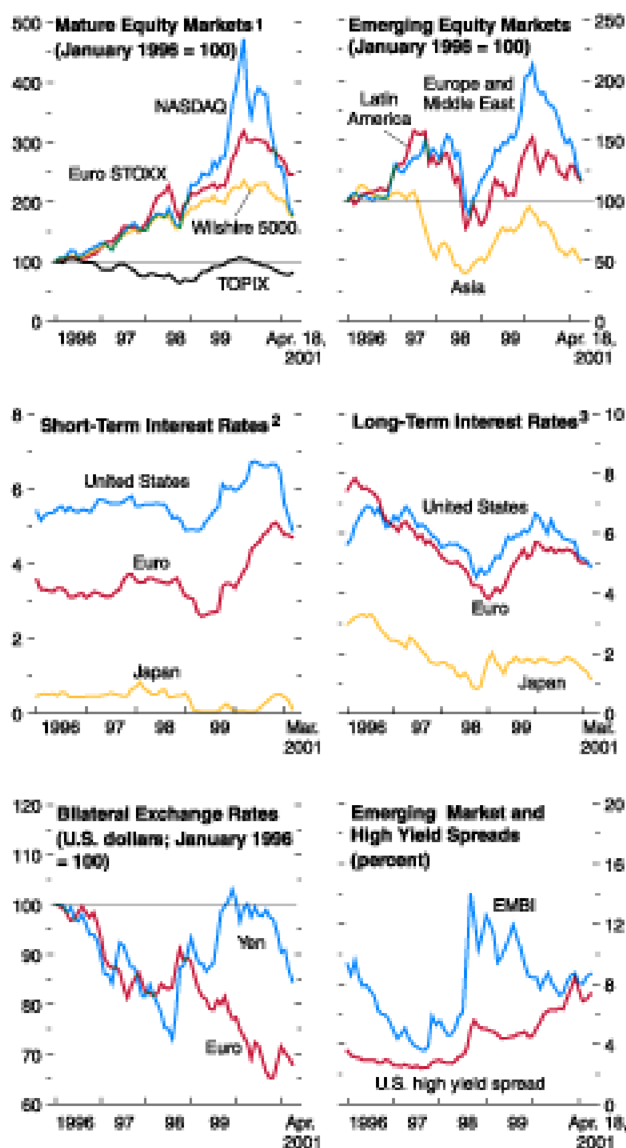
and financing conditions deteriorated (although both have stabilized recently). Spillover effects from the renewed financial crisis in Turkey, culminating in the floating of the Turkish lira in mid-February, have so far been limited, but economic difficulties in Argentina appear to have had more of an impact, particularly on spreads in neighboring countries.

To date, the effects of the global economic slowdown have been seen primarily in those countries with close trade ties to the United States, including Canada and Mexico, and emerging Asia. In Canada and Mexico, the effect will be partly cushioned by solid domestic demand growth; in emerging Asia, where confidence had already been weakened by a variety of domestic and external factors, the impact may be more substantial and would be compounded by a larger-than-expected deterioration in Japan. In other countries, where a key concern is the impact through financial markets and the knock on effects through consumer and business confidence, the effects have as yet been more moderate, although important risks remain. However, looking forward to the remainder of 2001, much will depend on how deep and prolonged the slowdown in the United States proves to be. This remains subject to considerable uncertainty. However, there are a number of reasons to believe that the slowdown may be relatively moderate and short-lived:

- First, long-term interest rates in the United States have fallen during 2000 and, more recently, short-term rates have been cut significantly. This should begin to have a direct effect on U.S. activity in the second half of the year, providing support to the global economy, although the pace of this recovery may be slowed by the recent further decline in equity prices. Lower oil prices will also be helpful.
- Second, with inflationary risks receding, policymakers in most advanced economies have substantial room to maneuver, which some countries, most notably the United States, but also including Australia, Canada, and the United Kingdom, have begun to

**Figure 1.3. Financial Market Developments**

Notwithstanding lower interest rates, mature and emerging equity markets continued to decline through early April, driven by the fall in the NASDAQ. The euro has modestly appreciated against the U.S. dollar, while the yen has fallen back on rising concerns about the sustainability of the Japan's recovery.




Sources: Bloomberg Financial Markets, LP; European Central Bank; IMF Treasurer's Department, Nikkei Telecom; and WEFA, Inc.

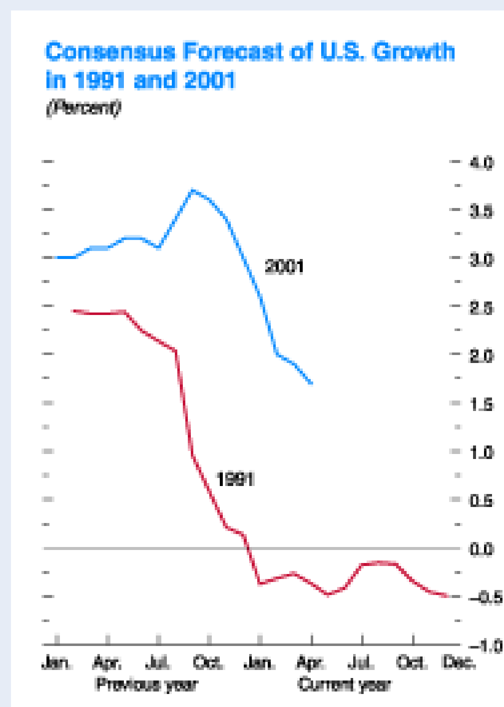
[1] Average of the month.

[2] Three month deposit rate; euro area data prior to January 1999 reflect Germany.

[3] Ten-year government bond rate. To December 1998, euro area yields are calculated on the basis of harmonized national government bond yields weighted by GDP. Therefore, the weights are nominal outstanding amounts of government bonds in each maturity band.

## Box 1.1. How Well Do Forecasters Predict Turning Points?

The rapid change in the U.S. economic outlook has taken most people by surprise, with the Consensus forecast for real GDP growth in 2001 falling from 3.7 percent in September 2000 to 1.7 percent in April 2001, the most rapid adjustment in expectations since the early 1990s when the United States entered its last recession (see the first figure). As much previous work has indicated, the failure to predict major slowdowns or contractions in activity has been a notable feature of forecasts of the U.S. economy for many years.[1] A recent paper reviews the experience with forecasts of a broad sample of advanced and emerging economies during the 1990s, based on the projections published in the private sector Consensus Forecasts.[2] It finds that, in April of the year before a recession year (defined as a year of negative real GDP growth), the Consensus mean forecast—averaged across the 60 episodes of recessions—was for 3 percent growth (see the second figure). By October, the mean forecast had been trimmed to about 2 percent, with a further trimming down to zero by April of the year of the recession. These downward revisions suggest that forecasters were clearly aware a slowdown was in progress. By October, the forecasts catch up with the reality of a recession, but still underestimate the actual decline.[3] A similar pattern is observed around business cycle troughs—forecasters are initially slow to adjust their projections, but then steadily adjust their forecasts upward to catch up to the reality of an upturn. As the paper also notes, since errors in official and the Consensus forecasts are highly correlated, such problems are not confined to the private sector.[4]



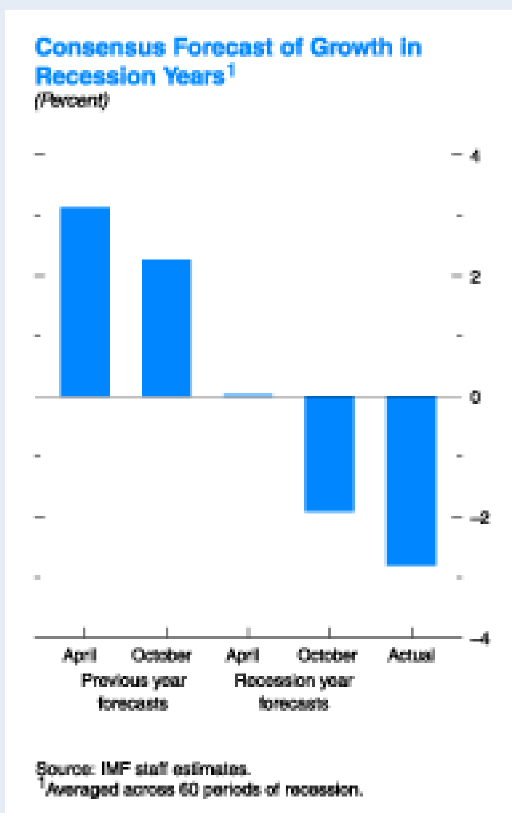

This evidence on the difficulties forecasters experience in predicting recessions highlights several points. First, identifying recessions is a complex task, even when they are occurring. This is why most recessions are determined to be such after the event, not during it. Even more important, the upward bias in projections is what would be expected if one focuses only on periods of recession. A forecaster needs to assess the probability of an outright recession against

[1]See for example, Victor Zarnowitz, "The Record and Improvability of Economic Forecasting," NBER Working Paper No. 2099 (Cambridge, Mass.: National Bureau of Economic Research, July 1987); and David Fintzen and H.O. Stekler, "Why Did Forecasters Fail to Predict the 1990 Recession," *International Journal of Forecasting*, Vol. 15 (July 1999), pp. 309–23.

[2]Prakash Loungani, "How Accurate Are Private Sector Forecasts? Cross Country Evidence from Consensus Forecasts of Output Growth," *International Journal of Forecasting* (forthcoming).

[3]The "actual" values used here are initial estimates, taken wherever possible from the May *World Economic Outlook* of the following year. These initial estimates are used in preference to final GDP data, which often reflect data revisions, re-benchmarking, and other such unforecastable changes.

[4]An earlier study of *World Economic Outlook* forecasts also found that they had substantially the same errors as private sector forecasts. See Michael Artis, "How Accurate are the IMF's Short-Term Forecasts? Another Examination of the World Economic Outlook," in *Staff Studies for the World Economic Outlook* (Washington: International Monetary Fund, December 1997).




Source: IMF staff estimates.
[1]Averaged across 60 periods of recession.

that of a more mild slowing of activity. Hence, one would expect growth over episodes of recession to be systematically over predicted—essentially, a worse-than-expected outcome does indeed occur when an economy moves into a recession.

However, the fact that forecasters tend to make steady upward or downward revisions to their projections—not just over recessions, but more generally—raises the question of whether forecasts themselves are efficient. As noted cogently by William Nordhaus:

> If I could look at your most recent forecasts and accurately say, "Your next forecast will be 2 percent lower than today's," then you can surely improve your forecast.[5]

Why might forecasters violate notions of forecast efficiency and prefer to adjust their forecasts in a smooth manner toward the actual? Nordhaus suggests two reasons: fear that "jumpy" or "jagged" forecasts will be treated as signs of inconsistency; and that forecasters tend to stay away from issuing "outlier" forecasts—a strategy that works well in most years since outliers are, by definition, rare events.[6] In addition, reported headline forecasts may not capture shifts in the weights the forecaster attaches to different scenarios, which could change significantly. To the extent that this is the case, such behavior can make the revisions in the Consensus forecast smooth and also guide it away from outlying values and indeed in some instances toward convergence to a forecast value that is far from the actual value.

While this is difficult to test for, in particular because Consensus forecasts by their nature contain a degree of serial correlation, preliminary evidence suggests forecasts may indeed contain a degree of inefficiency.[7] Hence there may be room to improve the Consensus forecasts by adjusting for the degree of serial correlation in forecast revisions in the past (on the other hand, preliminary analysis indicates that the dispersion of forecasts tends to rise only when the level of the forecast has started to fall significantly). For example, a simple correction applied to U.S. growth projections from the Consensus forecasts over the period 1990 to 2000 would reduce the mean absolute error of

[5]William D. Nordhaus, "Forecasting Efficiency: Concepts and Applications," *The Review of Economics and Statistics*, Vol. 69 (November 1987), pp 667–74.

[6]Indeed, a recent study finds that individual forecasters tend to conform to the mean (consensus) forecasts; in particular, an individual's forecast is strongly influenced by the consensus forecast of the previous month. See Giampiero Gallo, Clive Granger, and Yongil Jeon, "The Impact of the Use of Forecasts in Information Sets," Working Paper No. 99-18 (San Diego: University of California at San Diego, Department of Economics, August 1999).

[7]Serial correlation is particularly likely in averages of forecasts, because the individual projections may have been made at different times. Even if the individual forecasts do not contain serial correlation, averaging forecasts of different vintages will cause serial correlation.

**Box 1.1 *(concluded)***

the forecast by nearly 10 percent, and similar effects appear to be true of other major economies.[8] As forecasters become more aware of this bias, it is to be hoped that forecasts themselves will become more efficient and this serial correlation will be eliminated.

[8]For this illustration, the corrected forecast is obtained by adding to the recent forecast a multiple of the revision in the forecast made six months ago. The multiple depends on the relationship between past forecast errors and past forecast revisions. For details, see Oliver Kim, Steve C. Lim and Kenneth W. Shaw, "The Use of Forecast Revision in Reducing Built-in Biases in Mean Analyst Forecasts," *Journal of Accounting Research* (forthcoming). The procedure could in principle be generalized to account for more than two forecasts and possible differences in the adjustment factor depending on the stage of the business cycle.

use; Japan, where the scope for adjustment is much less, has also moved to ease monetary policy in the context of its new monetary framework. Moreover, given the substantial strengthening in fiscal positions in recent years (see Chapter III), most countries have room for fiscal easing as a second line of defense, or have already moved to somewhat easier fiscal stances.

- Third, while a number of countries continue to face serious difficulties, external and financial vulnerabilities in emerging markets have been generally reduced since the 1997–98 crises, and the shift away from soft exchange rate pegs has improved their ability to manage external shocks (Figure 1.4). (See Chapter IV.)

Against this background, the *World Economic Outlook's* baseline scenario projects that activity in the United States picks up during the second half of the year, while growth in Europe remains reasonably robust, and the recovery in Japan resumes in 2002. In emerging markets, external financing conditions would gradually improve during the remainder of the year, consistent with a modest pickup in private capital flows. While global growth in 2001 would still slow significantly, it would remain well above earlier troughs and return to close to trend in 2002.

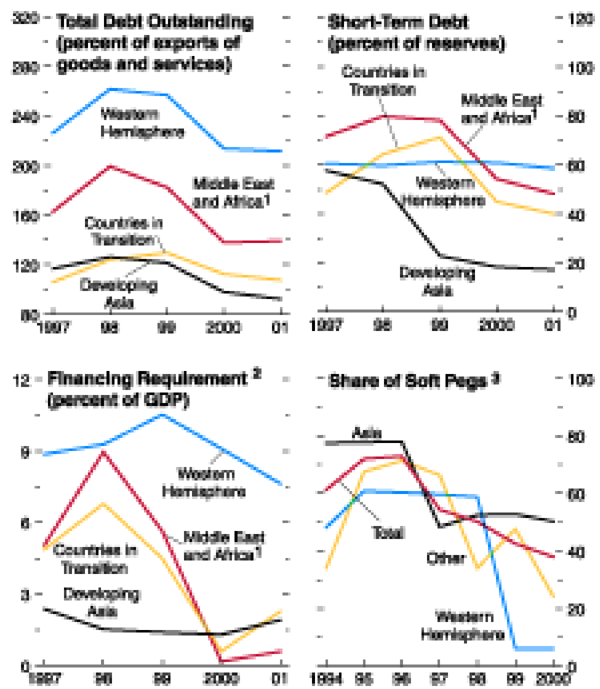
This scenario is certainly plausible, but it is far from assured. On the positive side, if confidence were to rebound quickly, it is possible that the pickup in the United States—and therefore in the global economy—could be more rapid than presently projected. However, with equity markets weak, the risks of a less favorable outcome are clearly significant. Experience suggests that when turning points are reached, the shift in momentum is often more pronounced than previously expected. As has been highlighted in many previous editions of the *World Economic Outlook*, this may be particularly the case given the substantial imbalances that have developed during the expansion, including the high current account deficit and the apparent overvaluation of the U.S. dollar, the negative personal saving rate, and—despite recent declines—equity markets that are still richly valued by historical standards. These imbalances are closely linked to expectations of continued strong productivity growth in the United States relative to other countries; and the extent, manner, and speed with which they unwind will depend on how those expectations evolve in a climate of slowing growth. In this connection, one risk is that the virtuous "new economy" circle of rising productivity, rising stock prices, increased access to funding, and rising technology investment that contributed to the strong growth in the 1990s (see Chapter II) could go into reverse.

If the slowdown in the United States were to prove deeper and more prolonged, this would pose several interlinked risks for the global outlook that would significantly increase the chance of a more synchronized and self-reinforcing downturn developing:

- First, over the past several years, the strong expansion in the U.S. economy has been instrumental in stabilizing global activity in the face of weak demand elsewhere. Unfortunately, with the recovery in Japan stalling, and potential growth in Europe still modest, the present slowdown in the United States is unlikely to be offset by higher demand growth elsewhere. In these circumstances there would be a greater risk of spillovers to other countries through financial market and confidence effects. The global economy would also become more vulnerable to adverse shocks, such as a sharper-than-expected weakening of activity in Japan.
- Second, as discussed extensively in recent issues of the *World Economic Outlook*, there would be a greater risk that the current account imbalances in the major currency areas, and the apparent misalignments among the major currencies, could unwind in a disorderly fashion. Historical experience suggests that current account deficits of the size that presently exists in the United States have not been sustained for long, and that adjustment is generally accompanied by a significant depreciation. Since the projections in the *World Economic Outlook*, like those of many other forecasters, assume constant real exchange rates, the baseline scenario shows relatively little change in global current account imbalances. As discussed in Appendix II, in a scenario allowing for a gradual adjustment in exchange rates—as has most often been the case in past episodes—these imbalances could adjust in a relatively manageable and nondisruptive fashion, especially if accompanied by stronger growth in Europe and Japan. However, in an environment where U.S. growth slows sharply, the portfolio and direct investment flows that have been financing the U.S. current account deficit could adjust more abruptly. This would heighten the risk of a more rapid and disorderly adjustment, possibly accompanied by financial

**Figure 1.4. External Vulnerabilities in Developing Countries**

External vulnerabilities have generally declined since the 1997–98 crises, although debt and financing requirements in Latin America remain high, and there has been a general shift toward hard pegs and/or more flexible exchange rate regimes.




[1]Including Malta and Turkey.
[2]Current account balance plus total amortization due.
[3]Defined as percentage of countries (weighted by purchasing-power-parity GDP) that have a fixed but adjustable exchange rate regime. Covers the major emerging market countries in each region; based on Stanley Fischer, "Exchange Rate Regimes: Is the Bipolar View Correct?" Distinguished Lecture on Economics in Government, AEA Meetings, January 2001 (available at www.imf.org).

market turbulence in both mature and emerging markets. Large swings in exchange rates could also limit the room for policy maneuver.
- Third, given that financial risks often tend to be underestimated in periods of rapid expansion, lower growth could expose fragilities in financial markets. Further downward revisions to expectations of corporate profit growth could intensify pressures on equity markets in the United States and elsewhere, with adverse effects on wealth, investment, confidence, and risk aversion—which would also directly affect demand for emerging market assets. Slower growth would also add to pressures on financial and corporate sectors, particularly in those countries where significant weaknesses remain.

To illustrate these risks, the *World Economic Outlook* also includes a "harder landing" scenario, based on the assumption of a further significant fall in U.S. equity valuations and in consumer and investor confidence in the United States and Japan, associated with a substantial and abrupt depreciation of the U.S. dollar against other currencies. As a result of the abrupt changes in financial market valuations and loss of confidence, the rebalancing of global demand is accompanied by a significant, generalized slowdown in output. Compared to the baseline scenario, global output falls by slightly over 1 percentage point through 2001 and 2002, with the impact varying from 1½ percentage points in the United States to 1 percentage point in other advanced countries. In developing countries, the impact is about one-half of that for the global economy, largely reflecting the fall in demand for net exports, but could be significantly larger if external financing conditions deteriorated sharply. Overall, this would result in a global slowdown broadly comparable to that experienced in 1998. Were the financial weakness to occur but the U.S. dollar depreciation to be delayed, the output loss would be larger in the United States as the increase in net exports would be more limited, and conversely the output losses in other advanced economies would be smaller.

Recent issues of the *World Economic Outlook* have called for policies in the main currency areas to be consistent with a rebalancing of growth and demand among the three main currency areas, supportive of an orderly resolution of global imbalances. This process is now clearly under way; however, it is taking place entirely through lower growth in the United States, with activity elsewhere doing little to offset this decline. With inflationary pressures easing, and downside risks to activity more pronounced, a proactive approach to macroeconomic policies is required, aimed at supporting a reasonably smooth transition to more sustainable growth rates in the United States; strengthening the expansion in Europe; and reenergizing the stalling recovery in Japan:
- In the United States, the aggressive reduction in interest rates that began in January has been appropriate. Monetary policy should remain the first line of defense, and further interest rate cuts may be needed in coming months. Moderate and relatively front loaded tax cuts could also provide useful support to activity, while minimizing the adverse impact on savings and the current account over the medium term.
- In Japan, the new monetary framework introduced in March, including the commitment to maintain it until inflation turns positive, is welcome and should be aggressively implemented. Given the very high level of public debt, the gradual fiscal consolidation under way should be maintained, with fiscal easing a last resort to forestall outright recession. However, the main policy requirement is to vigorously address underlying structural weaknesses, particularly in the financial sector, while seeking, to the extent possible, to minimize the adverse short-term impact on growth. The recently announced package of structural measures is a welcome step forward, but it will need to be implemented forcefully and supplemented with other steps.
- In the *euro area*, with increasing signs that activity is slowing, and underlying inflationary pressures expected to ease looking forward,

there is scope for a moderate downward adjustment in interest rates; and the European Central Bank (ECB) will need to move rapidly if signs of weakness become more accentuated or the euro appreciates sharply. Recent tax cuts, fortuitously timed from a cyclical perspective, will also help support activity in some countries and at this point no additional fiscal stimulus appears necessary beyond the automatic stabilizers. A more ambitious approach to structural reform, notably in labor markets, pensions, and health, is needed to raise potential growth and to ensure long-run fiscal sustainability.

- In *emerging markets*, prospects depend critically on maintaining investor confidence. External financing conditions have recently deteriorated and, given the uncertain global outlook and continued economic difficulties in some emerging market countries, are likely to remain volatile in the period ahead. This underscores the need to maintain prudent macroeconomic policies and to press ahead with corporate, financial, and—especially in the transition economies—institutional reforms, particularly in those countries that lag in this process.

The slowdown in global growth will clearly hurt the poor, both directly and through lower commodity prices, although the impact may be mitigated by the fact that two-thirds of the poorest live in south Asia and China, where activity is expected to remain relatively strong. In a number of the poorer countries, debt relief under the Enhanced Heavily Indebted Poor Country (HIPC) Initiative will release substantial resources to finance anti-poverty measures; provided those resources are used efficiently and are supported by comprehensive reform programs, this will help reduce poverty and boost growth over the medium term. To assist these efforts, the advanced economies have a special responsibility to increase aid flows, which are well below the United Nations' target of 0.7 percent of GDP; to promote peace and political stability, particularly in the war-torn regions of Africa; and to provide further assistance to fight the spread of the HIV/AIDS epidemic, which has become the most serious threat to human welfare and economic development on the African continent.

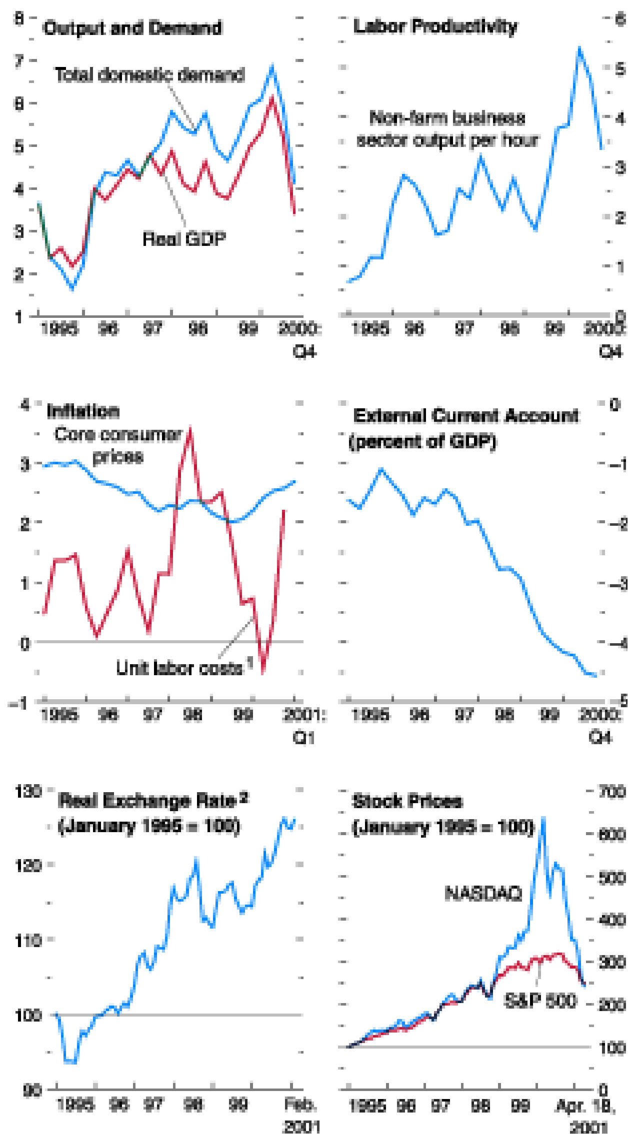
A major barrier to the progress of poorer developing countries remains the trade regimes in the advanced economies, which generally discriminate against the goods that poor countries produce most efficiently, in particular food and textiles and clothing (although quotas under the Multifiber Arrangement are due to be phased out by 2005). With a new round of multilateral trade liberalization on the horizon, it is important to recall that open trade is a major route for providing the benefits of globalization to poor countries. While developing countries also need to improve their trade systems (the case of Africa is discussed in more detail in Chapter II), it is essential for the advanced countries to recognize the substantial benefits that open export markets can provide to developing countries in general and to poor countries in particular. In this regard, the recent decision by the European Union to provide the poorest nations with immediate free access for most products is very welcome, particularly given the importance of the EU market for such countries. In addition, recent measures providing for significant market opening for the poorest nations have also been taken or announced by Canada, Japan, Korea, New Zealand, Norway, and the United States. Still more can and should be done by these and other countries to eliminate remaining barriers to the exports of the poorest countries.

## How Hard a Landing in the United States?

After a strong start, economic growth in the *United States* slowed sharply during the course of 2000 (Figure 1.5). Real GDP expanded at a 5¼ percent annual rate in the first half of 2000, outpacing even the most optimistic projections of potential growth, and the Federal Reserve appropriately raised interest rates in response to increasing inflationary risks. Growth slowed to an annual rate of just 1 percent in the fourth quarter, reflecting mainly the surge in energy prices

**Figure 1.5. United States: Sharp Slowdown and Persistent Imbalances**
*(Percent change from four quarters earlier unless otherwise noted)*

After a strong start, growth slowed sharply during 2000. Nevertheless, the growth of unit labor costs accelerated, the external current account deficit widened, and the real exchange rate appreciated.




Sources: Bloomberg Financial Markets, LP; Bureau of Labor Statistics; and WEFA, Inc.
[1] Non farm-business sector.
[2] Real effective exchange rate based on consumer prices indices.

and the tightening of financial conditions, including the drop in the NASDAQ and U.S. dollar appreciation. During the course of the year, warnings of slower sales and earnings growth resulted in substantial markdowns in the valuations of many leading high-tech companies, and the U.S. dollar retreated modestly from its peak. At the turn of the year, business and consumer confidence dropped sharply. The downturn in activity has been most severe in manufacturing. While personal spending growth is decelerating, consumer demand and residential construction appear to have provided moderate support to real activity in the first quarter of 2001.

More than the usual amount of uncertainty surrounds the outlook at the current juncture. The *World Economic Outlook's* baseline forecast envisages weak growth in the first half of 2001, reflecting rapid inventory adjustment and a slowdown in investment spending. This is followed by a pickup in activity, supported by lower short- and long-term interest rates, but slowed by the lagged effects of recent declines in equity prices on investment and consumption. This yields growth of 1½ percent for 2001 as a whole and 2½ percent for 2002. An upside risk is the stimulative impact of tax cuts, which have not yet been legislated. However, there is a significant downside risk that the imbalances built up during the long expansion—including equities that have remained richly valued by historical standards, high levels of corporate and household debt, and possible overinvestment in some sectors (notably telecommunications)—could unwind in a less orderly fashion, exacerbated by further declines in confidence and increases in risk aversion in financial markets.

The strength of domestic demand relative to output growth in 2000 led for the third consecutive year to a substantial widening of the external current account deficit. The gap was 4½ percent of GDP in 2000—significantly larger than in other major advanced economies (Table 1.2). With the fiscal surplus increasing, the widening deficit entirely reflected increasing private investment and declining household saving. Substantial capital inflows, partly in response to

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

| | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|
| **Advanced economies** | **–0.5** | **–1.0** | **–1.1** | **–1.0** |
| Major advanced economies | –1.1 | –1.6 | –1.6 | –1.5 |
| United States | –3.6 | –4.4 | –4.3 | –4.1 |
| Japan | 2.4 | 2.5 | 2.7 | 2.8 |
| Germany | –0.9 | –1.1 | –1.2 | –1.0 |
| France | 2.6 | 2.1 | 2.1 | 2.3 |
| Italy | 0.5 | –0.6 | –0.2 | 0.1 |
| United Kingdom | –1.1 | –1.7 | –1.8 | –2.2 |
| Canada | –0.4 | 1.8 | 1.3 | 0.8 |
| Other advanced economies | 2.0 | 2.0 | 1.8 | 1.6 |
| Spain | –2.1 | –3.2 | –3.0 | –3.0 |
| Netherlands | 4.3 | 3.7 | 3.7 | 3.4 |
| Belgium | 4.2 | 4.1 | 4.3 | 4.5 |
| Sweden | 3.5 | 2.6 | 2.4 | 2.3 |
| Austria | –2.8 | –3.0 | –2.8 | –2.3 |
| Denmark | 1.6 | 2.6 | 2.5 | 2.5 |
| Finland | 5.9 | 7.7 | 7.3 | 7.6 |
| Greece | –4.1 | –6.9 | –7.3 | –7.1 |
| Portugal | –8.7 | –10.4 | –9.7 | –9.3 |
| Ireland | 0.6 | –0.5 | –2.1 | –2.6 |
| Switzerland | 11.6 | 12.8 | 11.5 | 11.3 |
| Norway | 3.9 | 13.9 | 13.4 | 10.9 |
| Israel | –1.9 | –1.7 | –2.3 | –2.4 |
| Iceland | –7.0 | –10.3 | –10.6 | –8.2 |
| Cyprus | –4.5 | –8.0 | –5.3 | –4.6 |
| Korea | 6.0 | 2.4 | 2.3 | 1.2 |
| Australia | –5.8 | –4.0 | –3.3 | –3.2 |
| Taiwan Province of China | 2.9 | 3.0 | 2.4 | 2.5 |
| Hong Kong SAR | 6.6 | 5.8 | 3.0 | 4.1 |
| Singapore | 25.9 | 23.6 | 21.0 | 20.2 |
| New Zealand | –6.6 | –5.4 | –4.8 | –4.2 |
| *Memorandum* | | | | |
| European Union | 0.3 | –0.3 | –0.3 | –0.2 |
| Euro area[1] | 0.4 | –0.2 | –0.1 | — |

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

the perceived increase in trend productivity growth in the United States, led to further appreciation of the U.S. dollar. Past experience suggests that current account deficits of this magnitude are not usually sustained for very long (see Box 1.2), and that adjustment usually involves slower real income growth and gradual but significant real depreciation over a few years.[2]

Although core CPI inflation has edged up to about 2¾ percent, the slowdown has diminished inflationary risks. If activity continues to grow at below-potential rates, as expected, pressures on resource utilization should ease, albeit with a lag. At the same time, however, labor markets remain tight by historical standards, and the growth rate of unit labor costs is rising. Also, a sharp depreciation of the U.S. dollar could boost import prices. The balance of these factors will depend crucially on the evolution of labor productivity. At the present stage, the risk of an abrupt acceleration in inflation appears modest, allowing policymakers breathing room to reassess the underlying inflation situation as the extent of the slowdown in real activity becomes more clear. With the balance of risks shifting increasingly to slower growth, the timely and significant interest rate cuts in the first four months of 2001 were welcome. Some further easing would be called for if economic and financial conditions remain weak. In the financial system, there has been a slight increase in nonperforming loans and in defaults on corporate paper, partly attributable to the kinds of overreaching typically experienced during strong economic periods. Nevertheless, banks remain quite profitable by historical standards and have an average capital ratio of 12 percent, more than two percentage points above the minimum level required to be considered well capitalized.

At this stage, monetary policy remains the preferred response to cyclical developments. But unlike the situation that prevailed at the time of the October 2000 *World Economic Outlook*, moderate and relatively front-loaded tax cuts guided by structural considerations could now be useful from a cyclical perspective, while minimizing the adverse impact on savings and the external current account balance over the medium term. A multiyear tax plan enacted in phases would be preferable, with each phase put in place only once it is clear that sufficient budgetary resources will be available to finance it. The surpluses of the Social Security and Medicare Health Insurance trust funds should be preserved to help meet future pension and health care costs.

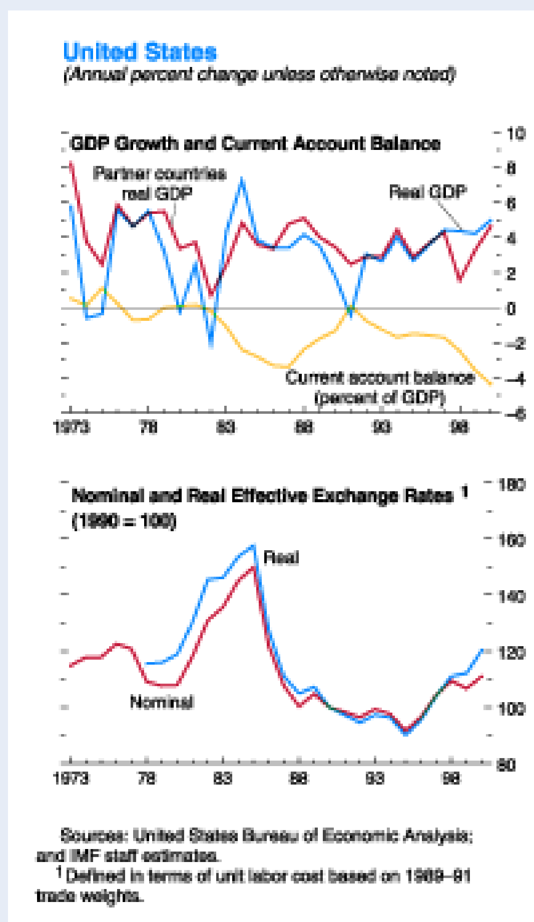
In Canada, the U.S. slowdown is an important factor behind the projected moderation of

[2]Caroline L. Freund, "Current Account Adjustment in Industrialized Countries," International Finance Discussion Paper No. 692 (Washington: Board of Governors of the Federal Reserve System, December 2000).

## Box 1.2. Sustainability of the U.S. External Current Account

The rise in the U.S. external current account deficit to high levels in recent years has raised doubts about its sustainability and concerns regarding the potential impact that a rapid and disorderly correction of this imbalance might have. The deficit rose from 1½ percent of GDP in 1995 to nearly 4½ percent in 2000 (compared with its average during the previous two decades of 1½ percent). The financing of the deficit in 2000 absorbed an estimated 7½ percent of the savings of the rest of the world, in contrast to the 2½ percent absorbed on average during most of the last two decades. Rapid U.S. GDP growth and relatively weaker growth in other parts of the world, notably Europe and Japan, as well as a sharp increase in the real foreign exchange value of the U.S. dollar driven in large part by capital inflows, contributed to the rise in the deficit (see the figure). The domestic counterpart has been a significant rise in investment.

A number of observers have argued that such high levels of the deficit cannot persist.[1] If they were to continue for an extended period, U.S. net external liabilities would rise to an extremely high level and U.S. assets would represent a growing portion of world portfolios that foreign investors might, at some point, become unwilling to hold. This situation would run the risk of large adjustments in the current account and the external value of the dollar, potentially leading to substantial dislocations in the global economy and disruptions in U.S. and world financial markets. Indeed, some observers argue that the risks arise not so much from the size of the U.S. deficit or the outstanding U.S. net liability position as from the suddenness of any adjustment.[2] While the experience of recent decades suggests that external adjustment has typically been gradual, there was a sharp fall in the real value of the dollar associated with the current account adjustment of the late 1980s.




Sources: United States Bureau of Economic Analysis; and IMF staff estimates.
[1]Defined in terms of unit labor cost based on 1989–91 trade weights.

Conventional trade equations imply that trade depends upon economic activity and real exchange rates. Accordingly, mechanisms that might lead to significant external adjustment on the trade side include:

- *Changes in cyclical positions.* After the robust growth in output of the last few years, the U.S. economy in 2000 was probably in a more cyclically advanced state than the euro area and (especially) Japan. While uncertainties about the levels and the underlying growth rates of potential complicate any assessment of the

[1]See, for example, Catherine Mann, "Is the U.S. Current Account Deficit Sustainable?" in *Finance and Development* (March 2000), pp. 42–45; and Francis Schott, "Is the U.S. Current Account Deficit Sustainable?" in *Business Economics* (July 2000), pp. 72–73.

[2]Maurice Obstfeld and Kenneth Rogoff, "Perspectives on OECD Economic Integration: Implications for U.S. Current Account Adjustment," paper presented at the Federal Reserve Bank of Kansas City symposium (August 2000).

size of this effect, current staff estimates suggest that "cyclical" factors might currently be adding around ½ percent of GDP to the U.S. current account deficit.

- *Changes in underlying growth performance.* The recent expansion of the U.S. current account deficit has coincided with increases in the estimated potential growth rate of the U.S. economy, and downgrades in the euro area and Japan. Clearly, an increase in potential growth rates in the euro area and Japan could help to reduce the U.S. current account deficit.[3] In addition, even if current potential growth trends continue, the U.S. deficit may not deteriorate as much as implied by conventional trade models, as one of the predictions from these models—that faster growing countries have trend depreciations in their real exchange rates or their external positions—is not consistent with the historical experience.[4]

[3]See the discussion of alternative scenarios in Appendix II of this Chapter for more on this issue.

[4]Rather, income elasticities for exports appear to vary systematically with long-term growth performance. See Paul Krugman, "Differences in Trade Elasticities and Trends in Real Exchange Rates," *European Economic Review,* Vol. 33 (May 1989), pp. 1031–54. The case of the United States is analyzed in Martin Cerisola, Hamid Faruqee, and Alex Keenan, "Long-Term Sustainability of the U.S. Current Account Balance," in United States: Selected Issues, IMF Staff Country Report No. 99/101 (Washington: International Monetary Fund, September 1999).

However, this effect is unlikely to imply a long-term improvement in the U.S. current account deficit.

- *Exchange rate adjustment.* A depreciation of the real value of the U.S. dollar from current levels (which may partly reflect capital inflows associated with robust U.S. growth—see Chapter II) is likely to be the main mechanism by which the U.S. current account deficit is reduced over the medium term. This would presumably be associated with a slowing of U.S. domestic demand, in particular investment. Given the size of the U.S. current account deficit, and the relatively small share of trade in the economy, the implied exchange rate adjustment could be significant.

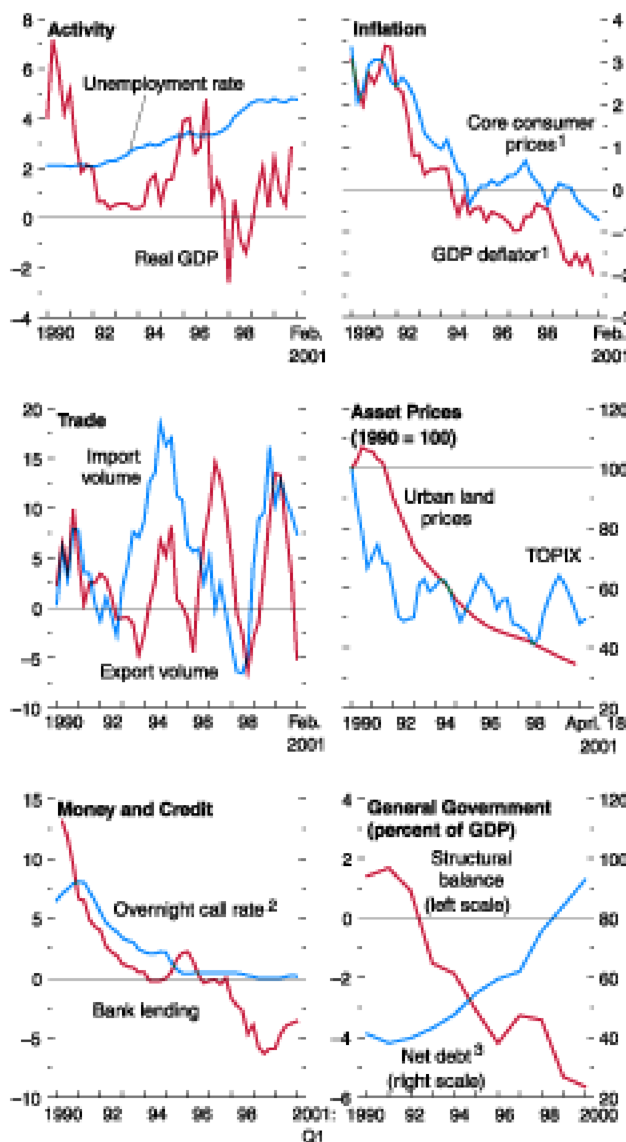
Appendix II of this Chapter reports a scenario in which the U.S. dollar gradually depreciates against other advanced economies. Over the medium term this generates a significant improvement in the external position of the United States, as domestic demand (in particular, investment) falls and external demand rises. From the historical record, such a gradual adjustment in underlying imbalances remains the most likely outcome.[5] However, a more abrupt adjustment remains a possibility.

[5]See Caroline L. Freund, "Current Account Adjustment in Industrial Countries," International Finance Discussion Paper No. 692 (Washington: Board of Governors of the Federal Reserve System, December 2000).

growth from 4¾ percent in 2000 to 2¼ percent in 2001. The economy is very open to trade, with 86 percent of exports (which amount to 37 percent of GDP) destined for the United States, and it produces non-energy commodities, whose prices are expected to remain weak. While previous interest rate increases will dampen demand for durable goods, housing, and business investment, activity should be supported by the buoyant labor market, income tax reductions, and solid consumer and business confidence. The main downside risk is a deeper and more prolonged downturn south of the border. Given the downside risk to growth, and with core inflation remaining around the middle of the 1–3 percent official target range, the interest rate cuts in January, March, and April were welcome. The Bank of Canada will need to remain alert to the possibility that activity slows faster than expected. Recently enacted income tax cuts have been fortunately timed, and the fiscal position remains sound. To further reduce the government debt-to-GDP ratio over time, the government should dedicate the bulk of any projected

**Figure 1.6. Japan: Recovery Faltering**
*(Percent change from four quarters earlier unless otherwise noted)*

Sustained growth will depend on aggressive action to address financial system weakness, especially as the scope for fiscal or monetary stimulus is limited.




Sources: Bloomberg Financial Markets, LP; WEFA; Nomura database; and IMF staff estimates (general government data, 1999–2000).
[1]Adjusted for impact of consumption tax increase in April 1997.
[2]Average of the month.
[3]Excluding social security.

budget surpluses to debt reduction. To enhance labor market flexibility and lower structural unemployment, new measures are needed to reduce the frequency of employment insurance use and eliminate regional extended benefits.

## Will Japan's Fragile Recovery Continue?

In Japan, the recovery is stalling, reflecting in part the global slowdown but also the continuing weakness of consumer confidence and underlying problems with the financial system. The 1¾ percent increase in economic activity in 2000 was driven mainly by a strong first quarter, boosted by one-time factors, including a delay in wage bonuses from December to January and a shift in imports associated with Y2K concerns (Figure 1.6). Thereafter, private consumption was weighed down by uncertainties regarding future economic prospects, and industrial activity was dampened by the slowdown in foreign demand and the downturn in the information technology cycle. Bank lending continued to contract, reflecting weak credit demand and ongoing financial system weaknesses. Public investment and external demand are estimated to have made negative contributions to growth after midyear, reflecting the waning of the November 1999 fiscal stimulus package and the slowdown in partner countries.

The growth forecast for 2001 has been marked down to ½ percent, reflecting the economy's vulnerability to the global electronics cycle as well as the impact of sharp declines in equity prices on confidence. Concerns over unemployment are likely to restrain household spending, and slowing world demand for electronic equipment threatens to dampen business investment. Indeed, the recent *Tankan* survey showed a significant drop in business confidence. Fiscal policy should give a temporary boost to public investment around the second quarter, as the November 2000 stimulus package comes on stream, and the impact of the global slowdown should be cushioned by the depreciation of the yen. An important downside risk is the effect of falling stock prices and deteriorating economic

conditions on the financial system. Market analysts are concerned that, at current stock prices, banks and life insurance companies face latent losses on their equity portfolios, which will directly reduce their capital once mark-to-market accounting comes into effect in April 2001, and doubts remain about the extent to which they have recognized and provisioned against problem loans. A sharper-than-expected slowdown in Japan would have a significant adverse impact on the rest of the world, especially Asia.

The faltering recovery is particularly regrettable after a decade of disappointing performance, punctuated by repeated recessions, and characterized by a series of adverse macroeconomic shocks and failures to decisively resolve important structural reform challenges. In particular, current weak growth reflects slow adjustment to the sharp fall in asset prices in the early 1990s, as well as the slow adaptation to globalization and technological change.[3] The prolonged slump in business investment reflects mainly excessive fixed assets and debt in the corporate sector, while lending was undermined by financial system weaknesses, including persistent bad loans and low core profitability, as financial institutions clung to low-margin corporate lending and were slow to expand fee-generating activities. Sluggish performance also reflects the slow shift in the main engines of growth from capital accumulation and exports to innovation and productivity gains.

Weak growth in the 1990s persisted despite expansionary macroeconomic policies. Monetary policy was progressively eased, with the overnight call rate falling from more than 8 percent in 1991 to effectively zero in 1999, but ongoing financial sector problems—which undermined bank lending—largely offset easier monetary policy. Fiscal policy was loosened through a series of stimulus packages, which raised the structural general government deficit by more than 6 percentage points of GDP between 1991–99. However, in practice the impact was relatively small, reflecting in part the lack of fiscal transparency and increasing concerns about growing fiscal imbalances.

In light of the deteriorating outlook and continued deflation, the introduction of a new monetary policy framework in March was welcome and it should be aggressively implemented (Box 1.3). Given the high level of public debt, the very gradual fiscal consolidation currently under way is appropriate for now, and fiscal easing should only be considered as a last resort in the event that stimulus is needed to forestall an outright recession (Table 1.3). To prepare for the lengthy period of fiscal consolidation that will eventually be needed, the authorities need to take immediate steps to elaborate their medium-term fiscal framework. Key elements of the strategy will need to include the production of consolidated fiscal accounts on a timely basis, the implementation of rigorous cost-benefit vetting of public works, the introduction of taxpayer identification numbers to widen the personal income tax net, and reform of public health care spending.

While macroeconomic policy can play some role, the prospects for a return to sustained growth in the medium term depend most critically on the implementation of fundamental reforms in the banking and corporate sectors. To aid this process, the government recently announced a package of measures—including the accelerated disposal of nonperforming loans by the major banks, measures to reduce banks' equity holdings, and guidelines to aid corporate restructuring and debt forgiveness—which are designed to accelerate the pace of bank and corporate sector restructuring (see Box 1.3). To minimize the adverse short-run impact of these needed structural reforms, the government also announced plans to enhance the social safety net. These new reforms are a welcome step forward, but they will need to be supplemented with other measures. Further, the regulatory and supervisory framework needs to be vigorously applied, particularly in light of the scheduled reimposition of limited deposit insurance in April 2002, including through enforcing more rigorous loan classification standards and more

[3]Tamim Bayoumi and Charles Collyns, eds., *Post-Bubble Blues: How Japan Responded to Asset Price Collapse* (Washington: International Monetary Fund, 2000).

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

*(Percent of GDP)*

| | 1984–94 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2006 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Major advanced economies** | | | | | | | | | | |
| Actual balance | –3.8 | –4.1 | –3.4 | –1.9 | –1.3 | –1.0 | 0.1 | –0.4 | –0.7 | 0.2 |
| Output gap | –0.7 | –2.2 | –2.1 | –1.5 | –1.4 | –1.0 | 0.2 | –0.8 | –1.1 | –0.1 |
| Structural balance | –3.4 | –3.2 | –2.6 | –1.2 | –0.7 | –0.6 | –0.4 | –0.2 | –0.3 | 0.2 |
| **United States** | | | | | | | | | | |
| Actual balance | –4.9 | –3.3 | –2.4 | –1.3 | — | 0.7 | 1.7 | 1.6 | 0.8 | 1.1 |
| Output gap | –1.9 | –3.2 | –2.9 | –1.8 | –0.7 | 0.3 | 2.0 | 0.2 | –0.5 | –0.1 |
| Structural balance | –4.3 | –2.2 | –1.5 | –0.7 | 0.2 | 0.6 | 1.0 | 1.5 | 1.0 | 1.1 |
| Net debt | 48.3 | 59.6 | 59.2 | 57.1 | 53.4 | 48.8 | 43.9 | 40.8 | 38.1 | 26.6 |
| Gross debt | 62.5 | 72.9 | 72.8 | 70.3 | 66.6 | 63.2 | 57.3 | 53.8 | 50.6 | 36.6 |
| **Japan** | | | | | | | | | | |
| Actual balance | 0.2 | –3.5 | –4.2 | –3.2 | –4.5 | –7.0 | –8.2 | –6.8 | –5.9 | –2.1 |
| Output gap | 0.8 | –1.4 | 0.1 | — | –2.9 | –3.7 | –3.3 | –3.8 | –3.8 | –0.2 |
| Structural balance | 0.3 | –3.1 | –4.2 | –3.3 | –3.4 | –5.7 | –7.2 | –5.6 | –4.8 | –2.2 |
| Net debt | 16.3 | 12.7 | 16.0 | 17.5 | 29.5 | 35.9 | 43.4 | 49.7 | 54.4 | 58.7 |
| Gross debt | 68.9 | 87.1 | 92.5 | 96.8 | 110.2 | 120.3 | 130.4 | 139.5 | 145.2 | 147.6 |
| *Memorandum* | | | | | | | | | | |
| Actual balance excluding social security | –2.8 | –6.3 | –6.7 | –5.8 | –6.5 | –8.8 | –9.5 | –7.7 | –6.6 | –3.3 |
| Structural balance excluding social security | –3.3 | –6.0 | –6.8 | –5.8 | –5.9 | –8.0 | –9.0 | –7.1 | –6.1 | –3.4 |
| **Germany**[2] | | | | | | | | | | |
| Actual balance[3] | –2.0 | –3.3 | –3.4 | –2.7 | –2.1 | –1.4 | 1.5 | –2.0 | –1.5 | –1.3 |
| Output gap | –0.9 | 0.2 | –0.9 | –1.4 | –1.2 | –1.7 | –0.9 | –1.3 | –1.0 | — |
| Structural balance | –1.2 | –3.3 | –2.7 | –1.6 | –1.1 | –0.4 | –0.5 | –1.3 | –1.0 | –1.3 |
| Net debt | 22.3 | 49.4 | 51.1 | 52.2 | 52.0 | 52.3 | 51.5 | 50.3 | 49.5 | 46.6 |
| Gross debt | 42.6 | 58.3 | 59.8 | 60.9 | 60.7 | 61.0 | 60.2 | 59.0 | 58.2 | 55.3 |
| **France** | | | | | | | | | | |
| Actual balance[3] | –3.0 | –5.5 | –4.1 | –3.0 | –2.7 | –1.6 | –1.3 | –0.6 | –0.8 | — |
| Output gap | –0.1 | –2.7 | –3.3 | –3.1 | –2.0 | –1.2 | –0.5 | –0.4 | –0.4 | — |
| Structural balance | –2.9 | –4.0 | –2.3 | –1.4 | –1.7 | –0.8 | –0.9 | –0.9 | –0.6 | — |
| Net debt | 24.8 | 45.8 | 48.1 | 49.6 | 50.0 | 49.2 | 48.6 | 48.6 | 47.4 | 37.7 |
| Gross debt | 34.4 | 54.5 | 57.1 | 59.3 | 59.7 | 58.9 | 58.3 | 57.9 | 55.9 | 49.0 |
| **Italy** | | | | | | | | | | |
| Actual balance[3] | –10.7 | –7.6 | –7.1 | –2.7 | –2.8 | –1.8 | –0.3 | –1.3 | –1.2 | 0.8 |
| Output gap | –0.2 | –1.1 | –2.0 | –2.3 | –2.4 | –2.7 | –1.8 | –1.8 | –1.4 | — |
| Structural balance | –10.7 | –7.0 | –6.2 | –1.7 | –1.8 | –0.6 | –0.7 | –0.5 | –0.6 | 0.9 |
| Net debt | 85.4 | 116.6 | 116.0 | 113.7 | 110.1 | 108.4 | 104.4 | 101.8 | 99.7 | 87.3 |
| Gross debt | 92.5 | 123.2 | 122.6 | 120.1 | 116.2 | 114.5 | 110.2 | 107.5 | 105.3 | 92.2 |
| **United Kingdom** | | | | | | | | | | |
| Actual balance[3] | –2.9 | –5.4 | –4.1 | –1.5 | 0.3 | 1.5 | 5.9 | 1.3 | 0.3 | 0.4 |
| Output gap | –0.1 | –1.1 | –0.9 | –0.4 | — | –0.1 | 0.1 | –0.2 | –0.1 | — |
| Structural balance | –2.0 | –4.4 | –3.4 | –1.0 | 0.5 | 1.5 | 3.4 | 1.3 | 0.4 | 0.4 |
| Net debt | 29.5 | 37.0 | 46.5 | 45.0 | 42.3 | 39.5 | 36.5 | 33.7 | 31.6 | 27.4 |
| Gross debt | 44.4 | 52.0 | 52.2 | 49.9 | 47.0 | 44.4 | 41.3 | 38.3 | 36.0 | 31.1 |
| **Canada** | | | | | | | | | | |
| Actual balance | –7.1 | –5.4 | –2.8 | 0.2 | 0.2 | 2.2 | 3.4 | 2.7 | 2.5 | 1.8 |
| Output gap | –2.0 | –4.4 | –5.3 | –3.6 | –3.3 | –1.6 | 0.2 | –0.3 | –0.6 | — |
| Structural balance | –5.7 | –2.9 | 0.1 | 2.2 | 1.9 | 3.0 | 3.3 | 2.9 | 2.9 | 1.8 |
| Net debt | 60.5 | 88.5 | 88.2 | 83.4 | 81.4 | 75.3 | 66.9 | 61.0 | 56.0 | 38.8 |
| Gross debt | 92.6 | 120.6 | 120.9 | 117.4 | 116.2 | 111.6 | 101.6 | 94.3 | 87.8 | 65.2 |

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

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

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

[3]Includes one-off receipts from the sale of mobile telephone licenses equivalent to 2.5 percent of GDP in 2000 for Germany, 0.6 percent of GDP in 2001 for France, 1.2 percent of GDP in 2000 for Italy, and 2.4 percent of GDP in 2000 for the United Kingdom.

## Box 1.3. Japan's Recent Monetary and Structural Policy Initiatives

The Japanese authorities have recently taken a number of welcome steps to enhance the monetary policy framework and to accelerate the pace of bank and corporate sector restructuring. These policy decisions were taken with the aim of ending the current period of deflation and bringing about the fundamental reforms necessary in the banking and corporate sectors to underpin strong, sustained growth over the medium term.

### *Monetary Policy Framework*

On March 19, in response to mounting evidence that the economic recovery had stalled, the Bank of Japan announced that it was adopting a new framework for monetary policy based on:

- A quantitative target for outstanding current account balances at the central bank (mainly consisting of central bank reserves), rather than a target for the overnight interbank call rate. The current target for banks' balances held at the central bank is ¥5 trillion, about ¥1 trillion above the average balance held in the months prior to the policy change.
- Stepped-up outright purchases of long-term government bonds, if needed, to achieve the reserves target. In a significant departure from its earlier policy of purchasing a fixed amount of government bonds in the secondary markets each month, the Bank of Japan signaled its willingness to step up outright purchases of long-term government bonds in the secondary market (*rinban* operations), if necessary, to ensure the smooth provision of liquidity.[1]
- A commitment to maintain this new policy until year-on-year CPI inflation (excluding perishables) has stably reached zero or above.

Following the announcement, the overnight call rate, which is now market-determined, declined to effectively zero. Moreover, the Bank of Japan's increased commitment to combat deflation has underpinned market expectations that short-term interest rates will stay near zero at least through mid-2002.

The Bank of Japan's willingness to tread new ground and its stated commitment to at least stabilize consumer prices are welcome signs of greater flexibility in dealing with the current deflationary environment. This new approach goes further than merely returning to the zero interest rate policy and provides scope for the Bank of Japan to inject further stimulus to the economy if needed in the future. It also improves policy transparency—the objective of stabilizing consumer prices is more clearly defined than the previous zero-interest rate policy that sought to maintain zero interest rates until "deflationary concerns were dispelled"—and should help to reduce deflationary expectations. However, to be most effective the Bank of Japan will need to follow through in using the scope provided by the framework to clearly demonstrate its determination to combat deflation.

### *Financial and Corporate Restructuring*

On April 6, in response to concerns about the pace of bank and corporate restructuring, the government announced a package of measures designed to accelerate the pace of such restructuring. The main elements of the package were:

- Accelerated disposal of nonperforming loans by the major banks. The plan calls for the major banks to dispose of existing nonperforming loans (NPLs) already classified as "in danger of bankruptcy" and below over a two-year period and new NPLs within three years of their being classified as such. Banks will periodically be required to disclose their progress toward loan disposal, and the situation will be monitored by the Financial Services Agency.
- Measures to reduce banks' equity holdings. To reduce banks' exposure to market risk and curtail cross shareholdings, the plan calls for a yet-to-be-determined limit on banks' equity holdings relative to capital. As a temporary measure, a Bank Shareholdings Acquisition Corporation (BASAC) will be established, with public sector financial support, to buy the banks' excess equity holdings at market prices.

[1]However, long-term government bonds effectively held at the central bank cannot rise above the outstanding issue of bank notes.

**Box 1.3 *(concluded)***

- The promotion of corporate restructuring. Guidelines are to be established to guide the process of corporate restructuring and debt forgiveness, with the participation of the authorities along the lines of the London Approach.
- Other measures to support restructuring. These include steps to enhance the social safety net and to improve liquidity in the real estate market. Tax reform measures are also under consideration for inclusion in the package at a later date.

While the new emphasis on banking and corporate issues is welcome, the package will need to be implemented vigorously and complemented by additional measures to maximize its impact. One important way to enhance the package would be to broaden coverage to include disposal of NPLs by the regional banks (given that the major banks make up less than half of the assets of deposit taking institutions). In addition, supervision should continue to be strengthened, including to ensure appropriate classification of the large stock of loans to watch list borrowers a significant part of which—according to market analysts—may in fact be impaired, with appropriate levels of provisioning to reflect a realistic forward looking assessment of prospects of loan recovery. The need to provision against newly downgraded loans may well result in some banks becoming undercapitalized, which could require a further injection of public capital, with appropriately strict conditionality to address moral hazard concerns. The equity purchase scheme in the package needs to be designed to minimize distortions, ensure transparency, and limit the amount of public funds at risk. Finally, it will be essential to ensure that corporate restructuring agreements under the scheme involve sufficiently deep adjustment to restore the long term viability of firms being restructured.

Thus, while the new proposals make a welcome step forward, they will need to be implemented with vigor, and supplemented with other steps to encourage the broad-based bank and corporate restructuring needed to lay the basis for sustained recovery in Japan.

aggressive provisioning against problem loans. To improve the environment for corporate restructuring as banks and firms agree on debt forgiveness in exchange for restructuring plans, a number of complementary reforms are also needed, including to land regulations and to relevant parts of the tax and legal system. Other priority areas for reform include: the deregulation of the telecommunications, power, transportation, and housing sectors; strengthening the role of outside auditors and directors on corporate boards to improve governance; and encouraging private defined-contribution pensions to enhance labor mobility across firms.

## Can Domestic Demand Sustain European Growth?

Growth in the euro area is expected to be cushioned by domestic demand, although the global slowdown and financial market weakness are having an adverse impact on activity (Table 1.4). Real GDP growth eased during the course of 2000, mostly reflecting the negative effect of higher oil prices on purchasing power, particularly in *Germany* (Figure 1.7). In recent months, business confidence has weakened and signs of slowing industrial activity have intensified. Looking ahead, growth in 2001 is expected to remain relatively well sustained at about 2½ percent, exceeding growth in the United States for the first time since 1991. Household spending is expected to be underpinned by expanding disposable income, reflecting both continued employment growth and personal income tax cuts in some countries. While business sentiment has declined markedly in some countries, the vulnerability of business investment is likely to be limited by high levels of capacity utilization and full order books, the fall in long-term interest rates,

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

| | Real GDP | | | | Consumer Prices | | | | Unemployment | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 1999 | 2000 | 2001 | 2002 | 1999 | 2000 | 2001 | 2002 |
| **Advanced economies** | **3.4** | **4.1** | **1.9** | **2.7** | **1.4** | **2.3** | **2.1** | **1.8** | **6.4** | **5.9** | **5.9** | **5.9** |
| Major advanced economies | 3.0 | 3.8 | 1.6 | 2.4 | 1.4 | 2.3 | 1.9 | 1.7 | 6.1 | 5.7 | 5.9 | 6.0 |
| United States | 4.2 | 5.0 | 1.5 | 2.5 | 2.2 | 3.4 | 2.6 | 2.2 | 4.2 | 4.0 | 4.4 | 5.0 |
| Japan | 0.8 | 1.7 | 0.6 | 1.5 | –0.3 | –0.6 | –0.7 | — | 4.7 | 4.7 | 5.3 | 5.2 |
| Germany | 1.6 | 3.0 | 1.9 | 2.6 | 0.7 | 2.1 | 2.0 | 1.3 | 8.3 | 7.8 | 7.6 | 7.4 |
| France | 3.2 | 3.2 | 2.6 | 2.6 | 0.6 | 1.8 | 1.5 | 1.4 | 11.3 | 9.7 | 8.8 | 8.2 |
| Italy | 1.6 | 2.9 | 2.0 | 2.5 | 1.7 | 2.6 | 2.2 | 1.6 | 11.4 | 10.6 | 9.9 | 9.5 |
| United Kingdom[1] | 2.3 | 3.0 | 2.6 | 2.8 | 2.3 | 2.1 | 2.2 | 2.4 | 6.0 | 5.6 | 5.3 | 5.4 |
| Canada | 4.5 | 4.7 | 2.3 | 2.4 | 1.7 | 2.7 | 3.0 | 2.2 | 7.6 | 6.8 | 7.2 | 7.1 |
| Other advanced economies | 4.8 | 5.2 | 3.0 | 3.8 | 1.3 | 2.4 | 2.8 | 2.3 | 7.3 | 6.3 | 6.1 | 5.7 |
| Spain | 4.0 | 4.1 | 2.9 | 3.2 | 2.2 | 3.4 | 2.9 | 2.3 | 15.9 | 14.1 | 12.7 | 11.7 |
| Netherlands | 3.9 | 3.9 | 2.9 | 2.7 | 2.0 | 2.3 | 3.9 | 2.4 | 3.2 | 2.8 | 3.0 | 3.0 |
| Belgium | 2.7 | 3.9 | 2.4 | 2.4 | 1.1 | 2.9 | 2.2 | 1.3 | 8.8 | 7.0 | 7.0 | 7.0 |
| Sweden | 4.1 | 3.6 | 2.6 | 2.8 | 0.5 | 1.0 | 1.8 | 1.9 | 5.6 | 4.7 | 4.1 | 4.0 |
| Austria | 2.8 | 3.2 | 2.2 | 2.6 | 0.5 | 2.0 | 1.7 | 1.6 | 3.8 | 3.3 | 3.4 | 3.3 |
| Denmark | 2.1 | 2.9 | 2.1 | 2.3 | 2.6 | 3.1 | 2.5 | 2.1 | 5.6 | 5.2 | 5.3 | 5.3 |
| Finland | 4.2 | 5.7 | 4.2 | 4.0 | 1.3 | 3.0 | 2.6 | 2.4 | 10.3 | 9.8 | 9.2 | 8.8 |
| Greece | 3.4 | 4.0 | 3.8 | 3.8 | 2.2 | 2.9 | 3.4 | 3.3 | 11.7 | 11.1 | 10.9 | 10.7 |
| Portugal | 2.8 | 3.0 | 2.4 | 2.8 | 2.2 | 2.8 | 3.8 | 2.3 | 4.4 | 4.1 | 4.0 | 4.0 |
| Ireland | 9.8 | 10.7 | 7.0 | 6.2 | 2.5 | 5.3 | 4.0 | 3.3 | 5.6 | 4.3 | 3.7 | 3.7 |
| Luxembourg | 7.3 | 8.5 | 4.2 | 4.3 | 1.0 | 3.2 | 1.5 | 1.3 | 2.9 | 2.6 | 2.7 | 2.6 |
| Switzerland | 1.5 | 3.4 | 2.0 | 2.0 | 0.8 | 1.6 | 1.4 | 1.5 | 2.7 | 1.9 | 1.9 | 1.8 |
| Norway | 0.9 | 2.2 | 1.9 | 2.3 | 2.3 | 3.0 | 2.8 | 2.5 | 3.2 | 3.4 | 3.5 | 3.5 |
| Israel | 2.3 | 6.0 | 1.8 | 4.3 | 5.2 | 1.1 | 0.9 | 2.5 | 8.9 | 8.8 | 9.4 | 8.6 |
| Iceland | 4.1 | 3.6 | 1.9 | 2.1 | 3.4 | 5.0 | 4.6 | 3.5 | 1.9 | 1.3 | 1.8 | 2.1 |
| Cyprus | 4.5 | 5.0 | 4.5 | 4.0 | 1.8 | 4.1 | 2.7 | 2.7 | 3.6 | 3.5 | 3.6 | 3.8 |
| Korea | 10.9 | 8.8 | 3.5 | 5.5 | 0.8 | 2.2 | 4.3 | 3.0 | 6.3 | 4.1 | 4.2 | 3.5 |
| Australia[2] | 4.7 | 3.7 | 1.9 | 3.5 | 1.5 | 4.5 | 3.7 | 2.4 | 7.2 | 6.6 | 7.0 | 6.7 |
| Taiwan Province of China | 5.4 | 6.0 | 4.1 | 5.6 | 0.2 | 1.3 | 1.4 | 1.5 | 2.7 | 3.2 | 3.4 | 3.2 |
| Hong Kong SAR | 3.1 | 10.5 | 3.5 | 4.8 | –4.0 | –3.7 | 0.5 | 2.0 | 6.3 | 5.0 | 4.7 | 4.1 |
| Singapore | 5.9 | 9.9 | 5.0 | 5.8 | 0.1 | 1.4 | 1.9 | 1.9 | 3.5 | 3.1 | 2.7 | 2.5 |
| New Zealand[2] | 3.9 | 3.5 | 2.6 | 2.7 | 1.1 | 2.7 | 2.8 | 2.1 | 6.8 | 6.0 | 5.8 | 5.9 |
| *Memorandum* | | | | | | | | | | | | |
| European Union | 2.6 | 3.4 | 2.4 | 2.8 | 1.4 | 2.3 | 2.3 | 1.8 | 9.1 | 8.2 | 7.8 | 7.5 |
| Euro area | 2.6 | 3.4 | 2.4 | 2.8 | 1.2 | 2.4 | 2.3 | 1.7 | 9.9 | 9.0 | 8.4 | 8.1 |

[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.

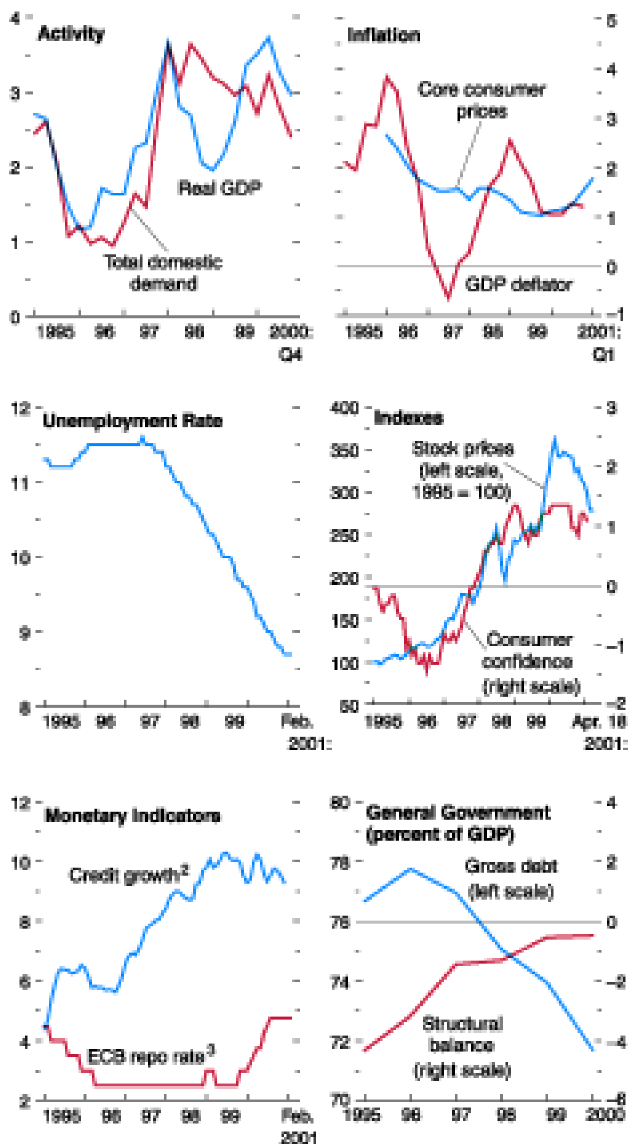
and the relative importance of bank lending (rather than market-based finance). Among the major economies, growth has the greatest momentum in France, driven by relatively strong final domestic demand. In addition, France has more limited vulnerability to external developments, reflecting a lower share of manufacturing in value added, a smaller proportion of capital goods in exports, and weaker trade linkages with the United States and Asia. In Germany and Italy, final domestic demand has been much weaker, although in both countries (particularly in Germany) tax cuts should support private consumption during 2001. Weakening external demand will help reduce overheating pressures in the countries on the periphery, especially *Ireland*, which receives substantial U.S. foreign direct investment and whose economy is relatively technology intensive, but may exacerbate already large current account deficits, including in *Portugal* and—to a lesser extent—*Greece*.

Monetary policy has been on hold since the ¼ percentage point tightening in October 2000. Underlying inflation is expected to remain steady in 2001 at 1½ percent, with little evidence thus far of pass-through effects from last year's

**Figure 1.7. Euro Area: Growth Moderating, but Still Reasonably Robust**

*(Percent change from four quarters earlier unless otherwise noted)*

Growth slowed during 2000, with both private consumption and business investment easing. Despite falling unemployment, domestic price pressures remain contained.




Sources: Eurostat; European Central Bank; European Commission; IMF, *International Financial Statistics*; and IMF staff estimates.
[1] Dow Jones EURO STOXX index.
[2] Three month center moving average.
[3] Prior to 1999, Bundesbank repo rate.

higher energy prices or the weaker euro to wages, though inflation is higher in countries on the periphery. The moderation of broad money growth and indicators of underlying inflation—including unit labor costs, profit margins, services price inflation, and core inflation purged of indirect energy effects—point to muted domestic price pressures. At the same time, the fall in external demand has become more pronounced. Given the shift in the balance of inflation risks, a moderate cut in interest rates is now appropriate, with a larger one being in order if the exchange rate were to appreciate sharply or indications of the impact of the global slowdown were to mount.

At this stage fiscal policy is not needed to support activity, given the flexibility to use monetary policy to provide stimulus, though fiscal execution should allow the full play of automatic stabilizers. The structural fiscal balance in the euro area as a whole is expected to remain broadly unchanged in 2001, with a deterioration in Germany (¾ percent of GDP) offset by improvements elsewhere, including in France and *Spain*. Reductions in personal and corporate income taxes in Germany, France, Italy, and *the Netherlands* are expected to improve labor supply incentives, reduce investment distortions, and increase these countries' attractiveness to foreign investors. Tax cuts need to be accompanied by spending restraint in the future to allow medium-term budget targets to be met. In most countries, structural spending cuts should be targeted mainly on subsidies, social transfer programs, and public employment. Countries with overheating pressures should avoid loosening fiscal policies, even if they have a significant fiscal surplus, as in Ireland, and—if monetary policy is eased during the year—may need to consider offsetting fiscal measures.

While the near-term growth outlook in the euro area is still quite favorable relative to North America and Japan, policymakers should not be satisfied with a potential growth rate estimated at 2½ percent. Although important progress has been made in some areas of structural reform, unemployment remains high and a deepening

and acceleration of market-oriented reforms are needed, especially of pension systems, labor markets, and product markets. Rising pension and health care costs remain serious medium-term challenges (see Chapter III). In Germany, pension reform that will lay the foundation for a funded "second pillar" to supplement the public pension pillar is moving through the legislative process, albeit with some compromises. In many other euro area countries as well, the establishment of a similar funded "second pillar" will be essential to reduce the burden of aging populations on public pensions and diminish the need for further increases in social contribution rates that could harm labor market performance. Cuts in benefits provided under public pensions—through, among other actions, increases in the retirement age—beyond levels currently envisaged will also be needed in the longer run. Controlling public health care costs will depend on measures to improve cost-sharing and administrative capacity.

Further reductions in unemployment over the medium term will depend largely on additional progress in addressing labor market rigidities. Germany shows signs of greater flexibility in *de facto* working conditions and wages, but legal changes are needed to allow employers and workers to reach wage agreements more in line with firm-level conditions. In France, the 35-hour work week initiative has proceeded relatively smoothly to date, but with the legislation being extended to small firms, flexible implementation—including the relaxation of restrictions on allowable annual overtime hours—will be needed as the labor market tightens. In Italy, the main challenge is to raise employment in the south by linking wages to productivity to achieve greater geographic wage differentiation. In Spain, the priorities are fostering part-time work, reducing dismissal costs to stimulate the growth of employment, and increasing flexibility in wage bargaining.

Additional product market reforms will also be important to increase potential growth rates. Germany has recently implemented impressive reforms in the telecommunications and energy sectors, but further actions are needed, including the liberalization of shop opening hours, and privatization of financial institutions and of the remaining state holdings in public utility companies. Similarly, in France, the recent progress in privatization is welcome, although there is further scope for liberalization of the financial system, especially with regard to administered interest rates, and of the telecommunications and energy sectors. In Italy, the large privatization program in recent years provides a good basis for additional measures, including further liberalization of the energy sector, reform of the legal framework governing nonlisted companies, and vigorous implementation of the simplifications in public administration and licensing procedures.

With its greater openness to trade and financial flows, the *United Kingdom* is more vulnerable than the euro area to external developments. Growth is showing signs of moderating and the forecast for 2001 is now at 2½ percent, with the balance of risks tilted downward. Domestic demand growth is projected to moderate, despite a strong pickup in public spending, and the external balance is expected to continue to make a negative contribution to growth. Notwithstanding high levels of resource utilization, core inflation has been below target, hovering around 2 percent, reflecting the strength of sterling against the euro, wage moderation, and—more recently—softening economic activity. As inflationary pressures remain subdued, the Bank of England's interest rate cuts in February and April were appropriate, and there remains room for further easing if the growth outlook were to deteriorate further. The March 2001 budget envisages a reduction of the public sector surplus from 1½ percent of GDP in 2000/01 to ½ percent of GDP in 2001/02. While this expansion most likely can be accommodated without overheating, it could contribute to a policy mix that may tend to keep sterling elevated. Over the medium term, the large planned increase in public investment in infrastructure and human capital should help to raise productivity growth. However, it would be better to avoid

**Table 1.5. Selected Asian Countries: Real GDP, Consumer Prices, and Current Account Balance**
*(Annual percent change unless otherwise noted)*

| | Real GDP | | | | Consumer Prices[1] | | | | Current Account Balances[2] | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 1999 | 2000 | 2001 | 2002 | 1999 | 2000 | 2001 | 2002 |
| **Emerging Asia[3]** | **6.3** | **7.1** | **5.6** | **6.2** | **2.1** | **1.8** | **2.8** | **3.2** | **3.7** | **2.7** | **1.9** | **1.5** |
| **Newly industrialized Asian economies** | **7.9** | **8.2** | **3.8** | **5.5** | **—** | **1.1** | **2.8** | **2.3** | **7.0** | **5.1** | **4.2** | **3.9** |
| Hong Kong SAR | 3.1 | 10.5 | 3.5 | 4.8 | –4.0 | –3.7 | 0.5 | 2.0 | 6.6 | 5.8 | 3.0 | 4.1 |
| Korea | 10.9 | 8.8 | 3.5 | 5.5 | 0.8 | 2.2 | 4.3 | 3.0 | 6.0 | 2.4 | 2.3 | 1.2 |
| Singapore | 5.9 | 9.9 | 5.0 | 5.8 | 0.1 | 1.4 | 1.9 | 1.9 | 25.9 | 23.6 | 21.0 | 20.2 |
| Taiwan Province of China | 5.4 | 6.0 | 4.1 | 5.6 | 0.2 | 1.3 | 1.4 | 1.5 | 2.9 | 3.0 | 2.4 | 2.5 |
| **ASEAN-4** | **2.8** | **5.0** | **3.4** | **4.7** | **10.2** | **3.0** | **5.7** | **4.7** | **9.2** | **7.7** | **6.1** | **4.9** |
| Indonesia | 0.8 | 4.8 | 3.5 | 4.6 | 20.7 | 3.8 | 8.9 | 5.7 | 4.1 | 4.2 | 3.5 | 2.0 |
| Malaysia | 5.8 | 8.5 | 4.5 | 6.0 | 2.8 | 1.5 | 2.0 | 2.4 | 15.9 | 9.7 | 6.3 | 5.6 |
| Philippines | 3.3 | 3.9 | 3.3 | 4.5 | 6.6 | 4.3 | 6.1 | 5.8 | 10.0 | 12.4 | 12.1 | 11.5 |
| Thailand | 4.2 | 4.3 | 3.0 | 4.5 | 0.3 | 1.5 | 2.1 | 3.6 | 10.2 | 7.6 | 5.9 | 4.5 |
| **South Asia[4]** | **6.2** | **6.2** | **5.4** | **5.9** | **4.8** | **4.1** | **4.1** | **5.8** | **–1.0** | **–1.2** | **–1.3** | **–1.5** |
| Bangladesh | 5.2 | 5.0 | 4.5 | 4.5 | 6.3 | 4.7 | 5.8 | 6.3 | –1.7 | –1.6 | –1.8 | –2.1 |
| India | 6.6 | 6.4 | 5.6 | 6.1 | 4.7 | 4.0 | 3.8 | 5.9 | –0.6 | –1.0 | –1.2 | –1.3 |
| Pakistan | 4.3 | 5.1 | 4.4 | 5.0 | 4.1 | 4.4 | 4.9 | 4.6 | –2.7 | –1.6 | –1.4 | –0.9 |
| **Formerly centrally planned economies[5]** | 7.1 | 8.0 | 7.0 | 7.1 | –1.4 | 0.4 | 1.0 | 1.5 | 1.6 | 1.2 | 0.6 | 0.2 |
| China | 7.1 | 8.0 | 7.0 | 7.1 | –1.4 | 0.4 | 1.0 | 1.5 | 1.6 | 1.2 | 0.6 | 0.2 |
| Vietnam | 4.2 | 5.5 | 5.0 | 6.0 | 4.1 | –1.7 | 4.0 | 4.2 | 4.5 | 2.1 | –0.3 | –4.2 |

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

returning to a budget deficit, so as not to reduce the pool of national savings available for private investment.

Other advanced European economies are even more open than the United Kingdom and thus more vulnerable to external developments. Growth in *Switzerland* is expected to slow sharply from 3½ percent in 2000 to 2 percent in 2001, because of the relatively high importance of the U.S. export market. Growth in Sweden is projected to decline from 3½ percent to 2½ percent, reflecting mainly lower external demand but also the impact of declining stock prices, particularly in the technology sector, on domestic demand. At the same time, low unemployment in both countries, as well as in *Denmark* and *Norway*, is expected to support both consumption and investment in 2001, as firms seek ways around skill shortages. On the whole, monetary policy in these countries is well positioned to react quickly and aggressively to sharper-than-envisaged weakness in activity. In *Iceland*, where the current account deficit has widened sharply, fiscal policy needs to play a supporting role in addressing domestic and external imbalances, accompanied by early measures to strengthen the financial system; the recent floating of the currency, together with the adoption of inflation targeting, is welcome and will help promote long-term financial stability.

## How Will the Global Slowdown Affect Asia?

In emerging Asia, GDP growth rose to 7.1 percent in 2000, buoyed by the continuing recovery from the 1997–98 crisis (Table 1.5). However, following rapid growth in the first half of the year, the pace of activity has since fallen back markedly, and in 2001 regional growth is expected to decline to 5.7 percent. While a slowdown from the high growth rates during the re-

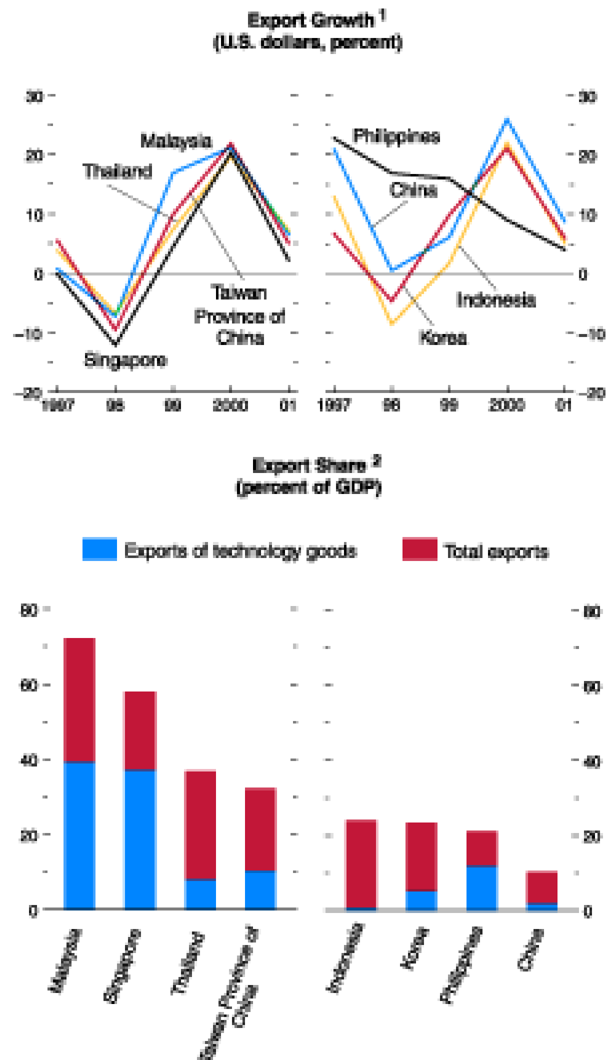
covery period was expected, this also reflected a series of shocks, including higher oil prices; slowing growth in the United States, the fall in the NASDAQ, and the downturn in the global electronics cycle; political uncertainties; and in a number of countries, concerns over the lagging pace of corporate and financial restructuring. The slowdown was accompanied—and exacerbated—by a sharp decline in regional equity markets, declining portfolio inflows, and in some cases downward pressure on exchange rates.

The impact of these shocks has varied across the region. In *China* and *India*, which account for three-quarters of regional output (excluding Japan), exposure to external developments is moderate and growth in activity is expected to be relatively well maintained. Elsewhere, while activity will in most cases be cushioned by lower U.S. interest rates and to a modest degree by lower oil prices, the effect will be significantly greater. Growth is expected to slow sharply in a number of the newly industrialized and ASEAN countries, with the extent of the slowdown depending on their cyclical positions; vulnerability to external shocks (Figure 1.8); and country-specific factors, such as political uncertainties. Given the improvement in macroeconomic fundamentals over the past three years, combined with more flexible exchange rate management, these countries are in general better placed to manage external shocks than in the past. Nonetheless, the impact of the global slowdown will still be substantial, and would be significantly exacerbated in the event of a harder landing in the United States, a deeper-than-expected slowdown in Japan, or a sharp depreciation of the yen.

In China, the largest economy in the region, activity remained robust during 2000, propelled by rising exports, recovering private consumption, and higher public spending; inflation turned modestly positive as deflationary pressures receded. Given the deterioration in the external environment, GDP growth is expected to moderate to 7 percent in 2001 while inflation remains subdued. The fiscal deficit in the 2001

**Figure 1.8. Selected Asian Countries: The Impact of Weakening External Demand**

A number of newly industrialized and ASEAN economies are vulnerable to weaker external demand, especially for technology goods.




Source: IMF staff estimates.
[1]Goods.
[2]Excluding imported intermediate inputs used in those exports.

budget reflects an appropriately expansionary policy stance, although a modest mid-year spending package may be required if the heightened downside risks to growth materialize. Over the medium term, the scope for further stimulus will be constrained by the need to tackle the substantial off-budget liabilities relating to bank and SOE restructuring, and pension liabilities. As elsewhere, financial and enterprise reforms remain the central priority. Asset Management Companies have now taken over a substantial proportion of nonperforming loans, but need additional powers and political support to move forward with enterprise restructuring. Given the ongoing structural changes in the economy, including those associated with accession to the World Trade Organization (WTO), greater exchange rate flexibility will also be desirable at the appropriate time. In *Hong Kong SAR*, after a strong "V-shaped" recovery, growth is expected to slow markedly to 3.5 percent in 2001, in part reflecting slowing export growth in the Mainland, the weakening regional situation, and falling retail sales. Activity in *Taiwan Province of China* is also expected to weaken, mainly reflecting the downturn in the global electronics cycle, as well as financial sector problems.

Turning to South Asia, GDP growth in India slowed to 6.4 percent in 2000, owing to a second consecutive year of below average monsoons and a weakening of industrial output. Overall activity is expected to slow further to about 5.6 percent in 2001, as a rebound in agricultural production is offset by continued sluggishness in manufacturing and the effect of the devastating earthquake in Gujarat. Inflation increased sharply in 2000 and early 2001, but this appears to have mainly reflected the effects of adjustments in administered fuel prices, and price pressures have recently begun to ease. Despite India's heavy reliance on imported oil, the impact of higher world prices on the current account deficit has been largely offset by buoyant exports and sluggish non-oil imports. The weakness of the rupee and the downward pressure on international reserves that emerged in 2000 have eased, aided by higher remittances from expatriate Indians, and the Reserve Bank of India was able to lower its Bank rate in February and March 2001. The central challenge for India's policymakers remains to sustain—and indeed improve upon—the economy's strong growth during the 1990s to support meaningful poverty reduction. This will require major structural reforms that improve the environment for private investment and a substantial reduction in the overall public sector deficit, which—at 10–11 percent of GDP—consumed one-half of overall gross domestic saving in 2000/01. The government's 2001/02 budget suggests that the fiscal deficit may remain high, especially once privatization receipts are excluded from the calculation and taking into account the possibility that activity may be slower than expected. Nonetheless, the budget included welcome signs that the commitment to structural reform has been reinvigorated, and proposed fiscal responsibility legislation also signals an encouraging willingness to take the steps necessary to achieve medium-term fiscal consolidation. In *Pakistan*, the depreciation of the rupee and the tightening of monetary policy in the second half of 2000 helped reverse the decline in official reserves, which had reached dangerously low levels. After bumper harvests of major crops last year, manufacturing output has started to pick up, but a severe drought is now casting a shadow over growth prospects for 2001–2002. The recent resolution of tariff disputes with independent power producers will boost investor confidence, but an enduring improvement in consumer and investor sentiment will require accelerated structural reforms to strengthen private sector activity and improve fiscal performance.

Turning to the remaining newly industrialized and ASEAN economies, activity is expected to slow most markedly in those countries where the recovery is furthest advanced; while this is expected, in a number of cases the slowdown has been exacerbated by domestic and external developments. This is particularly the case in *Korea*, where domestic confidence and demand have been weakened by concerns about the pace of corporate restructuring, and exports—

particularly of electronics goods—have slowed sharply. In *Singapore* and *Malaysia*, which are also advanced in the recovery, domestic demand remains relatively strong—notwithstanding some weakening in confidence in Malaysia on account of concerns over corporate restructuring—but slowing external demand is a serious concern. Elsewhere, the recovery has been much slower, and is in danger of weakening further. In the *Philippines*, while recent political uncertainties have now been resolved, they have been accompanied by substantial fiscal slippages. In *Thailand*, the recovery has been held back by weak consumer and investor sentiment, as well as by policy uncertainty and the slow pace of debt restructuring. Despite a pickup in activity in 2000, the economic and political situation in *Indonesia* remains very fragile, with deteriorating market sentiment reflected in continued downward pressure on the rupiah. Debt restructuring and asset recovery remain key to maintaining a sound macroeconomic framework, supported by safeguards to minimize the risks associated with ongoing fiscal decentralization. In a number of these countries, where inflation and fiscal sustainability are not a concern, there has been scope for moderate interest rate reductions, and, in some cases, for easing the pace of fiscal consolidation. However, the central challenge throughout the region remains to accelerate the pace of reform in the financial and corporate sectors. Although further restructuring could hamper activity in the short run, it is critical to boost domestic and external confidence (the gains from which would partly offset the short term negative impact), reduce financial risks, and to provide a basis for a sustained recovery in investment.

In *Australia* and *New Zealand*, strong export growth has continued, underpinned by strong external demand and highly competitive exchange rates, which continued to depreciate during much of 2000.[4] This provided strong support to activity—although in both cases the impact was offset by weakening domestic demand during the year—and also contributed to a significant reduction in current account deficits, which have been quite high by international standards. While activity in New Zealand has remained robust, domestic demand in Australia slowed sharply in the fourth quarter of 2000, although this largely reflected the impact of the mid-2000 changes in the tax regime on housing investment. In both countries, activity in 2001 will be adversely affected by the weakening external environment. With underlying inflationary pressures easing, both countries have reduced interest rates, and there is room for additional cuts if activity were to weaken further. On the structural side, Australia has successfully completed a major tax reform, recently enacted measures aimed at fostering innovation, and is preparing to tackle welfare reform (although less progress is being made on labor market deregulation). In New Zealand, despite some evidence of a pickup in productivity growth in the 1990s, the growth dividend from 15 years of reform appears to have been less than might have been expected. While the new government's focus on human capital development is appropriate, the authorities need to monitor closely the effects of recent measures that could reduce labor and product market flexibility.

## How Will the Global Slowdown Affect Latin America?

In Latin America and the Caribbean, GDP growth picked up to 4.1 percent in 2000, aided by buoyant U.S. demand, higher oil prices, and a recovery in domestic demand from the depressed levels of 1999 (Table 1.6). Within this, performance differed markedly across the region, with the strongest growth rates experienced in Mexico, Chile, and Brazil, underpinned by generally sound macroeconomic policy frameworks. Modest expansions are under way in the *Andean region*, with activity hampered in some cases by political uncertainties, while Argentina continues to struggle to escape recession. Notwithstanding the positive impact of

[4]See Chapter II, Box 2.1, for a discussion of developments in the Australian and New Zealand dollars.

**Table 1.6. Selected Western Hemisphere Countries: Real GDP, Consumer Prices, and Current Account Balance**
*(Annual percent change unless otherwise noted)*

| | Real GDP | | | | Consumer Prices[1] | | | | Current Account Balances[2] | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 1999 | 2000 | 2001 | 2002 | 1999 | 2000 | 2001 | 2002 |
| **Western Hemisphere** | **0.2** | **4.1** | **3.7** | **4.4** | **8.8** | **8.1** | **6.3** | **4.8** | **–3.2** | **–2.5** | **–3.3** | **–3.2** |
| **South America** | **–1.4** | **3.2** | **3.7** | **4.3** | **6.7** | **7.7** | **6.0** | **4.4** | **–3.0** | **–1.9** | **–2.9** | **–2.8** |
| Argentina | –3.4 | –0.5 | 2.0 | 3.8 | –1.2 | –0.7 | 0.6 | 0.6 | –4.4 | –3.4 | –3.4 | –3.0 |
| Brazil | 0.8 | 4.2 | 4.5 | 4.5 | 4.9 | 7.0 | 5.5 | 3.7 | –4.7 | –4.2 | –4.5 | –4.4 |
| Chile | –1.1 | 5.4 | 4.8 | 5.5 | 3.3 | 3.8 | 3.5 | 3.2 | –0.1 | –1.4 | –1.7 | –2.1 |
| Colombia | –4.3 | 2.8 | 3.2 | 3.8 | 10.9 | 9.2 | 8.8 | 6.9 | –0.1 | 0.2 | –1.8 | –2.7 |
| Ecuador | –7.3 | 2.3 | 3.4 | 3.0 | 52.2 | 96.2 | 40.6 | 11.9 | 6.9 | 5.3 | –1.2 | –2.6 |
| Peru | 1.4 | 3.6 | 2.5 | 5.0 | 3.5 | 3.8 | 3.3 | 2.4 | –3.5 | –3.0 | –2.4 | –2.4 |
| Uruguay | –3.2 | –1.0 | 2.0 | 4.0 | 5.7 | 4.8 | 4.9 | 4.4 | –2.5 | –2.9 | –2.5 | –2.1 |
| Venezuela | –6.1 | 3.2 | 3.3 | 2.8 | 23.6 | 16.2 | 12.5 | 13.6 | 3.6 | 10.8 | 4.3 | 4.3 |
| **Central America and Caribbean** | **3.8** | **6.2** | **3.7** | **4.6** | **13.6** | **8.8** | **7.0** | **5.6** | **–3.4** | **–3.4** | **–3.9** | **–3.8** |
| Dominican Republic | 8.0 | 7.8 | 6.5 | 6.4 | 6.5 | 7.7 | 10.9 | 4.4 | –2.5 | –6.3 | –3.3 | –3.1 |
| Guatemala | 3.5 | 3.6 | 3.0 | 2.9 | 5.3 | 7.0 | 7.6 | 10.1 | –5.6 | –4.7 | –4.4 | –4.3 |
| Mexico | 3.8 | 6.9 | 3.5 | 4.7 | 16.6 | 9.5 | 6.9 | 5.5 | –2.9 | –3.1 | –3.9 | –3.8 |

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

higher oil prices for many countries, the regional current account deficit improved only slightly, partly reflecting a strong rebound in domestic demand from the depressed levels of 1999. While vulnerability indicators have generally improved, the regional external financing requirement is the highest among developing country groups (Figure 1.3 and Table 1.7).

Looking to 2001, GDP growth is projected at 3.7 percent, with losses from the slowdown in the United States and somewhat lower oil prices partly offset by the positive impact of lower U.S. interest rates. While the situation differs across countries, the direct impact of the global slowdown on activity will be largest in Mexico (Figure 1.9) and in a number of countries in the Andean region and in Central America, but more moderate in those countries—such as Brazil and Argentina—that are less open and where trade links with the United States are less important. Given the still large external financing requirements across the region, the implications of the U.S. slowdown for financial markets is critical. While external financing conditions improved following the cut in U.S. interest rates in early 2001—allowing a number of countries to cover a substantial proportion of their external public sector financing requirements—they have deteriorated following the renewed economic difficulties in Argentina. If a hard landing in the United States were to be accompanied by greater financial market turbulence and a rise in investor risk aversion, or a slowdown in inward foreign direct investment (which finances the bulk of the regional current account deficit), the risks would correspondingly increase. With fiscal sustainability remaining a central concern in many countries, it will be important to maintain prudent fiscal policies, along with structural reforms—particularly in financial and corporate sectors, privatization, and labor markets—to retain the confidence of international investors, increase investment, and reduce the very high unemployment rates across much of the region.

During the latter part of 2000, developments in the hemisphere were overshadowed by the crisis in *Argentina*. Having withstood the Asian crisis relatively well, the economy came under increasing pressure during 1999 and 2000 from the combined impact of large terms of trade losses, the floating of the Brazilian real, the strength of the U.S. dollar (which hurt trade with Europe and Brazil, Argentina's two largest trading partners), and rising international interest rates.

**Table 1.7. Emerging Market Economies: Net Capital Flows[1]**
*(Billions of U.S. dollars)*

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Total** | | | | | | | | | | |
| Private capital flows, net[2] | 124.5 | 141.3 | 189.0 | 224.2 | 120.3 | 53.0 | 69.8 | 32.6 | 56.5 | 106.2 |
| Private direct investment, net | 56.6 | 80.9 | 96.8 | 120.2 | 144.9 | 151.0 | 150.3 | 143.9 | 150.5 | 155.8 |
| Private portfolio investment, net | 81.7 | 110.2 | 42.8 | 85.2 | 42.9 | 0.7 | 21.5 | 25.0 | 20.2 | 26.2 |
| Other private capital flows, net | –13.9 | –49.8 | 49.5 | 18.7 | –67.5 | –98.7 | –101.9 | –136.2 | –114.2 | –75.8 |
| Official flows, net | 54.1 | 8.2 | 31.3 | 0.9 | 56.8 | 62.1 | 10.6 | 4.8 | 5.9 | 7.4 |
| Change in reserves[3] | –64.5 | –69.0 | –118.9 | –109.6 | –62.4 | –34.8 | –85.5 | –119.9 | –85.7 | –96.0 |
| *Memorandum* | | | | | | | | | | |
| Current account[4] | –116.9 | –74.2 | –92.2 | –96.1 | –71.0 | –57.3 | 32.5 | 112.9 | 48.9 | –3.8 |
| **Africa** | | | | | | | | | | |
| Private capital flows, net[2] | 3.2 | 11.4 | 12.3 | 12.3 | 16.8 | 10.9 | 12.7 | 8.6 | 14.7 | 14.0 |
| Private direct investment, net | 2.2 | 2.4 | 2.9 | 4.7 | 8.1 | 7.0 | 8.9 | 6.8 | 10.3 | 8.4 |
| Private portfolio investment, net | 0.9 | 3.5 | 3.1 | 2.8 | 7.0 | 3.7 | 8.7 | 4.3 | 3.9 | 4.4 |
| Other private capital flows, net | 0.0 | 5.5 | 6.4 | 4.9 | 1.6 | 0.1 | –4.9 | –2.4 | 0.5 | 1.2 |
| Official flows, net | 4.5 | 5.0 | 3.9 | –2.1 | –1.8 | 2.7 | 1.4 | –4.4 | –1.5 | –2.6 |
| Change in reserves[3] | 3.2 | –5.4 | –2.0 | –9.1 | –10.6 | 1.9 | –3.5 | –14.4 | –13.7 | –11.0 |
| *Memorandum* | | | | | | | | | | |
| Current account[4] | –12.3 | –12.3 | –16.9 | –6.3 | –8.0 | –20.5 | –15.5 | 1.3 | –3.7 | –5.5 |
| **Developing Asia[5]** | | | | | | | | | | |
| **Crisis countries[6]** | | | | | | | | | | |
| Private capital flows, net[2] | 20.7 | 33.4 | 38.9 | 64.0 | –9.0 | –32.7 | –9.1 | –10.2 | –16.8 | 0.2 |
| Private direct investment, net | 6.7 | 6.5 | 8.8 | 9.8 | 10.5 | 10.9 | 7.8 | 8.6 | 10.0 | 11.8 |
| Private portfolio investment, net | 17.1 | 11.3 | 17.7 | 23.6 | 7.2 | –9.3 | 3.6 | 4.0 | –0.6 | 1.9 |
| Other private capital flows, net | –3.1 | 15.5 | 12.4 | 30.5 | –26.7 | –34.3 | –20.5 | –22.7 | –26.1 | –13.6 |
| Official flows, net | 3.3 | 0.9 | 14.9 | –3.9 | 14.6 | 17.8 | –5.6 | 2.5 | –0.4 | –3.3 |
| Change in reserves[3] | –20.6 | –6.1 | –19.0 | –5.4 | 39.4 | –46.9 | –39.3 | –22.9 | –9.1 | –21.2 |
| *Memorandum* | | | | | | | | | | |
| Current account[4] | –13.5 | –23.2 | –39.1 | –53.0 | –25.5 | 69.9 | 62.9 | 44.8 | 38.3 | 30.4 |
| **Other Asian emerging markets** | | | | | | | | | | |
| Private capital flows, net[2] | 20.9 | 33.7 | 35.6 | 50.0 | 22.4 | –14.3 | 9.6 | 8.4 | 3.4 | 13.1 |
| Private direct investment, net | 26.4 | 38.2 | 39.7 | 45.7 | 49.7 | 48.5 | 42.8 | 38.5 | 39.7 | 43.1 |
| Private portfolio investment, net | 0.9 | 7.6 | 2.0 | 3.5 | –0.1 | –6.3 | 0.7 | 8.7 | 3.1 | 3.9 |
| Other private capital flows, net | –6.3 | –12.1 | –6.1 | 0.8 | –27.1 | –56.4 | –33.9 | –38.8 | –39.4 | –34.0 |
| Official flows, net | 8.2 | 2.3 | –3.6 | –7.9 | –7.3 | 0.4 | 3.1 | –5.9 | 0.9 | 1.4 |
| Change in reserves[3] | –16.7 | –51.5 | –25.4 | –41.7 | –46.9 | –17.0 | –38.7 | –25.8 | –19.7 | –25.2 |
| *Memorandum* | | | | | | | | | | |
| Current account[4] | –7.2 | 18.3 | 8.1 | 14.9 | 51.0 | 41.5 | 38.3 | 33.3 | 22.3 | 16.6 |
| **Middle East, Malta, and Turkey[7]** | | | | | | | | | | |
| Private capital flows, net[2] | 25.1 | 15.1 | 11.1 | 14.6 | 19.4 | 8.1 | 3.7 | –16.2 | –10.8 | 0.2 |
| Private direct investment, net | 3.3 | 5.3 | 7.4 | 8.3 | 7.3 | 7.9 | 5.0 | 9.0 | 8.6 | 10.5 |
| Private portfolio investment, net | 6.9 | 8.1 | 3.0 | 2.7 | 1.7 | –11.4 | –4.2 | –2.1 | –2.5 | 0.6 |
| Other private capital flows, net | 14.9 | 1.7 | 0.8 | 3.5 | 10.4 | 11.6 | 2.9 | –23.1 | –16.9 | –10.9 |
| Official flows, net | 5.6 | 2.3 | 3.2 | 4.7 | 2.0 | 8.5 | 5.0 | –5.3 | –3.3 | 0.4 |
| Change in reserves[3] | 1.2 | –4.7 | –11.3 | –22.0 | –20.8 | 10.3 | –6.5 | –23.0 | –18.7 | –12.9 |
| *Memorandum* | | | | | | | | | | |
| Current account[4] | –29.9 | –7.1 | –5.9 | 4.2 | 1.9 | –29.5 | 4.2 | 54.8 | 45.1 | 19.8 |

*(continued)*

With domestic demand weakening, Argentina became mired in a circle of near stagnation, declining business and consumer confidence, and rising interest rates. As emerging market spreads widened from late September, political uncertainties triggered a sharp deterioration in the country's financing conditions, with investor attention focusing increasingly on the large gross public financing requirement in 2001 and beyond. This was accompanied by signs of contagion to other countries in the region.

In response, the authorities moved quickly to strengthen the policy framework. Key elements included a fiscal pact with the provinces, to ensure that budget balance is achieved by 2005; improving product and labor flexibility to facilitate adjustment under the currency board system; reducing fiscal impediments to investment; a re-

## Table 1.7 *(concluded)*

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Western Hemisphere** | | | | | | | | | | |
| Private capital flows, net[2] | 37.3 | 42.8 | 41.6 | 62.8 | 68.1 | 61.8 | 40.4 | 39.2 | 60.6 | 70.7 |
| Private direct investment, net | 12.2 | 23.1 | 24.9 | 39.3 | 53.8 | 56.3 | 64.2 | 56.9 | 53.9 | 53.5 |
| Private portfolio investment, net | 47.2 | 62.4 | 2.5 | 38.0 | 19.0 | 19.9 | 10.4 | 4.7 | 10.7 | 11.6 |
| Other private capital flows, net | –22.1 | –42.6 | 14.2 | –14.4 | –4.7 | –14.5 | –34.2 | –22.3 | –4.1 | 5.6 |
| Official flows, net | 30.5 | 7.8 | 17.5 | 6.1 | 16.2 | 15.4 | 7.4 | 17.1 | 9.1 | 8.4 |
| Change in reserves[3] | –20.7 | 4.0 | –23.4 | –29.4 | –13.8 | 19.0 | 9.3 | –12.9 | –5.0 | –11.5 |
| *Memorandum* | | | | | | | | | | |
| Current account[4] | –45.9 | –52.0 | –36.9 | –38.9 | –66.8 | –90.2 | –55.7 | –47.9 | –66.4 | –68.7 |
| **Countries in transition** | | | | | | | | | | |
| Private capital flows, net[2] | 17.4 | 4.8 | 49.6 | 20.5 | 2.5 | 19.2 | 12.5 | 2.8 | 5.4 | 8.2 |
| Private direct investment, net | 6.0 | 5.3 | 13.1 | 12.4 | 15.5 | 20.5 | 21.6 | 24.2 | 28.1 | 28.4 |
| Private portfolio investment, net | 8.7 | 17.3 | 14.6 | 14.6 | 8.0 | 4.0 | 2.2 | 5.3 | 5.5 | 3.9 |
| Other private capital flows, net | 2.7 | –17.8 | 21.9 | –6.5 | –20.9 | –5.2 | –11.2 | –26.7 | –28.3 | –24.1 |
| Official flows, net | 2.1 | –10.1 | –4.5 | 4.0 | 33.1 | 17.3 | –0.8 | 0.8 | 1.0 | 3.0 |
| Change in reserves[3] | –10.8 | –5.3 | –37.8 | –2.0 | –9.8 | –2.1 | –6.7 | –21.0 | –19.5 | –14.2 |
| *Memorandum* | | | | | | | | | | |
| Current account[4] | –8.1 | 2.2 | –1.5 | –16.8 | –23.7 | –28.4 | –1.7 | 26.7 | 13.5 | 3.6 |

[1]Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing. Emerging markets include developing countries, countries in transition, Korea, Singapore, Taiwan Province of China, and Israel. No data for Hong Kong SAR are available.
[2]Because of data limitations, other net investment may include some official flows.
[3]A minus sign indicates an increase.
[4]The sum of the current account balance, net private capital flows, net official flows, and the change in reserves equals, with the opposite sign, the sum of the capital account and errors and omissions.
[5]Includes Korea, Singapore, and Taiwan Province of China. No data for Hong Kong SAR are available.
[6]Indonesia, Korea, Malaysia, the Philippines, and Thailand.
[7]Includes Israel.

form of the health and pension systems; and substantial additional financing from the IMF, other multilateral and bilateral creditors, and the private sector to ease the government's financing needs in 2001 and beyond. The strengthened economic program was well received by financial markets, with an initial sharp decline in spreads. However, spreads have since rebounded as a result of evidence of difficulties in the fiscal area and renewed concerns on external financing issues, and as yet, there is no clear indication of a turning point in economic activity. The authorities' most recent initiatives to strengthen the policy framework are welcome; but with very limited room for policy maneuver it will be critical that fiscal restraint is maintained, and that the authorities at all levels of government adhere to the economic program.

In *Mexico*, activity remained very strong during most of 2000, buoyed by rising exports to the United States and rapid consumption and investment growth. In response to rising demand pressures, monetary policy was tightened steadily during the year; inflation was held within the authorities' 10 percent target, but the external current account widened to 3.1 percent of GDP (notwithstanding significantly higher oil revenues). From late 2000, industrial production growth decelerated sharply, particularly in those sectors most closely linked to the United States. With oil prices also declining modestly, GDP growth is expected to fall back to 3.5 percent in 2001, and the current account balance to widen to 4 percent of GDP, increasing vulnerability to external shocks. Against this background, Mexico should maintain—and if possible strengthen—the prudent fiscal stance incorporated in the new administration's 2001 budget. On the structural side, the authorities' plans to reform the budgetary process, simplify the tax system, and move toward international standards for fiscal accounting are welcome. Further measures to strengthen banks' capital base are also a priority, building on the significant progress of recent years.

In Brazil, output growth has remained robust, despite concern about potential for contagion

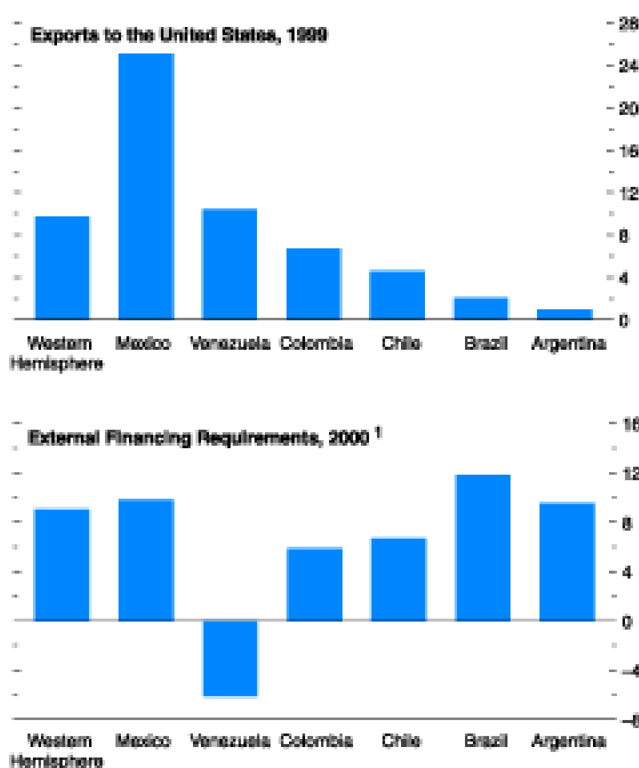
from the Argentine crisis. GDP growth averaged 4.5 percent in 2000, and is projected to reach a similar level in 2001, as slowing export growth is offset by robust domestic demand. With consumer price inflation of 6 percent, inflation was held in line with the target for the second year in a row, which helped the inflation targeting framework to gain substantial credibility. While Brazil remains vulnerable to adverse developments in the external environment, given the sizable current account deficit and external financing requirement, the economy is now in stronger shape to withstand such shocks. The recent tightening of monetary policy underlined the central bank's full commitment to the inflation targeting regime and was appropriate considering, among other factors, the weakening of the real against the U.S. dollar since the beginning of the year. Monetary policy should continue to respond swiftly to developments that could threaten the inflation target. Similarly, the government's proposal to strengthen its fiscal position for 2002–04, and maintain the primary surplus target of the consolidated public sector at 3 percent of GDP, will help to contain the adverse effect of higher interest rates on the budget and put the debt-to-GDP ratio firmly on a downward path. In view of current uncertainties, the authorities should stand ready to take additional action if necessary.

In *Chile*, activity rebounded in 2000 aided by rising exports and investment, although both industrial production and exports have weakened recently and unemployment remains stubbornly high. Given its relatively open economy—and substantial share of exports to the United States and emerging Asia—growth is expected to decline in 2001, although vulnerability to external financial market developments is more modest. Over the medium term, the structural fiscal balance target of 1 percent of GDP may help avoid the procyclical fiscal policy stance that has afflicted many countries in the region.

In the Andean region, GDP growth was generally stronger than expected in 2000, and—notwithstanding lower oil prices—is expected in

**Figure 1.9. Western Hemisphere: Exposure to External Shocks**
*(Percent of GDP)*

The extent of trade linkages with the United States varies widely. Most countries have substantial external financing requirements, making them vulnerable to developments in international financial markets.




Sources: IMF, *Direction of Trade Statistics*; and IMF staff estimates.
[1]External current account deficit plus amortization payments.

**Table 1.8. Selected African Countries: Real GDP, Consumer Prices, and Current Account Balance**
*(Annual percent change unless otherwise noted)*

| | Real GDP | | | | Consumer Prices[1] | | | | Current Account Balances[2] | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 1999 | 2000 | 2001 | 2002 | 1999 | 2000 | 2001 | 2002 |
| **Africa** | 2.3 | **3.0** | **4.2** | **4.4** | **11.5** | **13.5** | **9.6** | **5.7** | **–3.6** | **0.3** | **–0.8** | **–1.2** |
| **Maghreb** | **2.5** | **2.6** | **5.2** | **3.7** | **2.0** | **1.4** | **3.4** | **3.4** | **–0.6** | **7.5** | **5.8** | **3.6** |
| Algeria | 3.2 | 3.0 | 3.1 | 3.1 | 2.6 | 0.3 | 4.0 | 4.5 | 0.0 | 17.3 | 13.8 | 9.4 |
| Morocco | –0.7 | 0.8 | 7.8 | 3.3 | 0.7 | 2.0 | 2.8 | 2.3 | –0.5 | –1.7 | –1.4 | –1.0 |
| Tunisia | 6.2 | 5.0 | 6.2 | 6.1 | 2.7 | 3.0 | 2.9 | 2.7 | –2.1 | –3.7 | –3.0 | –2.7 |
| **Sub-Sahara[3]** | 2.4 | 3.0 | 4.0 | 5.0 | 19.1 | 23.3 | 14.5 | 7.3 | –7.5 | –3.3 | –5.3 | –4.4 |
| Cameroon | 4.4 | 4.2 | 5.4 | 5.7 | 2.9 | 0.8 | 2.0 | 2.0 | –4.1 | –1.7 | –2.7 | –2.4 |
| Côte d'Ivoire | 1.6 | –2.0 | 0.3 | 3.6 | 0.7 | 2.5 | 2.0 | 2.0 | –4.2 | –4.6 | –4.3 | –3.7 |
| Ghana | 4.4 | 3.7 | 5.0 | 5.5 | 12.4 | 25.0 | 30.0 | 17.8 | –9.9 | –6.6 | –3.6 | –2.7 |
| Kenya | 2.0 | –0.4 | 2.1 | 2.8 | 3.5 | 6.2 | 5.0 | 4.5 | –2.4 | –2.9 | –9.3 | –5.1 |
| Nigeria | 1.1 | 2.8 | 1.7 | 2.5 | 6.6 | 6.9 | 12.5 | 7.8 | –9.5 | 4.9 | –2.1 | –0.9 |
| Tanzania | 4.8 | 5.1 | 5.4 | 5.7 | 6.3 | 6.2 | 5.0 | 4.2 | –3.9 | –2.4 | –3.5 | –3.3 |
| Uganda | 7.6 | 4.6 | 5.0 | 7.2 | –0.2 | 6.3 | 5.0 | 5.0 | –7.2 | –8.1 | –8.4 | –10.3 |
| **South Africa** | **1.9** | **3.2** | **3.8** | **3.8** | **5.2** | **5.4** | **5.2** | **4.5** | **–0.4** | **–0.1** | **0.2** | **–0.3** |
| ***Memorandum*** | | | | | | | | | | | | |
| Oil importers | 2.3 | 3.0 | 4.7 | 4.7 | 11.0 | 13.4 | 8.7 | 5.1 | –3.0 | –3.0 | –3.0 | –2.9 |
| Oil exporters | 2.0 | 3.0 | 2.8 | 3.2 | 13.2 | 13.7 | 12.8 | 7.9 | –5.8 | 9.6 | 5.6 | 4.4 |

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

most cases to pick up further in 2001, aided by strengthening domestic demand. In *Venezuela*, activity has been boosted by a sharp increase in government spending. While the authorities have set aside part of the windfall gain in oil prices, with the non-oil balance in large deficit, the fiscal position remains very vulnerable to developments in oil prices. The fiscal position also remains a challenge in *Colombia*, especially given the potential costs of bank restructuring and pension reform. In *Ecuador*, dollarization continues to proceed satisfactorily, and macroeconomic stability has improved. However, further progress is needed to strengthen the banking system, while the recent defeat of the authorities' proposed tax reform in the congress will set back the needed strengthening of the fiscal policy framework unless the partial presidential veto, which seeks to maintain key elements of the tax reform, is sustained.

In Central America, GDP growth slowed in most countries in 2000, as the cost of oil imports rose and world coffee prices remained depressed, although *Honduras* and *Nicaragua* continued to register robust growth as they recovered from the effects of Hurricane Mitch. With the region heavily exposed to developments in the United States, economic growth may be slower than expected, although the impact may be offset by the expansion in access to U.S. markets following the Caribbean Basin Initiative in October 2000 (involving *El Salvador*, *Guatemala*, and Honduras); and debt relief under the Enhanced HIPC Initiative (Nicaragua and Honduras). The region will need to continue to strengthen fiscal policy, with an emphasis on raising tax revenues, which tend to be low in relation to GDP. On January 1, 2001, El Salvador introduced the U.S. dollar as legal tender, with a view to strengthening the country's integration with the world economy. The other countries in the region, apart from Panama, do not intend to dollarize.

## Can Africa Achieve Sustained Higher Growth?

In *Africa*, after two decades of economic stagnation, GDP growth picked up substantially in the second half of the 1990s, underpinned by a

renewed commitment to sound economic policies and more open and better managed economies. This was accompanied by improved macroeconomic performance, notably lower inflation and a reduction in fiscal and current account deficits (although, given Africa's still high debt burden, the latter generally remain substantial—see Table 1.8).[5] However, particularly in sub-Saharan Africa, the rate of improvement fell back significantly later in the decade (Figure 1.10). In large part, this deterioration can be traced to the rising incidence of war and civil conflict, and to a lesser extent terms of trade losses from weak commodity prices and latterly from high oil prices. Countries that maintained sound economic policies and political stability (see Figure 1.10) were able to maintain relatively strong rates of growth—notwithstanding, in some cases, sizable commodity price shocks.

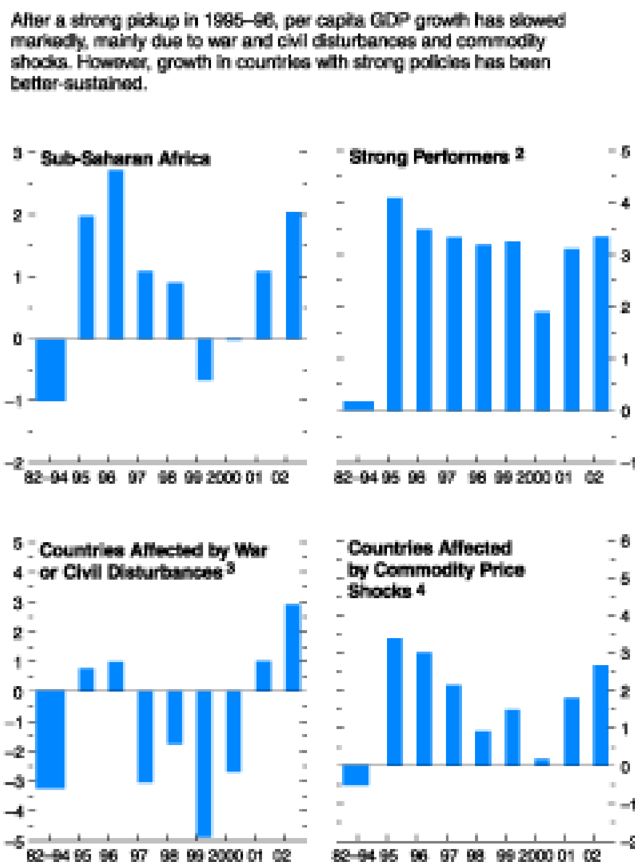
Growth in Africa is projected to rise to 4.2 percent in 2001 and somewhat further in 2002, with activity picking up fastest in those countries that suffered most from domestic or external shocks. This pickup will, however, depend on the implementation of sound macroeconomic and structural policies, as well as a significant improvement in the security situation in many countries.[6] Recent improvements remain fragile (the experience of *Zimbabwe* shows how quickly macroeconomic gains can be lost); in addition, Africa would suffer from a steeper than expected global slowdown, particularly as a result of falling commodity prices. Nonetheless, the recent strengthening of economic policies—supported by debt relief through the enhanced HIPC initiative and the IMF's Poverty Reduction and Growth Facility (Box 1.4)—has helped to improve the environment to achieve sustained growth. This is an important beginning, but

[5]See Chapter IV for a detailed discussion of the factors underlying the improvement in inflation in developing countries.

[6]Over the past decade, partly because these conditions have not been satisfied, the IMF's forecasts for growth in Africa have been consistently over optimistic; growth projections made at the beginning of the forecast year have averaged about 1 percentage point higher than the actual outcome.

**Figure 1.10. Sub-Saharan Africa: Why Has the Recent Expansion Slowed?[1]**
*(Per capita real GDP growth, percent)*

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




[1]Excluding South Africa.
[2]Countries with generally strong macroeconomics and structural policies; comprises Benin, Botswana, Burkina Faso, Cameroon, Mali, Mauritius, Mozambique, Rwanda, Tanzania, Senegal, Seychelles, and Uganda (24 percent of sub-Saharan African GDP).
[3]Countries experiencing war or significant civil disturbances during 1998–2000; comprises Angola, Burundi, Comoros, Congo, Dem Rep. of, Congo, Rep. of, Côte d'Ivoire, Ethiopia, Guinea-Bissau, Lesotho, and Sierra Leone (20 percent of sub-Saharan African GDP).
[4]Countries experiencing adverse commodity price shocks exceeding 10 percent in 2000 compared with the 1995–97 average; comprises Benin, Burundi, Burkina Faso, Central African Rep. , Chad, Côte d'Ivoire, Ethiopia, Ghana, Madagascar, Mali, Mauritius, Rwanda, São Tomé and Príncipe, Tanzania, Togo, Zambia, and Uganda (33 percent of sub-Saharan African GDP).

African countries continue to face enormous development challenges. Strong domestic policies, undertaken in an environment of peace and reasonable political stability, additional international assistance, and more open markets in industrial countries, will all be needed in order to raise growth to the levels necessary to support a meaningful reduction in poverty.

In *South Africa,* activity is recovering well from a series of adverse shocks, including higher oil prices, unfavorable weather conditions, and contagion from the crisis in Zimbabwe. GDP growth is estimated at 3.2 percent in 2000, and should rise to 3.8 percent in 2001. However, with global demand slowing, and consumer and business confidence still quite weak, there are downside risks to the outlook. Moreover, while the current account deficit is modest, persistent capital outflows—linked in part to the Zimbabwe crisis—have contributed to a steady weakening in the rand. With inflation having peaked at about 8 percent, the Reserve Bank appears on track to meet its target of 3 to 6 percent in 2002; with direct inflationary pressures easing, there may be scope to ease interest rates later in the year, once it is clear that second round effects from rand weakness and oil price hikes are dissipating. Over the medium term, to address high unemployment, poverty, and extreme income inequality, the challenge is to increase growth to above 6 percent through accelerated structural reforms, particularly in the labor market and privatization.

Elsewhere in Africa, developments continue to depend importantly on commodity prices. The oil exporting countries of north and west Africa have experienced a large improvement in their terms of trade, resulting in much stronger fiscal and external balances. However, GDP growth has generally increased only modestly, constrained by structural weaknesses in non-oil sectors and in some cases war and political uncertainty. In *Nigeria*, the democratically elected government that took office in May 1999 initially took important measures to address macroeconomic imbalances and began to tackle corruption. However, signs of sustained economic recovery remain elusive; federal government spending has risen sharply, primarily due to higher wages; reserve money growth has accelerated, leading to rising inflation and pressures on the naira; and structural reforms have fallen behind schedule. Higher oil prices temporarily boosted the current account, but the medium term external situation remains difficult. To restore macroeconomic stability, strict financial discipline—through limiting expenditure by federal government—remains critical, supported by market-based reforms—especially in the conduct of monetary and exchange rate policies, privatization, trade policy, and governance—and additional debt relief. In *Algeria*, where unemployment is estimated at 30 percent, the main challenge is to achieve a sustained increase in growth, without jeopardizing the hard won progress toward macroeconomic stability in recent years. While the fiscal position remains in strong surplus, recent substantial increases in the minimum wage and civil service salaries may increase vulnerability to developments in oil prices (as well as exacerbate labor market imbalances). It will also be important to accelerate the pace of structural reform, particularly in the areas of banking and privatization.

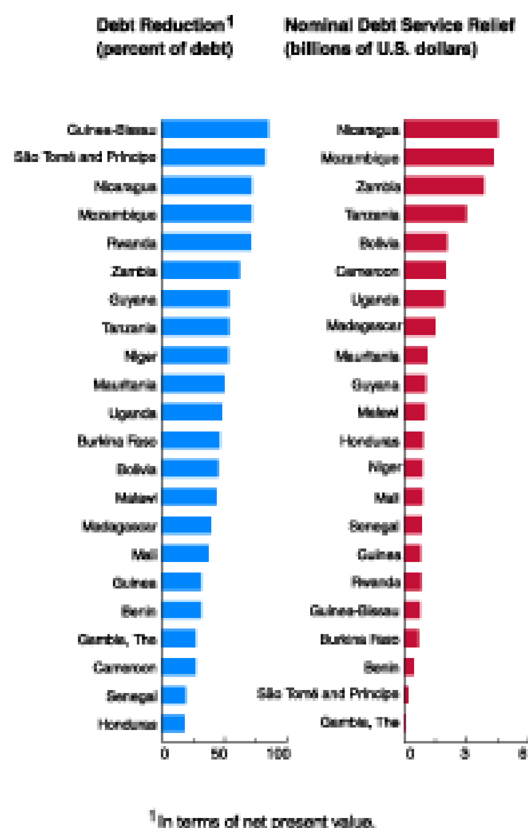
In much of the rest of Africa, the terms of trade have deteriorated substantially in recent years. While this has been partly offset by rising export volumes—particularly in the Horn of Africa and eastern and southern Africa—much of the impact has been absorbed through lower domestic demand and growth. In 2001–02, nonfuel commodity prices are projected to remain weak, albeit offset to some extent by lower oil prices. Macroeconomic stability has in general improved, but remains a concern in some countries, particularly in southern and eastern Africa. In a number of these—notably *Angola*, the *Democratic Republic of the Congo*, and Zimbabwe—conflicts or domestic political turmoil have contributed to a substantial weakening in macroeconomic policies, and in some cases—especially Zimbabwe—have had adverse effects on neighboring countries.

For the region as a whole, the central policy challenge remains to improve the environment

## Box 1.4. The Enhanced HIPC Initiative in Africa

To address the problem of unsustainable debt burdens in poor countries, mainly in Africa, the IMF and the World Bank launched the Initiative for the Heavily Indebted Poor Countries (HIPC Initiative) in 1996. This was enhanced in the fall of 1999 in the context of strengthening the links between debt relief and poverty reduction by providing faster, deeper, and broader debt relief, supported by country-owned and participatory strategies designed to help these countries reach the International Development Goals for poverty reduction and other key social indicators.[1] The main goals are reducing the proportion of people living in extreme poverty by at least one half by 2015 (from the 1990 level); achieving universal primary education in all countries by 2015; eliminating gender disparity in primary and secondary education by 2005; and reducing child mortality by two-thirds and maternal mortality by three-fourths by 2015 (from the 1990 level).

For Africa, the enhancements to the HIPC Initiative resulted in a broadening of the number of countries that could qualify for debt relief to 33.[2] So far, 18 African countries reached the point where they qualify for and can start to receive HIPC debt relief—their so-called decision points—and will receive total debt service relief amounting to $25 billion in nominal terms ($15 billion in net present value terms). On average,




HIPC relief combined with existing debt relief mechanisms will reduce countries' debt service by two-thirds (see the figure), equivalent to between 1 and 2½ percent of GDP per year. The debt relief allows significant increases in pro-poor expenditure, in particular, in education and health, for which today's public spending levels in sub-Saharan Africa average about 6 percent of GDP (compared with 6.5 percent for the average of all IMF-supported program countries).

All African countries that have reached their decision points are significantly increasing the budget allocations for social and other program spending, in several countries by more than the

[1] See "The New Approach to Poverty Reduction", Chapter IV in the May 2000 *World Economic Outlook* for a detailed description of the Enhanced HIPC Initiative. See also http://www.imf.org/external/np/HIPC.

[2] Of these, 18 have reached the point at which they qualify for debt relief (Benin, Burkina Faso, Cameroon, The Gambia, Guinea, Guinea-Bissau, Madagascar, Malawi, Mali, Mauritania, Mozambique, Niger, Rwanda, São Tomé and Príncipe, Senegal, Tanzania, Uganda, and Zambia), 12 have still to qualify (Burundi, Central African Republic, Chad, Republic of Congo, Democratic Republic of Congo, Côte d'Ivoire, Ethiopia, Liberia, Sierra Leone, Somalia, Sudan, and Togo), and two are expected not to require assistance (Angola and Kenya). Ghana decided in 1999 not to seek debt relief under the Initiative.

### Box 1.4 *(concluded)*

HIPC debt relief through a reallocation of resources from lower-priority uses. But it is equally, if not more, important to ensure that such spending is efficient and reaches the poor. This involves major efforts to strengthen the budget process, including through the introduction or strengthening of medium-term expenditure frameworks (such as in Uganda, Malawi, and Zambia). It also involves the systematic tracking of government expenditure to the intended programs and their beneficiaries (for example, special surveys are being undertaken with donor support in Cameroon, The Gambia, and Madagascar). And more generally, it involves steps to enhance accountability in the use of public resources (including HIPC relief) through the establishment or strengthening of the general accountant's office (like in The Gambia, Niger, Rwanda, and São Tomé and Príncipe) or the introduction or strengthening of financial management systems (like in Zambia and Malawi).

A critical element in the HIPC Initiative is that every country prepares an *Interim Poverty Reduction Strategy Paper* (IPRSP) and then a *Poverty Reduction Strategy Paper* (PRSP) through a consultative process. These papers focus on:

- Maintenance of macroeconomic stability and achievement of equitable growth, both essential for sustainable poverty reduction.
- Greater specification of measurable targets for poverty reduction and social indicators and incorporation of the costs of reaching these targets in the budget.
- Increases in the level and efficiency of pro-poor spending. HIPC relief permits countries to continue the upward trend in such spending shown in recent years, while maintaining overall fiscal balances consistent with debt sustainability.
- Clearer identification of pro-poor spending in the budget and improvements in monitoring. This typically involves adopting new budget classifications, introducing medium-term expenditure frameworks, undertaking regular public expenditure reviews, decentralizing social services provision to local governments, and holding regular beneficiary "tracking" surveys.

The focus on poverty reduction and safeguarding the efficient use of debt relief are also reflected in triggers for reaching the point at which HIPC debt relief becomes fully and irrevocably available to the country—the so-called completion point. The triggers for African HIPCs have typically covered:[3]

- *Governance.* Measurable progress in public expenditure management, accountability, anti-corruption safeguards, and tracking of expenditures to beneficiaries.
- *Education.* Measurable progress in public spending levels/efficiency; number of teachers and classrooms; improved incentives for rural teachers; and enrollment rates.
- *Health.* Measurable progress in public spending levels/efficiency; number of health workers and equipped health centers; provision of drugs; immunization rates, mortality, and morbidity rates.
- *Other reforms* essential for poverty reduction, such as the implementation of AIDS action plans; rural road maintenance: improvements in micro finance institutions; and privatization of essential public enterprises.

In the period ahead, the critical issue for countries that have reached the decision point is to ensure that poverty reduction strategies are fully implemented. They need also to improve their expenditure systems to ensure that available resources (including HIPC relief) are used efficiently and reach the poor. Assistance from countries' external partners for the PRSP process and expenditure management is essential. For the 12 HIPC-eligible African countries that still have to qualify for HIPC relief, however, there are many obstacles to overcome. Nine of these countries are affected by ongoing or past armed conflicts, many have poor eco-

[3]For reaching their completion points, it is necessary that countries have maintained macroeconomic stability, as evidenced by satisfactory implementation of the PRGF-program, and have prepared, and implemented satisfactorily for one year, a full PRSP.

nomic performance linked to weak governance, and several have large and protracted arrears, including to the World Bank, IMF, and African Development Bank. Through technical assistance and policy advice, often under staff-monitored programs, the IMF is helping these countries, where possible, to establish a minimum track record of good economic policies and to regain access to financing from multilateral institutions and bilateral donors. In all of the HIPC countries, however, debt relief by itself is not enough. As stressed in Chapter I of this *World Economic Outlook*, additional foreign aid is needed, and, even more important, advanced economies must provide these countries greater access to their markets to ensure that the poorest countries can begin to share more fully in global prosperity.

for private investment, which remains very low compared with other developing country regions. The priorities are to strengthen public service delivery, including education and poverty relief, financed by debt relief and improved tax administration; to improve infrastructure (including through privatization); and to continue to open up to the outside world. There is also a pressing need to improve governance, which remains a pervasive problem, including through greater transparency in public sector resource management (under way in *Kenya* and *Mozambique*); developing sound and efficient civil services and legal frameworks (in progress in *Cameroon* and *Zambia*); and attacking corruption (where *Senegal*, *Tanzania*, and *Uganda* have taken important steps).

For many countries, AIDS has become a major threat to sustainable development, with between 20 and 36 percent of the adult population of countries in southern Africa now infected with the virus. Since combination therapies to prolong life are generally not available, due to the high cost of anti-retroviral drugs and weak medical infrastructure (particularly in rural areas), deaths in the adult population will rise sharply over the next 10 years, with severe social and economic consequences.[7] Prevention efforts—which are relatively inexpensive and have proved quite effective in some countries, including Uganda and Senegal—have been stepped up in many countries, but only a few countries—including South Africa recently—provide drug treatments to pregnant women to reduce transmission to unborn children. While budgetary resources are generally very limited, every effort will need to be made to reduce nonproductive outlays to finance additional health-related expenditures. Given the scale of the problem, substantial external support will also be essential.

[7]See Box 1.4 of the October 2000 *World Economic Outlook* for a discussion of the macroeconomic consequences of AIDS in Africa.

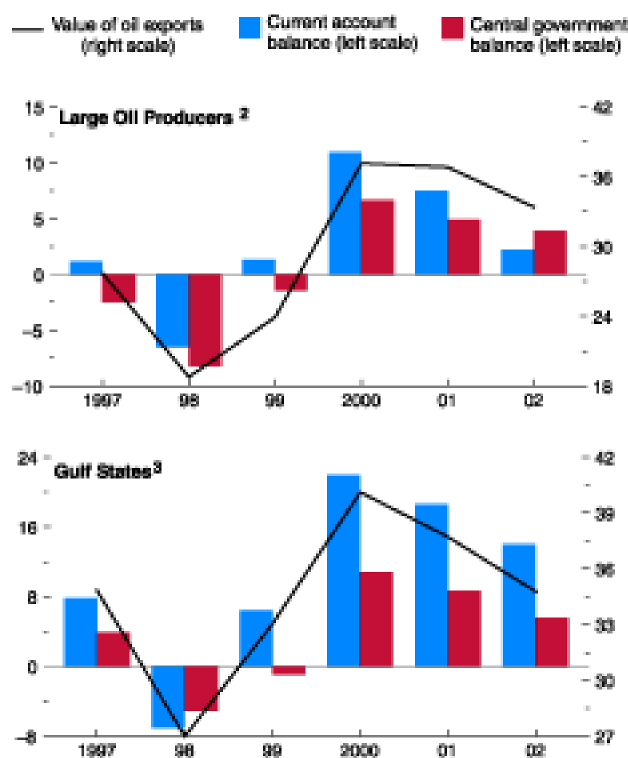
## The Middle East: Managing Terms of Trade Volatility

In the Middle East, oil price fluctuations continue to dominate economic developments, resulting in sharp terms of trade volatility. After falling by 20 percent in 1998, the terms of trade for the region soared by some 50 percent in 1999–2000, as oil prices rebounded. Higher oil revenues have largely been saved, leading to a substantial improvement in fiscal and external imbalances in many countries (Figure 1.11 and Table 1.9). The strengthening terms of trade, and several increases in OPEC oil production quotas during 2000, also boosted activity, with GDP growth rising by 2.1 percentage points to 4.8 percent in 2000, the highest since the early 1990s.

While oil prices have fallen back somewhat from their peaks in late 2000, they are expected to remain relatively high in historical terms in 2001. Since the windfall gains from higher oil prices have in general been prudently used, the

**Figure 1.11. Middle East: Responding to Oil Price Volatility**[1]
*(Percent of GDP)*

In most countries, the recent windfall increases in oil prices have been prudently used, and the projected decline in 2001–02 will be manageable.




[1]Data for 2001 and 2002 are IMF staff projections.
[2]Iran, Islamic Rep. of, Libya, and Saudi Arabia.
[3]Bahrain, Kuwait, Oman, Qatar, and United Arab Emirates.

impact of somewhat lower prices in most countries is expected to remain manageable. Thus, growth is projected to remain reasonably robust in 2001 and 2002, and in most cases fiscal and external positions would be able to absorb the bulk of the oil price fall. However, given the continued volatility in oil prices and recent production cuts, there may be downside risks to the outlook. Hence, a prudent approach to fiscal policy remains desirable, especially in those countries—such as *Saudi Arabia*—that need to reduce government debt.

More generally, recent oil price volatility continues to underscore the need for reforms to promote economic diversification and growth. In the *Gulf Cooperation Council* countries (*Bahrain, Kuwait, Oman, Qatar, Saudi Arabia*, and *United Arab Emirates*), efforts should continue to focus on encouraging the expansion of the non-oil private sector, including through removing impediments to foreign direct investment; strengthening labor markets; and accelerating privatization. In other countries, where growth and employment are constrained by dominant state sectors and widespread controls, the challenge is more wide ranging. *Iran*, in a clear break with the past, is enacting a welcome program of reforms, although in some areas—notably price and trade liberalization, privatization, and the development of a social safety net—a bolder approach could pay dividends.

Turning to other countries in the region, GDP growth in the *Mashreq* (comprising Egypt, Jordan, Lebanon, Syria, and the West Bank and Gaza Strip) increased to 4.2 percent, while inflation remained well under control. Growth in the region has been the strongest in *Egypt*, spurred by broad-based economic reform in the mid-1990s. However, from late 1997, external shocks, including the appreciation of the U.S. dollar, combined with relatively expansionary fiscal and monetary policies and a slowdown in structural reforms, resulted in a deterioration in the external position, and a decline in international reserves. After allowing the currency to depreciate by about 12 percent in 2000, the authorities adopted an adjustable band (of +/–1 percent)

**Table 1.9. Selected Middle Eastern Countries: Real GDP, Consumer Prices, and Current Account Balance**
*(Annual percent change unless otherwise noted)*

| | Real GDP | | | | Consumer Prices[1] | | | | Current Account Balances[2] | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 1999 | 2000 | 2001 | 2002 | 1999 | 2000 | 2001 | 2002 |
| **Middle East[3]** | 2.7 | 4.8 | 4.8 | 4.5 | 12.0 | 11.2 | 9.8 | 8.9 | 1.4 | 11.0 | 7.8 | 3.8 |
| **Oil exporters[4]** | 2.1 | 5.0 | 5.0 | 4.4 | 15.7 | 14.6 | 12.4 | 11.0 | 3.0 | 15.2 | 11.5 | 6.5 |
| Saudi Arabia | –1.0 | 4.1 | 4.8 | 3.0 | –1.2 | –0.6 | — | 0.8 | –1.2 | 8.6 | 7.3 | 1.3 |
| Iran, Islamic Rep. of | 2.5 | 3.6 | 4.0 | 4.5 | 20.4 | 18.5 | 15.5 | 13.0 | 4.7 | 14.8 | 7.2 | 3.0 |
| Kuwait | –2.4 | 3.6 | 1.9 | 2.0 | 1.8 | 1.5 | 2.5 | 2.5 | 16.7 | 29.7 | 25.9 | 22.0 |
| **Mashreq[5]** | 4.1 | 4.2 | 4.1 | 4.9 | 2.0 | 2.2 | 2.6 | 3.1 | –3.6 | –3.0 | –4.3 | –4.9 |
| Egypt | 6.0 | 5.1 | 4.5 | 5.3 | 3.8 | 2.8 | 2.8 | 3.0 | –2.0 | –1.2 | –1.8 | –2.2 |
| Jordan | 3.1 | 4.0 | 3.0 | 4.5 | 0.6 | 0.7 | 1.8 | 2.3 | 5.0 | 1.6 | –2.2 | –1.7 |

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

against the U.S. dollar from February 2001; this new regime should be operated in an appropriately flexible manner. Credit to the private sector has slowed substantially, which, along with the depreciation of the Egyptian pound, is helping to strengthen the balance of payments position. In addition, somewhat tighter fiscal policies would be desirable. After what appears to have been a temporary slowdown in growth in early 2000, some modest signs of recovery have emerged, although much will depend on the speed with which investor confidence strengthens and on developments in the region. In both Egypt and other countries in the Mashreq, which have yet to share fully in the benefits of globalization, further reform of trade and investment regimes remains a priority. Recent regional trade initiatives—including the negotiation of Association Agreements with the European Union, so far completed with *Jordan* and Egypt—are encouraging, and, along with entry into the WTO, could provide external anchors to underpin reform efforts more generally. In Lebanon, the very high fiscal deficit and public debt ratios remain a serious concern.

In *Israel*, activity rebounded strongly in 2000, led by buoyant technology sector exports. However, the economic impact of the deterioration in the security situation, as well as the political uncertainties in the run up to the recent elections, contributed to a sharp decline in GDP growth in the fourth quarter of 2000, and activity is expected to slow sharply in 2001. Domestic demand is weakening, and tourism bookings have dropped; in addition, export growth is slowing due to weakening external demand and the turndown in the global electronics cycle. With inflation running below the 3–4 percent target band, the Bank of Israel has room to continue with cautious interest rates cuts, while monitoring the possible repercussions in currency markets. Continued budgetary consolidation remains important given Israel's very high public debt.

## Rebalancing the Policy Mix in Europe's Emerging Markets

Growth surged in Europe's emerging markets in 2000, but in many countries high inflation persisted and external current account deficits remained wide, reflecting strong domestic demand and higher world oil prices (Table 1.10). Current account deficits were largely financed by foreign direct investment, which in turn was supported by the prospect in many countries of eventual accession to the European Union (see Box 1.5 and Chapter III in the October 2000 *World Economic Outlook*). In late 2000, the European Commission presented a detailed

## Table 1.10. European Union Accession Candidates: Real GDP, Consumer Prices, and Current Account Balance

*(Annual percent change unless otherwise noted)*

| | Real GDP | | | | Consumer Prices[1] | | | | Current Account Balances[2] | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 1999 | 2000 | 2001 | 2002 | 1999 | 2000 | 2001 | 2002 |
| **European Union accession candidates** | **–0.1** | **4.8** | **1.9** | **4.5** | **25.3** | **24.4** | **20.5** | **12.7** | **–4.1** | **–5.1** | **–2.9** | **–2.7** |
| Turkey | –4.7 | 7.2 | –2.6 | 4.9 | 64.9 | 54.9 | 48.4 | 28.4 | –0.7 | –4.8 | 0.4 | 0.1 |
| Excluding Turkey | 1.9 | 3.8 | 3.9 | 4.3 | 11.2 | 13.1 | 9.9 | 6.4 | –5.8 | –5.2 | –5.0 | –4.8 |
| Bulgaria | 2.4 | 5.0 | 5.0 | 5.0 | 2.6 | 10.4 | 8.5 | 3.2 | –5.5 | –5.5 | –4.4 | –3.9 |
| Cyprus | 4.5 | 5.0 | 4.5 | 4.0 | 1.8 | 4.1 | 2.7 | 2.7 | –4.5 | –8.0 | –5.3 | –4.6 |
| Czech Republic | -0.8 | 3.1 | 3.0 | 3.5 | 2.1 | 3.9 | 4.2 | 4.4 | –3.0 | –4.8 | –4.7 | –4.3 |
| Estonia | –1.1 | 6.4 | 5.5 | 5.5 | 3.3 | 4.0 | 5.0 | 2.8 | –5.8 | –6.7 | –7.2 | –6.7 |
| Hungary | 4.5 | 5.3 | 4.9 | 4.7 | 10.0 | 9.8 | 8.5 | 6.4 | –4.3 | –3.5 | –5.1 | –5.1 |
| Latvia | 1.1 | 5.5 | 6.0 | 6.0 | 2.4 | 2.7 | 2.1 | 3.0 | –9.7 | –7.2 | –6.6 | –5.5 |
| Lithuania | –4.2 | 2.7 | 3.2 | 3.8 | 0.8 | 1.0 | 1.3 | 2.6 | –11.2 | –6.9 | –6.7 | –6.3 |
| Malta | 3.5 | 3.2 | 4.3 | 3.3 | 2.5 | 2.5 | 2.5 | 2.5 | –3.7 | –3.9 | –3.7 | –3.1 |
| Poland | 4.1 | 4.1 | 4.0 | 4.5 | 7.3 | 10.1 | 7.0 | 5.0 | –7.5 | –6.1 | –5.4 | –5.0 |
| Romania | –3.2 | 2.0 | 3.0 | 4.0 | 45.8 | 45.7 | 34.2 | 16.4 | –3.8 | –3.7 | –4.4 | –4.8 |
| Slovak Republic | 1.9 | 2.2 | 3.1 | 4.4 | 10.7 | 12.0 | 6.9 | 6.0 | –5.7 | –3.6 | –4.8 | –4.9 |
| Slovenia | 5.2 | 4.9 | 4.5 | 4.0 | 6.2 | 8.9 | 7.0 | 5.0 | –3.9 | –3.2 | –2.7 | –2.4 |

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

timetable for accession, which aims at concluding the negotiations on all chapters of the *acquis communautaire*[8] by mid-2002, and EU heads of state agreed to internal reforms that set the stage for admitting new members in the coming years. Turkey experienced two financial and currency crises in late 2000 and early 2001, but the spillovers to other countries appear to have been relatively limited thus far.

In most countries, growth is expected to remain relatively well sustained in 2001, although activity is vulnerable to a faster-than-projected slowdown in western Europe and external current account deficits are forecast to remain large. A rebalancing of the policy mix toward a relatively tighter fiscal policy would help restrain domestic demand while limiting upward pressures on interest rates and exchange rates, which would adversely affect net exports and private investment. To promote sustainable growth in the medium term and ensure continued progress toward EU accession, further structural and institutional reforms are needed, notably in privatization, enterprise restructuring, financial regulation and supervision, labor market reform, and pension and health care systems.[9]

In Turkey, growing problems in the banking system and the widening external current account deficit led to a financial and currency crisis in late 2000. Under the economic program adopted in 1999, good progress was made in strengthening public finances, lowering inflation, and reviving growth. However, the current account deficit grew from ¾ percent of GDP in 1999 to an estimated 4¾ percent of GDP in 2000, reflecting a combination of policy, domestic, and external factors. The introduction of a preannounced exchange rate path helped reduce nominal interest rates, but the effect on inflation expectations was not as strong, and the resulting sharp decline in real interest rates spurred domestic demand, which—combined with the rise in world energy prices and the global slowdown—contributed to the drop in

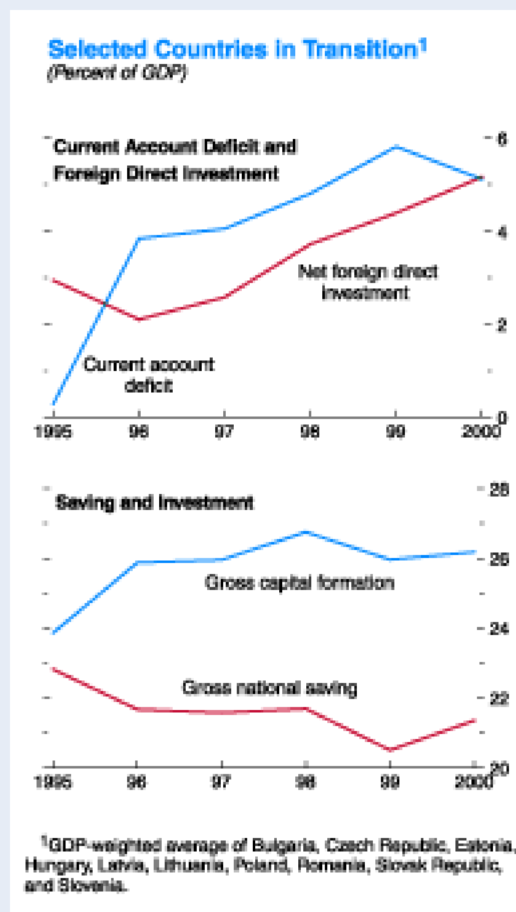
[8]The detailed body of laws and regulations that underpins the European Union.

[9]These issues were discussed in Chapter IV of the October 2000 *World Economic Outlook.*

## Box 1.5. Large Current Account Deficits in Transition Countries Seeking Membership in the European Union

Most Central and Eastern European (CEE) transition countries have in recent years registered current account deficits of magnitudes that have often been associated with balance of payments crises both within the region and elsewhere (see the figure).[1] While in most countries these current account deficits have more recently narrowed, owing to a mixture of policy adjustment, slower domestic activity, and strong export performance, with few exceptions they remain at relatively high levels—with a median deficit of just under 5 percent in 2000. This box examines the factors behind the current account deficits, their financing, and policies to mitigate vulnerability.

In general, the composition of financing (predominantly inward foreign direct investment or FDI) and exchange rate regimes (primarily hard pegs or relatively free floats) suggest that the vulnerability of the CEE countries to a full-fledged balance of payments crisis may be limited. Indeed, the resilience of these countries to the fallout from the Russia crisis is testament to this. However, as inward foreign direct investment is partly linked to prospects of early EU accession, changes to those expectations could affect the financing of current account deficits. Continued strengthening of both financial systems and, in most cases, fiscal positions will be necessary in the coming years. Policymakers will also need to be alert to a possible shift in the composition of financing toward more liquid and thus readily reversible flows.




[1]GDP-weighted average of Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia.

### *Some Facts*

With the exception of Slovenia and Bulgaria, current account deficits as a ratio to GDP in the other eight countries seeking EU membership peaked at more than 7 percent in the mid- to late 1990s. By and large, this reflected rising investment to GDP ratios and to a lesser extent greater consumption (see the figure). Large general government deficits, especially in Lithuania, Romania, and Slovakia, also contributed to wide current account deficits.

The current account deficits of the CEE countries have generally been financed without much difficulty, and largely through private resources. In the 1995–99 period, the median net private capital flow to the 10 countries in the process of accession (6½ percent of GDP) was considerably higher than to other emerging and transition countries (some 3 percent of GDP). In addition, FDI—a large part of which was related to privatization—has been a major component (about

[1]For example, the Czech Republic experienced a balance of payments crisis in 1997, Hungary in 1993–94, and the Slovak Republic in 1998. The European Union has accepted 10 CEE countries as candidates for accession: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia.

## Box 1.5 *(concluded)*

half) of the inflows to the CEE countries, again more than recorded to other transition and emerging market countries.

### *Factors Behind the Large Capital Flows*

*The role of policy.* The CEE countries have with few exceptions coped well with the massive upheaval entailed by the transition process, securing in less than a decade macroeconomic stability while transforming themselves into investor friendly locations. And indeed the rewards to resolute policy implementation have been evident among the CEE countries, with the strong reformers (among them Estonia, Hungary, and Poland) receiving significantly more capital inflows than weak reformers (Romania).

*Proximity to the European Union and capital accumulation.* The proximity of the CEE countries to the European Union and their eligibility for membership have made these countries an attractive location for investment.[2] The large and persistent differences in output per worker between the European Union and the CEE countries are partly due to differences in capital stocks. Thus, the potential magnitude of flows necessary to equalize the rate of return on capital can be estimated using a Cobb-Douglas production function framework. On this basis, cumulative capital flows in the range of 147 percent of GDP (Slovenia) to 825 percent of GDP (Latvia) would have been required to equalize output per worker between Germany (representing the European Union) and the CEE countries at the start of the transition period.[3] The actual level of capital flows has, of course, been considerably less. Nevertheless, the fact that most of the inflows appear to have financed rising investment is consistent with this story.

*Country size.* Another distinguishing feature of the CEE countries is the fact that half are particularly small, with populations of less than or close to five million. Small countries tend to show greater volatility in their external balances, reflecting their higher degree of openness. Even modest capital flows from the perspective of creditors can generate large capital flows from the perspective of small countries, inducing large changes in their current account balances. Recently, current account deficits in the smaller CEE countries have been markedly high.

### *Mitigating Vulnerability*

With a median current account deficit of 5 percent of GDP and the possibility that consumption and investment ratios may rise in the coming years, the CEE countries should attempt to mitigate their vulnerability by adopting appropriate policies. In terms of exchange rate policy, the picture is broadly appropriate.[4] The CEE countries have over time moved toward either strong fixes (Bulgaria, Estonia, and Lithuania have currency boards) or relatively free floating regimes (Czech Republic, Poland, Romania, Slovakia, and Slovenia). Latvia has a conventional peg but for all intents and purposes follows quasi-currency board rules, while Hungary has a crawling peg. The countries with pegged exchange rates have relatively flexible product and labor markets.

A stronger fiscal position will be necessary to avoid rising imbalances and to cope with the demands of accession. Most CEE countries will need considerable investment to bring their infrastructure to EU standards. To the extent that private saving will be broadly stable, public savings will need to rise to facilitate the potentially higher public and private investment needs. At the same time, fiscal policy has to be ready to re-

[2]See Stanley Fischer, Ratna Sahay and Carlos Végh, "How Far is Eastern Europe from Brussels?" IMF Working Paper 98/53, (Washington: International Monetary Fund, April 1998).

[3]See Leslie Lipschitz, Timothy Lane, and Alex Mourmouras, "Capital Flows to Transition Economies: Servant or Master?" IMF Working Paper (Washington: International Monetary Fund, forthcoming).

[4]See Robert Corker, Craig Beaumont, Rachel van Elkan, and Dora Iakova, "Exchange Rate Regimes in Selected Advanced Transition Economies—Coping with Transition, Capital Inflows, and EU Accession," IMF Policy Discussion Paper 00/3 (Washington: International Monetary Fund, April 2000).

spond to and manage shocks that the CEE countries will inevitably encounter.

Finally, the composition of financing may shift away from FDI (in part as privatization is completed) to more liquid flows intermediated by local financial institutions in the coming years. Vulnerability to speculative attacks and contagion can be mitigated by strengthening financial systems in the CEE countries. While the financial sectors in many CEE countries have improved considerably over the years, strengthening their health and the manner in which they are supervised remains a challenge.

net exports. In November 2000, the worsening external position and weakening confidence led to growing liquidity problems in the banking system, which were exacerbated by asset/liability maturity mismatches. The central bank's provision of liquidity supported increased purchases of foreign currency, which—given the preannounced exchange rate—led to declining official foreign reserves.

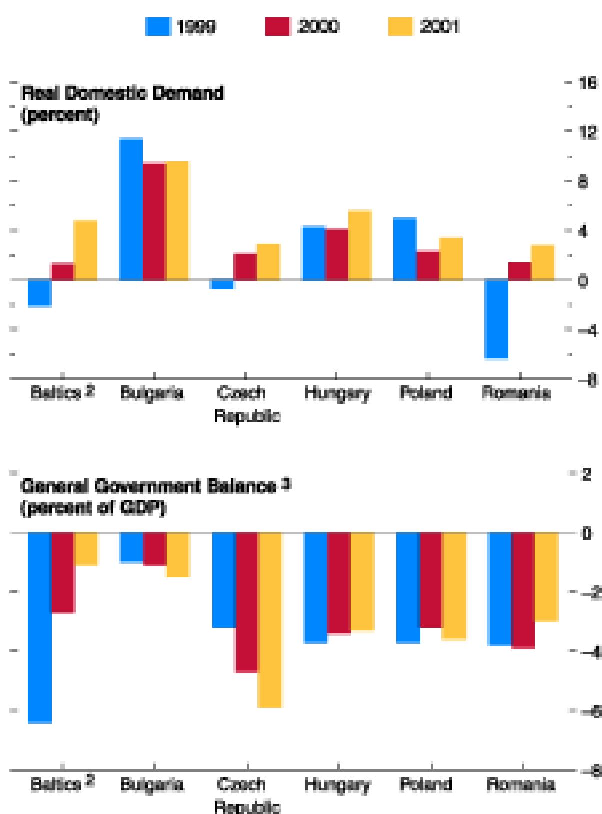
In response, the Turkish government announced in December 2000 a revised economic program, supported by additional financing from the IMF. The revised program included tighter macroeconomic policy settings and accelerated structural reform. While the program elicited a positive initial response from financial markets, a combination of events in late January and early February 2001, including delays in privatizing key telecommunications and energy companies, the implications of these delays for the government budget, increased political uncertainty, and a worsening of external financing conditions, undermined investor confidence. In response to rapidly declining official foreign reserves, the authorities allowed the currency to float. The situation remains difficult, with a contraction in activity likely in the aftermath of the crisis.

Contagion from the crises in Turkey to other emerging markets through trade and financial links has so far been modest. Turkey's imports from trading partners are expected to fall and the real depreciation of Turkish lira will make Turkey's exports more competitive, possibly reducing other countries' exports to third markets. However, both of these trade effects are likely to be small, as Turkey is not a major export market for any other country, and Turkey's second largest export is tourism (after textiles). The crises in Turkey hurt investors' perceptions of emerging market borrowers in general, put upward pressure on the spreads of large borrowers, and reinforced concerns about the vulnerability of pegged exchange rate regimes. However, international investors and leveraged players are believed to be less involved in Turkey than in the Asian or Russian crises, partly because some investors have been unwinding positions since last fall, and investors are seen as discriminating more between different fundamentals among emerging market borrowers. Finally, Turkish-owned banks' lending in other markets, particularly in the Commonwealth of Independent States (CIS), could be reduced, but such banks do not account for large shares of those banking systems.

In *Romania* and *Bulgaria* sovereign bond spreads rose moderately and temporarily in response to the crises in Turkey. Romania has close business and financial ties with Turkey, and some investors may have perceived a parallel between the currency board arrangements in Bulgaria and Argentina. Other external developments strongly influenced both countries in 2000: expanding exports to the European Union and the improved security situation in Kosovo boosted growth, while the oil shock fueled inflation and put pressure on the external current account deficit. In Bulgaria, important progress in stabilization and structural reform since 1997—including the currency board arrangement, wage restraint in state enterprises, enter-

**Figure 1.12. Selected European Countries: Domestic Demand Growth and General Government Balances**[1]

With accelerating domestic demand expected to support growth in 2001, a rebalancing of the policy mix toward tighter fiscal policy would help reduce upward pressures on interest rates and exchange rates.




[1]Data for 2001 are IMF staff projections.
[2]Weighted average of Estonia, Latvia, and Lithuania.
[3]The data should be treated with caution, as some quasi-fiscal activities are not reflected in the general government balance and countries have not yet adopted ESA-95.

prise restructuring, and privatization—provide the basis for solid growth, declining inflation, and a narrowing current account deficit over the next few years. By contrast, in Romania, the momentum of economic reform was interrupted in 2000; durable growth, disinflation, and an improved external position require fiscal consolidation, prudent monetary policy, wage and financial discipline in state-owned enterprises, and accelerated restructuring of the enterprise and banking sectors.

In Central Europe, current account deficits are expected to remain substantial in 2001, ranging from 4¾ percent of GDP in the *Czech Republic* to 5½ percent of GDP in *Poland.* To support growth in the near term, restrain inflation, and help narrow the current account deficit, the macroeconomic policy mix in most countries needs to be rebalanced toward relatively tighter fiscal policy (Figure 1.12). In the Czech Republic, which has an inflation targeting framework, additional fiscal consolidation would allow interest rates to decline, helping to alleviate upward pressures on exchange rates. In *Hungary,* which has a crawling exchange rate, tighter fiscal policy would help reduce inflationary pressures and contain the current account deficit. In Poland, given falling inflation and inflationary expectations, the recent interest rate cut was welcome, though real interest rates remain at regional and historical highs.

In the Baltic countries, growth accelerated sharply and inflation remained moderate in 2000, with cross-country variation determined in part by different hard currency pegs. The depreciation of the euro against other major currencies boosted inflation in *Estonia,* which pegs to the euro, but had little effect on inflation in *Latvia,* which pegs to the IMF's special drawing right or SDR, or *Lithuania,* which pegs to the U.S. dollar. While current account deficits remained large in all three countries, they were mostly financed by non-debt creating capital flows. Fiscal positions improved substantially and important progress on structural reform continued to support a conducive environment for foreign direct investment. Prospects for 2001 are fa-

vorable, in part because oil prices have declined from last year's highs, though a sharper slowdown in the advanced economies of Europe could curb net exports and harm confidence. An appreciation of the euro against other major currencies would improve competitiveness in Latvia and Lithuania and have only a limited adverse effect on Estonia, as the euro area is the main export market. Notwithstanding recent progress, further fiscal consolidation is under way in all three countries to allow for the government spending needed in connection with EU accession, and in light of looming pension liabilities.

In the *Federal Republic of Yugoslavia*, the economy is devastated after years of regional conflicts, international isolation, and economic mismanagement. In 2000, economic activity stood at less than half of its 1989 level, end-year inflation exceeded 100 percent, and the ratio of external debt to GDP was about 140 percent. The key source of inflationary pressures was the monetary financing of quasi-fiscal deficits of state-owned enterprises. The immediate macroeconomic strategy aims to bring inflation under control by limiting the growth of credit, strengthening the underlying fiscal position, and preventing a further accumulation of expenditure arrears. Achieving a viable balance of payments position will require, in addition to prudent macroeconomic policies and bold structural reforms, a restructuring of external debt. Peace and economic stability will provide the foundation for economic growth in Yugoslavia, which will have important spillover effects on other countries in the region, including *Albania*, *Bosnia and Herzegovina*, and *FYR Macedonia*.

## Commonwealth of Independent States: Oil Prices Are Key

Strong economic performance in Russia in 2000, reflecting a combination of higher world energy prices and the real exchange rate depreciation following the 1998 crisis, helped to boost growth and external positions in most CIS countries (Table 1.11). In addition, robust foreign demand contributed to these favorable outcomes, while spillovers from the crises in Turkey were limited. However, some oil-importing countries were adversely affected by the rise in oil prices.[10] Also, the record on inflation was mixed: there was a sharp decline in Russia, but it rose in Ukraine. In line with the decline in oil prices from their recent highs and slowing growth in partner countries (mainly Europe), growth and external positions in many CIS countries are projected to be lower in 2001. In most countries, a substantial structural reform agenda remains, and many countries appear to be stuck in a reform trap, with further progress blocked by vested interests that benefit from a situation of partial reform (see Chapter III of the October 2000 *World Economic Outlook*). In *Russia*, the rise in world energy prices and the depreciated currency spurred growth and generated exceptionally large current account and fiscal surpluses in 2000 (Figure 1.13). Prudently, most of the oil windfall appears to have been saved, with the rise in the current account surplus being almost as large as the increase in energy exports. About two-thirds of these savings were captured in official foreign reserves—gross reserves more than doubled during the year—though private capital outflows remained high. Foreign exchange purchases were partly sterilized through a combination of the central bank deposit facility and a buildup of government deposits at the central bank. Notwithstanding these efforts, the strong balance of payments position led to rapid monetary expansion, which added to inflationary pressures.

Lower oil prices, the global slowdown, and the real appreciation of the ruble during the course of last year are expected to reduce growth in Russia to 4 percent in 2001. The general government surplus is expected to decline sharply though remain in overall surplus, reflecting lower oil tax receipts, the revenue loss

[10]See the IMF Research Department's "The Impact of Higher Oil Prices on the Global Economy," available at *http://www.imf.org/external/pubs/ft/oil/2000/index.htm.*

**Table 1.11. Commonwealth of Independent States: Real GDP, Consumer Prices, and Current Account Balance**
*(Annual percent change unless otherwise noted)*

| | Real GDP | | | | Consumer Prices[1] | | | | Current Account Balances[2] | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 1999 | 2000 | 2001 | 2002 | 1999 | 2000 | 2001 | 2002 |
| **Commonwealth of Independent States** | **3.1** | **7.1** | **4.1** | **4.1** | **70.6** | **25.0** | **19.1** | **12.5** | **7.8** | **14.0** | **9.0** | **6.2** |
| Russia | 3.2 | 7.5 | 4.0 | 4.0 | 85.7 | 20.8 | 17.6 | 12.3 | 12.4 | 18.4 | 12.0 | 8.2 |
| Excluding Russia | 2.7 | 6.3 | 4.2 | 4.4 | 41.8 | 34.6 | 22.2 | 12.8 | –1.5 | 1.9 | –0.3 | –0.3 |
| Armenia | 3.3 | 6.0 | 6.5 | 6.0 | 0.7 | –0.8 | 4.5 | 3.0 | –16.6 | –14.5 | –14.1 | –12.1 |
| Azerbaijan | 7.4 | 10.3 | 8.5 | 8.0 | –8.5 | 1.8 | 2.5 | 2.5 | –13.0 | –0.3 | –14.7 | –19.6 |
| Belarus | 3.4 | 6.0 | 2.5 | 3.1 | 293.7 | 169.0 | 75.0 | 23.7 | –2.2 | –2.6 | –2.9 | –4.0 |
| Georgia | 2.9 | 1.5 | 3.8 | 5.0 | 19.1 | 4.0 | 7.6 | 4.0 | –8.0 | –8.1 | –7.1 | –6.2 |
| Kazakhstan | 2.8 | 9.4 | 5.0 | 5.0 | 8.4 | 13.4 | 9.2 | 5.8 | 1.0 | 7.4 | 3.3 | 4.9 |
| Kyrgyz Republic | 3.7 | 5.0 | 5.0 | 5.2 | 36.8 | 18.7 | 9.1 | 7.2 | –16.3 | –12.2 | –9.3 | –4.5 |
| Moldova | –3.4 | 1.9 | 5.0 | 6.0 | 39.3 | 31.3 | 12.7 | 10.0 | –2.6 | –5.6 | –7.0 | –4.9 |
| Tajikistan | 3.7 | 8.3 | 5.0 | 5.0 | 27.6 | 34.0 | 39.6 | 8.8 | –3.4 | –6.4 | –6.0 | –6.2 |
| Turkmenistan | 16.0 | 17.6 | 10.0 | 6.0 | 23.5 | 8.0 | 15.0 | 15.0 | –16.0 | 2.7 | 2.0 | 2.0 |
| Ukraine | –0.4 | 4.2 | 4.0 | 4.5 | 22.7 | 28.2 | 15.1 | 12.1 | 2.7 | 4.8 | 2.3 | 2.1 |
| Uzbekistan | 4.3 | 4.0 | 1.0 | 1.0 | 29.1 | 25.4 | 35.5 | 24.7 | –1.0 | 0.6 | 2.4 | 3.5 |

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

associated with the implementation of desirable tax reform, and additional expenditures that are appropriate in light of the strong expenditure compression in recent years. The external position is expected to remain strong, so the central bank will have to actively sterilize its foreign exchange interventions to help contain inflationary risks.

The present favorable macroeconomic environment offers the opportunity to move ahead with structural and institutional reform, where progress has been modest. In July 2000, the government adopted a long-term reform program covering the period through 2010, but the program remains to be fully developed in a number of key areas, including the banking sector and measures to reduce arrears. Major tax code revisions included in the government's program were approved by the Duma in August 2000, while the remainder—including revisions to the profit tax and amendments to strengthen tax administration—are still under preparation. There is a need to ensure that the cost of tax reforms does not become too high. There has been backtracking in the energy sector, with export restrictions reintroduced in August.

In *Ukraine*, the economy grew in 2000 for the first time since independence, as net exports were boosted by rapid growth in Russia—the main export market—and the substantial real depreciation of the hryvnia in 1998–99. The fiscal position improved markedly, as strong economic growth boosted tax revenue, and government expenditure was kept in check. Extensive unsterilized foreign exchange intervention stemmed the appreciation of the currency and contributed to the acceleration of inflation. Growth is expected to remain strong in 2001, with domestic demand boosted by improved consumer and business confidence, and the current account surplus should narrow, as slower growth in Russia and elsewhere dampen exports. The targeted reduction in inflation will depend on prudent fiscal policy, including the use of privatization proceeds primarily for debt reduction, and greater exchange rate flexibility. Further progress on structural reform, especially in the banking system, privatization, and payment arrears, is needed to bolster private investment.

In other CIS countries, exports to Russia also grew rapidly in 2000, though economic performance differed depending largely on the role of

oil. In energy-exporting countries, including *Kazakhstan*, *Azerbaijan*, and *Turkmenistan*, growth was supported by the increase in oil and natural gas prices, with the exceptional growth in Turkmenistan reflecting primarily greater success in securing payment for its energy exports. Conversely, the direct effect of the oil shock on energy-importing countries, including *Armenia*, *Georgia*, *the Kyrgyz Republic*, *Moldova*, and *Tajikistan*, was negative. Growth in 2001 will be influenced mainly by the moderation of energy prices since 2000 and the prospect of somewhat weaker but still robust growth of exports to Russia.

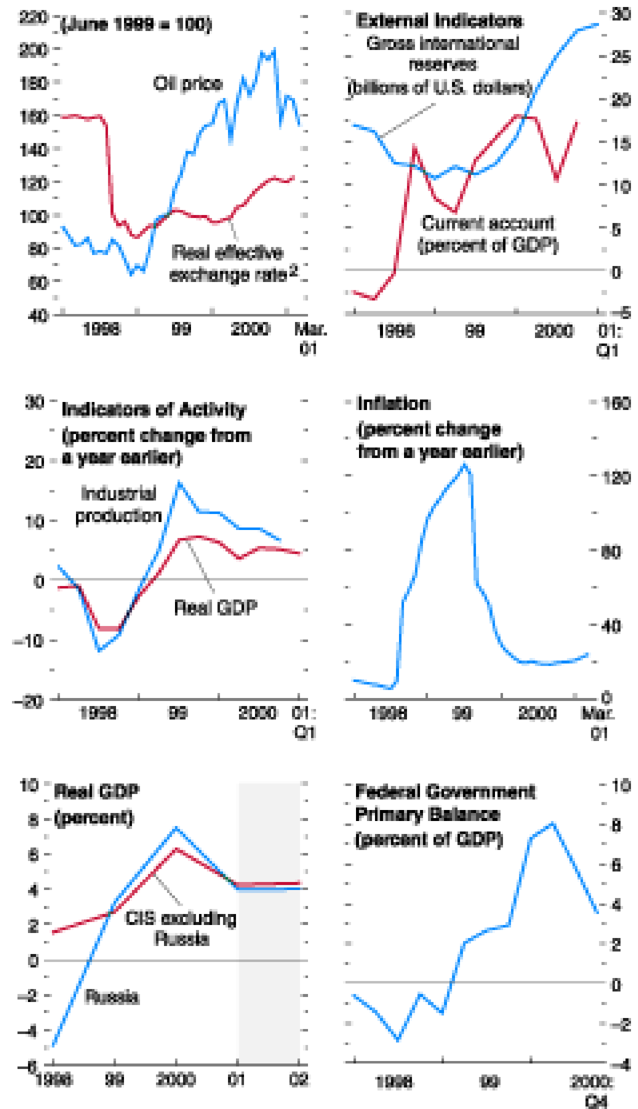
Sustainable growth in the medium term depends on structural and institutional reform, especially deregulating small and medium-sized enterprises, hardening budget constraints, improving corporate governance, introducing greater competition, developing financial systems, and transforming the role of the state. Inflation has moderated somewhat, but it remains high in many countries, reflecting mainly fiscal problems. Although government expenditures have generally been trimmed, quite extensively in some countries, revenue collection remains weak. Directed credit continues to undermine monetary policy in *Belarus*, Turkmenistan, and *Uzbekistan*. External debt burdens are especially high in Armenia, Georgia, the Kyrgyz Republic, Moldova, and Tajikistan.

## Appendix I: The Global Slowdown and Commodity Prices

The volatility in the spot price of oil and the associated uncertainty about its future price path continue to constitute a major issue for the global forecast. This volatility has shown no sign of abating and prices remain high despite slowing global growth. Developments in other commodity markets generally receive less attention, although a prolonged period of comparatively weak prices for most nonfuel prices has hurt many developing countries (as discussed in Chapter II of the October 2000 *World Economic Outlook*). The projected slowing of global

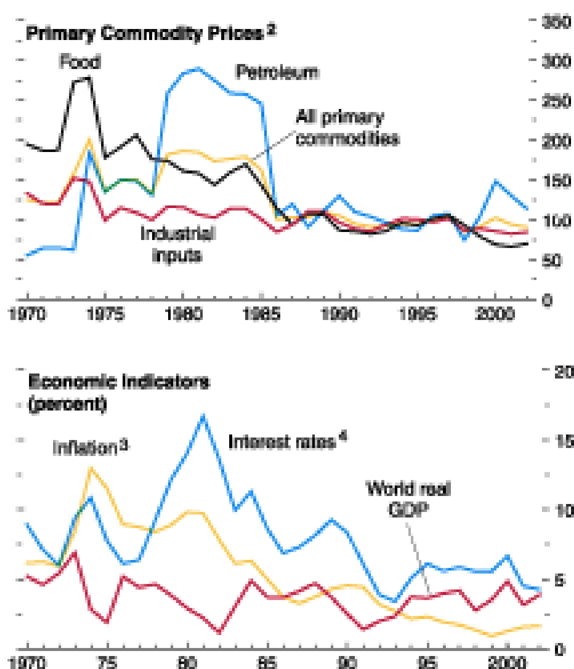
**Figure 1.13. Russia: Recovery Driven by Exchange Rate Depreciation and Oil Prices**[1]

Higher oil prices and a depreciated exchange rate boosted economic activity in Russia in 2000, which supported growth elsewhere in the Commonwealth of Independent States.




Sources: National authorities; and IMF staff calculations.
[1] Shaded area indicates IMF staff projections.
[2] Real effective exchange rate based on consumer prices indices.

**Figure 1.14. Primary Commodity Prices and Selected Economic Indicators[1]**




[1]Data for 2001 and 2002 are IMF staff projections.
[2]Indices measured in real U.S. dollars.
[3]Advanced economies GDP deflator.
[4]London interbank offered rate (LIBOR) on six-month U.S. dollar deposits in percent.

growth, and hence demand for commodities, could further harm economic prospects of many poorer nations, as well as producers of computer chips, which have many of the attributes of "traditional" commodities.

Prices of both oil and other commodities were strong in the mid 1990s, in part because of the strength of world growth (Figure 1.14). For metals (which are the most cyclically sensitive commodities) the stock overhang was all but eliminated. In addition, rapidly increasing incomes in Asia led to higher demand for meat, contributing to a buoyant market for livestock and associated feed stuffs. Subsequently, the economic problems associated with the 1997–98 financial and economic crises led to a fall in demand growth for most commodities and a slump in commodity prices. By the end of 1998 oil prices had fallen by nearly one-half to around $11 per barrel—their lowest nominal levels since the early 1970s, and in real terms even lower—while prices of nonfuel commodities were about 25 percent below their peaks only two years earlier, and stocks accumulated.

Since 1998, however, the price of oil and natural gas has soared while prices for most other commodities have remained in a slump. The turn around in energy prices has been led by oil, with natural gas prices following with a brief lag (gas prices are often linked to past oil prices).[11] Rapid oil price increases were largely the result of supply constraints, although demand growth and low levels of oil stocks were also contributing factors. After some false starts in 1998, in early 1999 members of Organization of the Petroleum Exporting Countries (OPEC) and a few non-OPEC cooperating countries reached an effective agreement to restrain production. During 2000, however, against a background of growing energy demand associated with accelerating global economic growth, oil producing countries increased production targets on four occasions. Despite these actions, in September 2000 oil prices moved well above the $22 to $28 reference price range that OPEC views as consis-

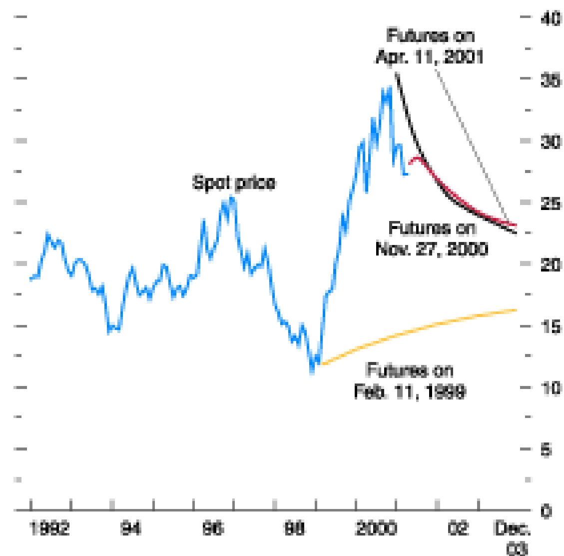
[11]Coal has recently also risen in price.

tent with long-term market stability, in part because stocks of crude oil and petroleum products remained low.

In December 2000, the upward movement in petroleum prices was reversed. Increases in production appeared to offer consumers some relief and there were worries about a slowdown in the rate of growth of the world economy, in particular in the United States. OPEC countries responded by announcing plans to lower production targets early in 2001. Despite weakening demand, these announcements, a marked slowing in Iraqi exports, and political uncertainties in the Middle East pushed oil prices up in late January and early February, although not back to levels seen between September and November 2000 (Figure 1.15). Given the large moves in spot oil prices over the last few months, the likely path for oil prices over the future remains highly uncertain. The futures market indicates a gradual reduction in prices, but further significant movements in spot prices (particularly downward as the world economy slows) cannot be ruled out.

Unlike energy, prices of other commodities have regained little of their mid-1990s luster since the Asian crisis. By the beginning of 1999, the IMF's price index of industrial inputs—mainly metals, timber, and fibers—had fallen 25 percent below its 1995–97 average. A 10 percent increase during 1999 was mostly erased during 2000 and early 2001 in U.S. dollar terms. The largest price changes have been in the prices of metals and timber. Prices of metals have weakened despite lower levels of stocks, apparently reflecting pessimistic expectations of demand. Food prices, comprising cereals, edible oils, meat, sugar, coffee, cocoa, and tea, saw a small upturn at the end of 1999, which was more than offset in U.S. dollar terms by a decrease in 2000, mostly attributable to declines in coffee prices.[12] Stocks of coffee have accumulated and prices have fallen as a result of a series of good har-

**Figure 1.15. West Texas Oil: Spot Price and Futures Contacts**
*(U.S. dollars per barrel)*




Source: Bloomberg Financial Markets, LP.

[12]See Chapter II of the October 2000 *World Economic Outlook* for a discussion of the impact of these price changes on poorer countries.

vests. Consumption of beef has also been adversely affected by health concerns, particularly in Europe, and stocks of cereals (while generally declining) remain high relative to consumption. At the same time, some of this weakness in commodity prices reflects the strength of the U.S. dollar. Prices of many commodities have remained relatively buoyant in terms of euros. This has cushioned the impact of recent U.S. dollar price declines, particularly in countries whose main trading ties are with Europe (which is often true of African nations).

Toward the end of 2000 and increasingly in the first months of 2001, concerns about the slowing of global economic growth have become more central to assessments of prospects for non-energy commodity prices, particularly metals. Estimates of U.S. demand for a number of metals—steel, aluminum, copper, nickel, and zinc—in the first quarter of 2001 are about 5 percent lower than the first quarter of 2000, and slowing growth elsewhere will exacerbate this situation. For other commodities, which are typically less cyclically sensitive than metals, the signals are less clear, as commodity-specific factors tend to dominate the near term prospects (the most visible example of this being the oil markets, discussed earlier).[13] Nevertheless, weakening global demand can be expected to put generalized downward pressure on prices, exacerbating the problems of many poor nations.

Finally, the slowdown in activity also negatively affects another market with many features in common with "traditional" commodities, namely computer chips. In mid-2000 the market for chips for use in personal computers, cell phones, and digital cameras appeared very strong. Prices for the dynamic random access memory chips (DRAMs), often described as "workhorse" memory chips, and the modules made from these chips had increased by about 50 percent from March to July 2000 on rising demand (Figure 1.16). The five leading Japanese chip producers were in the process of increasing investment by more than two-thirds over the previous year.

By October, however, slowing growth in the U.S. information technology market was becoming evident. Production targets for personal computers were reduced and there was a buildup of DRAM inventories. The leading Japanese microchip companies were cutting by half their forecasts of operating profits on semiconductor sales. By January 2001 DRAM prices were one-third the level six months earlier. In response, chip manufacturers have been cutting back on investment in new capacity and are reportedly trying to shift their production away from chips for personal computers to chips for cell phones and digital cameras, markets where rapid rates of growth are expected to continue. However, the fall in both price and slowing in demand for chips is significantly affecting economic prospects in several countries, most notably in Asia.

[13]Unexpected and often large movements in prices generally based on supply factors remain an important feature of world commodity markets. Over the past 30 years, the average annual change has varied between 9 percent (for bananas) to 37 percent (for sugar in the "free market"), and this variability has not decreased in recent years.

## Appendix II: Reducing External Imbalances

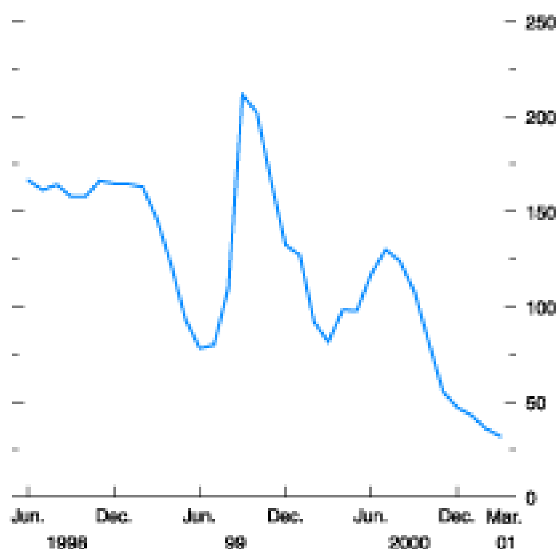
The baseline forecast in this *World Economic Outlook* contains a scenario in which, after a significant slowdown in global activity in 2001, growth rebounds back to close to its underlying potential in 2002 and is broadly stable subsequently (Figure 1.1). However, the accompanying path for domestic demand implies that existing trade and exchange rate imbalances across the major currency regions continue to remain large over the future (see Statistical Appendix Table 44). An important reason for the limited progress in addressing existing trade imbalances is that the *World Economic Outlook* forecasts are predicated on the assumption that real exchange rate is fixed over the future. This convention, which is also used by other forecasting publications, such as the OECD's *Economic Outlook*, follows existing evidence on short-term

exchange rate dynamics.[14] However, when exchange rates across the world's currency areas—particularly the United States and the euro area—appear significantly different from the values implied by medium-term fundamentals, it is useful to explore the consequences of a gradual movement in exchange rates that leads to a reduction in international trade imbalances.[15]

This appendix describes two simulations using MULTIMOD, the IMF's international macroeconomic model, to examine alternative paths by which these imbalances are reduced at a faster rate. The first is a "soft landing with imbalance adjustment" scenario, illustrating the consequences of a resolution of these imbalances through a gradual change in the values of major currencies and equity markets over the next three years. Next comes a "harder landing" scenario, in which existing tensions associated with imbalances in currency and stock markets lead to these changes in exchange rates occurring abruptly, with associated reductions in confidence and equity market valuations.[16]

These simulations should be taken as only illustrative for a number of reasons. In addition to the obvious fact that the future is inherently uncertain, it should also be recognized that the changes in external balances contained in these scenarios, while significant, are in all probability not large enough to fully address the trade imbalances that are currently present in the world

**Figure 1.16. Computer Chip Prices[1]**
*(U.S. dollars per unit)*



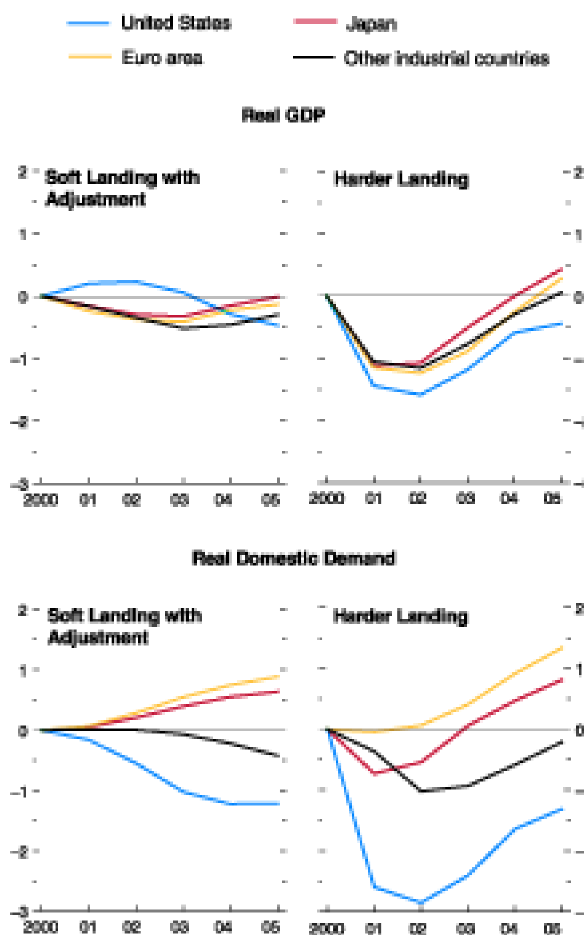

Source: Primark Datastream.
[1]Dynamic random access memory (DRAM) modules, 128 MB, 100 MGHZ bus, 16 by 64, U.S. spot price.

[14]The difficulties of forecasting short-run exchange rate dynamics was highlighted in a seminal paper by Richard Meese and Kenneth Rogoff, "Empirical Exchange Rate Models of the Seventies: Do They Fit Out of Sample," *Journal of International Economics*, Vol. 14 (1983), pp. 3–24. More recent work has found evidence for some reversion to underlying values over time, but at a relatively slow rate (see Ronald MacDonald, "Long Run Exchange Rate Modeling: A Survey of the Evidence," *IMF Staff Papers*, International Monetary Fund, Vol. 42 (1995), pp. 437–89).

[15]The IMF's approach to calculating exchange rate misalignments is discussed in Peter Isard and Hamid Faruqee, eds., *Exchange Rate Assessment: Extensions of the Macroeconomic Balance Approach*, IMF Occasional Paper No. 167 (Washington: International Monetary Fund, 1998).

[16]This has been a recurring theme in previous editions of the *World Economic Outlook*. See, for example, "Alternative Scenarios," Appendix I, Chapter I of the October 2000 edition.

Figure 1.17. Global Imbalances Adjustment Scenarios
(Deviation in percent from baseline real GDP)




Source: IMF MULTIMOD simulations.

economy. Other factors, in addition to exchange rate movements, could also contribute to resolving these imbalances. In particular, faster growth in potential output in the euro area and Japan brought about by more rigorous structural reforms can help. A MULTIMOD simulation in which potential growth rate in these regions was raised by ½ percent a year indicates that this could have a significant impact on trade imbalances, reducing the deficit in the United States by some $50 billion after five years (see Appendix I of Chapter I of the October 2000 *World Economic Outlook*). Finally, the increase in potential growth in the United States may also imply some change in underlying trade elasticities (see Box 1.2, which discusses the sustainability of the U.S. current account deficit).

The results of the "imbalance adjustment" scenario are reported in Table 1.12 and Figure 1.17. The real value of the U.S. dollar is assumed to steadily depreciate over the next three years by a cumulative total of 20 percent against the euro and the yen, and 15 percent against the other industrial countries (reflecting the fact that exchange rates of these countries tend to be linked more directly with the U.S. dollar).[17] This leads to a gradual adjustment in international imbalances, and in 2005 (by which time this adjustment is relatively complete) the U.S. trade balance has improved by over $85 billion, the main counterpart being a reduction in the trade balances of the euro area (slightly over $45 billion) and Japan (about $30 billion). By contrast, there is relatively little impact on the trade balance of the other industrial countries group, as the real effective exchange rate remains relatively unchanged, with the depreciation against the U.S. dollar being counterbalanced by appreciations against the euro and yen.

The adjustment in trade balances occurs primarily through a gradual rebalancing of world demand. Focusing initially on the United States, real exports rise and real imports fall compared

[17]The largest four members of the other industrial country group are Australia, Canada, Sweden, and the United Kingdom.

**Table 1.12. Alternative Scenario: Soft Landing with Imbalance Adjustment**
*(Percent deviation from baseline unless otherwise specified)*

| | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|
| World Real GDP | –0.1 | –0.2 | –0.3 | –0.3 | –0.3 |
| United States | | | | | |
| Real GDP | 0.2 | 0.2 | 0.1 | –0.3 | –0.5 |
| Real Domestic Demand | –0.2 | –0.5 | –1.0 | –1.2 | –1.2 |
| Real Investment | –0.5 | –2.0 | –3.5 | –4.1 | –4.3 |
| Real Effective Exchange Rate | –6.1 | –11.4 | –15.1 | –14.5 | –14.4 |
| Trade Balance ($billion) | 3.1 | 16.4 | 42.9 | 67.0 | 85.2 |
| CPI Inflation (percentage points) | 0.5 | 0.7 | 0.7 | 0.3 | 0.3 |
| Short-term interest rate (percentage points) | 0.3 | 0.8 | 1.2 | 1.2 | 1.2 |
| Equity Prices | –3.4 | –7.4 | –9.5 | –9.6 | –9.8 |
| Euro Area | | | | | |
| Real GDP | –0.2 | –0.4 | –0.4 | –0.2 | –0.1 |
| Real Domestic Demand | 0.1 | 0.3 | 0.5 | 0.8 | 0.9 |
| Real Investment | 0.3 | 1.0 | 1.8 | 2.3 | 2.3 |
| Real Effective Exchange Rate | 3.2 | 6.0 | 8.3 | 8.5 | 9.4 |
| Real U.S. Dollar Exchange Rate | 7.5 | 14.9 | 20.5 | 20.4 | 21.0 |
| Trade Balance ($billion) | –3.7 | –12.1 | –25.5 | –37.2 | –47.9 |
| CPI Inflation (percentage points) | –0.3 | –0.5 | –0.6 | –0.5 | –0.5 |
| Short-term interest rate (percentage points) | –0.6 | –1.3 | –1.9 | –2.1 | –2.2 |
| Equity Prices | 1.8 | 4.1 | 5.7 | 6.2 | 6.0 |
| Japan | | | | | |
| Real GDP | –0.2 | –0.3 | –0.3 | –0.2 | — |
| Real Domestic Demand | — | 0.2 | 0.4 | 0.6 | 0.6 |
| Real Investment | 0.2 | 0.7 | 1.2 | 1.4 | 1.5 |
| Real Effective Exchange Rate | 4.5 | 8.9 | 11.4 | 10.1 | 9.8 |
| Real U.S. Dollar Exchange Rate | 7.7 | 15.4 | 20.5 | 19.0 | 18.8 |
| Trade Balance ($billion) | 1.4 | –1.0 | –10.2 | –21.6 | –27.9 |
| CPI inflation (percentage points) | –0.2 | –0.2 | –0.2 | –0.1 | –0.2 |
| Short-term Interest Rates (percentage points) | –0.2 | –0.6 | –0.9 | –1.1 | –1.2 |
| Equity Prices | 1.3 | 2.4 | 3.4 | 3.5 | 3.6 |
| Other Industrial Economies | | | | | |
| Real GDP | –0.2 | –0.3 | –0.5 | –0.5 | –0.3 |
| Real Domestic Demand | — | — | –0.1 | –0.2 | –0.4 |
| Trade Balance ($billion) | –3.7 | –8.3 | –14.0 | –15.0 | –13.9 |
| Industrial Countries | | | | | |
| Real GDP | –0.1 | –0.1 | –0.2 | –0.3 | –0.3 |
| Real Domestic Demand | — | –0.1 | –0.1 | –0.2 | –0.1 |
| Trade Balance ($billion) | –2.8 | –5.0 | –6.8 | –6.8 | –4.5 |
| Developing Countries | | | | | |
| Real GDP | –0.1 | –0.2 | –0.3 | –0.4 | –0.4 |
| Real Domestic Demand | –0.2 | –0.4 | –0.6 | –0.7 | –0.8 |
| Trade Balance ($billion) | 3.4 | 6.0 | 8.0 | 11.4 | 7.8 |

to baseline through 2005, as trade responds to current and lagged exchange rate movements. The impact on real GDP is relatively small. It initially rises slightly above baseline values and subsequently falls below them. This is because the main counterpart to the change in real net exports is a reduction in real domestic demand compared to baseline. This comprises a fall in both real investment and, to a rather lesser extent, real consumption, resulting from a monetary policy tightening (to counteract imported inflationary pressures) and an erosion in equity prices (as lower investment reduces potential output and hence future expected profits). The opposite adjustment mechanism can be seen in the euro area and Japan. Real exports fall, real imports rise, and real domestic demand is boosted by a loosening of monetary policy and a rise in equity prices, while real GDP falls slightly below baseline.

Elsewhere, the other industrial country group experiences fewer benefits than the euro area and Japan, reflecting its closer trade and financial links with the United States. Both real GDP and real domestic demand fall compared to baseline. Developing countries see a medium-term reduction in real GDP and domestic demand compared to baseline, both because higher U.S. dollar interest rates reduce access to borrowing (and lead to a small improvement in the current account) and because the demand for exports falls as demand is switched from the United States, which trades relatively heavily with developing Asia and Latin America, to other countries that are mainly in Europe, whose trade is more directed to other advanced economies, the countries in transition, and Africa. For the world as a whole, the overall impact is to marginally reduce global growth, as reductions in U.S. investment are not fully offset by higher capital spending elsewhere.

The "harder landing" scenario assumes that these exchange rate adjustments (a fall in the real value of the dollar of 20 percent against the euro and yen, and 15 percent against currencies of other industrial countries) occur precipitately some time in early to mid-2001,[18] and are accompanied by:

- A fall in *global equity values* as investor confidence declines, with the United States being hit the hardest (a 20 percent fall in values), and the euro area and Japan the least.
- An accompanying erosion of *consumer and investor confidence* in the United States (due to the fall in equity prices) and in Japan (as weakness in global demand does further damage to an already weak economic situation).
- A gradual appreciation in equity values over the next three years as investor confidence is gradually restored, with this effect being again most pronounced in the United States.

The results from this scenario, reported in Table 1.13 and Figure 1.17, indicate that the adjustment of international imbalances and global demand is achieved more rapidly than in the "soft landing," but at the cost of significant short-term reductions in global growth.[19] World output falls by slightly over 1 percentage point compared to baseline in 2001 and stays at this level in 2002, after which it slowly recovers to baseline values by 2005. Although the larger falls in equity market values and confidence lead to a somewhat larger short-term reduction in real GDP compared to baseline in the United States than elsewhere in the advanced countries, the short-term losses in output are relatively similar across the advanced country regions, as the rapid depreciation of the U.S. dollar leads to largely offsetting movements in real net exports. Weaker output leads to a generalized fall in core inflation, and monetary policy is loosened throughout the advanced world. It is also possible that the decline in the U.S. dollar will be delayed, however, as capital continues to flow into the United States based on future growth prospects. In this case, the reduction in output and real demand in the United States would be larger in the short term as the benefits to real activity from a depreciation in the currency are delayed. Correspondingly, the real effects on other advanced country regions would be smaller.

Returning to the main "harder landing" scenario, the loss of confidence in the United States translates into more rapid divergence in relative levels of real domestic demand than in the "soft

[18]No particular event is postulated as starting this adjustment, as significant asset price movements can, and often do, occur without such a trigger once underlying imbalances have built up. For example, the recent global correction in equity valuations in the technology sector (discussed further in Chapter II) does not appear to have been driven by a significant specific macroeconomic event—nor were the 1929 and 1987 U.S. stock market crashes.

[19]The impact on global growth is somewhat smaller than in the harder landing reported in the last *World Economic Outlook*, particularly in the United States, reflecting the significant slowing of global growth and reduction in equity values already seen. Adjusted for the lower underlying forecast, the current simulation implies significantly weaker growth in 2001 than was implied by the earlier scenario.

**Table 1.13. Alternative Scenario: Harder Landing**
*(Percent deviation from baseline unless otherwise specified)*

| | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|
| World Real Growth | –1.1 | –1.1 | –0.8 | –0.3 | — |
| United States | | | | | |
| Real GDP | –1.4 | –1.6 | –1.2 | –0.6 | –0.4 |
| Real Domestic Demand | –2.5 | –2.7 | –2.3 | –1.6 | –1.3 |
| Real Investment | –9.8 | –9.9 | –7.7 | –6.0 | –4.7 |
| Real Effective Exchange Rate | –14.0 | –15.2 | –15.6 | –15.4 | –15.4 |
| Trade Balance ($billion) | 6.6 | 33.9 | 54.0 | 70.1 | 85.4 |
| CPI Inflation (percentage points) | 0.9 | –0.5 | –1.0 | –1.2 | –1.1 |
| Short-term interest rate (percentage points) | –2.8 | –3.0 | –3.0 | –2.3 | –1.5 |
| Equity Prices | –19.1 | –14.9 | –12.1 | –10.5 | –10.0 |
| Euro Area | | | | | |
| Real GDP | –1.1 | –1.2 | –0.9 | –0.3 | 0.3 |
| Real Domestic Demand | — | 0.1 | 0.4 | 0.9 | 1.4 |
| Real Investment | –0.1 | — | 0.5 | 1.3 | 2.3 |
| Real Effective Exchange Rate | 8.5 | 9.7 | 10.1 | 9.7 | 9.2 |
| Real U.S. Dollar Exchange Rate | 20.0 | 22.0 | 22.3 | 21.6 | 21.3 |
| Trade Balance ($billion) | –18.4 | –30.3 | –38.0 | –46.6 | –58.6 |
| CPI Inflation (percentage points) | –1.1 | –0.8 | –0.5 | –0.2 | –0.1 |
| Short-term interest rate (percentage points) | –2.9 | –3.0 | –3.0 | –2.8 | –2.7 |
| Equity Prices | –0.4 | 0.3 | 2.6 | 5.0 | 7.4 |
| Japan | | | | | |
| Real GDP | –1.1 | –1.1 | –0.5 | — | 0.4 |
| Real Domestic Demand | –0.7 | –0.6 | 0.1 | 0.5 | 0.8 |
| Real Investment | –4.0 | –2.6 | 0.2 | 1.0 | 1.7 |
| Real Effective Exchange Rate | 6.3 | 9.1 | 9.9 | 9.2 | 9.0 |
| Real U.S. Dollar Exchange Rate | 14.9 | 18.5 | 19.4 | 18.5 | 18.2 |
| Trade Balance ($billion) | 0.8 | –1.0 | –7.4 | –13.3 | –18.8 |
| CPI inflation (percentage points) | –0.3 | –0.4 | –0.4 | –0.4 | –0.4 |
| Short-term Interest Rates (percentage points) | –0.5 | –0.7 | –0.9 | –1.4 | –1.6 |
| Equity Prices | –0.1 | 2.8 | 3.2 | 4.0 | 3.9 |
| Other Industrial Economies | | | | | |
| Real GDP | –1.1 | –1.2 | –0.8 | –0.3 | 0.1 |
| Real Domestic Demand | –0.4 | –1.0 | –0.9 | –0.6 | –0.2 |
| Trade Balance ($billion) | –6.0 | 6.4 | 11.5 | 13.3 | 8.1 |
| Industrial Countries | | | | | |
| Real GDP | –1.2 | –1.3 | –0.9 | –0.3 | — |
| Real Domestic Demand | –1.1 | –1.3 | –0.9 | –0.3 | — |
| Trade Balance ($billion) | –16.9 | 9.0 | 20.1 | 23.5 | 16.1 |
| Developing Countries | | | | | |
| Real GDP | –0.5 | –0.5 | –0.4 | –0.3 | –0.2 |
| Real Domestic Demand | –0.8 | –0.8 | –0.6 | –0.4 | –0.3 |
| Trade Balance ($billion) | 18.5 | –5.4 | –14.1 | –14.7 | –5.2 |

landing" scenario, and by 2002 the adjustment in trade balances is twice as large. However by 2005, when the process of trade balance adjustment is essentially complete, the differences between the two scenarios have been largely erased. The U.S. trade balance improves by $85 billion compared to baseline (almost identical to the other scenario), with the main counterparts again being the euro area (almost $60 billion) and Japan (almost $20 billion). By this time, significant differences are also apparent in the path of real activity. Compared to baseline, real output recovers much more slowly in the United States than elsewhere, particularly in the euro area and Japan, as differential movements in real investment translate into changes in the level of potential output.

There is also a significant fall in real GDP and real domestic demand in developing countries, although it is only about half of that in the ad-

vanced world. Compared to the results in the "soft landing" scenario, the fall in real GDP and (in particular) real domestic demand is larger initially but smaller over the medium term. This reflects two competing forces. The larger initial fall in output in the advanced countries reduces demand for exports from developing countries, lowers commodity prices, and reduces capital flows. Over several years, however, the loosening of global monetary conditions coming from weakness in activity provides a boost to the developing world, particularly to regions that are heavily dependent on foreign borrowing, such as Latin America. The decline in output, however, could be significantly greater if the hard landing in the United States was accompanied by a substantial deterioration in financing conditions for emerging markets.