

WORLD ECONOMIC OUTLOOK
May 2001

Fiscal Policy and Macroeconomic Stability



© 2001 International Monetary Fund

This advance copy of the *World Economic Outlook* is provided solely for the convenience of the media. Although every effort has been made to ensure the accuracy of this advance copy, some figures contained herein may be corrected in the course of publication. The published *World Economic Outlook*, which will be available next month, remains the document of record.



CONTENTS

Assumptions and Conventions	vii
Preface	ix
Chapter I. Prospects and Policy Challenges	1
How Hard a Landing in the United States?	11
Will Japan's Fragile Recovery Continue?	16
Can Domestic Demand Sustain European Growth?	20
How Will the Global Slowdown Affect Asia?	24
How Will the Global Slowdown Affect Latin America?	27
Can Africa Achieve Sustained Higher Growth?	32
The Middle East: Managing Terms of Trade Volatility	37
Rebalancing the Policy Mix in Europe's Emerging Markets	39
Commonwealth of Independent States: Oil Prices Are Key	45
Appendix I: The Global Slowdown and Commodity Prices	47
Appendix II: Reducing External Imbalances	50
Chapter II. Three Current Policy Issues	57
Impact of the Global Technology Correction on the Real Economy	57
What is Driving the Weakness of the Euro and the Strength of the Dollar?	66
Trade Integration and Sub-Saharan Africa	75
Chapter III. Fiscal Improvement In Advanced Economies: How Long Will It Last?	85
Fiscal Improvement in OECD Countries: A Retrospective	87
The Role of Institutional Reform	99
Future Fiscal Performance	106
Chapter IV. The Decline of Inflation in Emerging Markets: Can It Be Maintained?	116
Why Do Countries Inflate?	117
Empirical Evidence on the Determinants of Inflation	122
What Explains the 1990s Inflation Performance in Emerging Markets?	126
Monetary Regimes and Inflation Performance	130
What Does the Recent Record Tell Us?	131
Safeguarding Low Inflation in Emerging Markets	143
Annex. Summing Up by the Acting Chairman	145
Statistical Appendix	151
Assumptions	151
Data and Conventions	151
Classification of Countries	156

CONTENTS

List of Tables	162
Output (Tables 1–7)	165
Inflation (Tables 8–13)	176
Financial Policies (Tables 14–21)	184
Foreign Trade (Tables 22–26)	193
Current Account Transactions (Tables 27–32)	200
Balance of Payments and External Financing (Tables 33–37)	210
External Debt and Debt Service (Tables 38–43)	220
Flow of Funds (Table 44)	228
Medium-Term Baseline Scenario (Tables 45–46)	232

Boxes

1.1 How Well Do Forecasters Predict Turning Points?	6
1.2 Sustainability of the U.S. External Current Account	14
1.3 Japan’s Recent Monetary and Structural Policy Initiatives	19
1.4 The Enhanced HIPC Initiative in Africa	35
1.5 Large Current Account Deficits in Transition Countries Seeking Membership in the European Union	41
2.1 The Weakness of the Australian and New Zealand Currencies	68
2.2 Africa’s Trade and the Gravity Model	78
3.1 Japan: A Fiscal Outlier?	90
3.2 Financial Implications of the Shrinking Supply of U.S. Treasury Securities	95
3.3 Impact of Fiscal Consolidation on Macroeconomic Performance	97
3.4 Fiscal Frameworks in Advanced and Emerging Market Economies	101
4.1 Why Emerging Market Countries Should Strive to Preserve Lower Inflation	120
4.2 Is There a Relationship Between Fiscal Deficits and Inflation?	124
4.3 Inflation Targeting in Emerging Market Economies: Implementation and Challenges	132
A.1 Economic Policy Assumptions Underlying the Projections for Selected Advanced Countries	152

Tables

1.1 Overview of the <i>World Economic Outlook</i> Projections	2
1.2 Selected Economies: Current Account Positions	13
1.3 Major Advanced Economies: General Government Fiscal Balances and Debt	18
1.4 Advanced Economies: Real GDP, Consumer Prices, and Unemployment	21
1.5 Selected Asian Countries: Real GDP, Consumer Prices, and Current Account Balance	24
1.6 Selected Western Hemisphere Countries: Real GDP, Consumer Prices, and Current Account Balance	28
1.7 Emerging Market Economies: Net Capital Flows	29
1.8 Selected African Countries: Real GDP, Consumer Prices, and Current Account Balance	32
1.9 Selected Middle Eastern Countries: Real GDP, Consumer Prices, and Current Account Balance	39
1.10 European Union Accession Candidates: Real GDP, Consumer Prices, and Current Account Balance	40
1.11 Commonwealth of Independent States: Real GDP, Consumer Prices, and Current Account Balance	46
1.12 Alternative Scenario: Soft Landing with Imbalance Adjustment	53

1.13 Alternative Scenario: Harder Landing	55
2.1 Change in Market Capitalization From March 2000 to March 2001	61
2.2 Impact of a Rise in Equity Valuations on Consumption	62
2.3 Impact of a Rise in Equity Valuations on Investment	65
2.4 Are Stock Valuations a Leading Indicator of The Business Cycle?	66
2.5 Explaining Bilateral Exchange Rate Movements	72
2.6 Measures of Trade Policy Regimes in Africa and Other Regions: Sachs-Warner Openness Index	77
2.7 Measures of Trade Policy Regimes in Africa and Other Regions: IMF's Trade Restrictiveness Index, 2000	77
3.1 Net Migration Flows to Major Industrial Economies in 2000 to 2050	114
4.1 Inflation in Industrial Countries and Emerging Markets	117
4.2 Inflation in Emerging Markets	119
4.3 Emerging Market Countries: Selected Variables	127
4.4 Major Emerging Market Exchange-Rate and Money-Based Stabilization Programs Since the 1970s	136
4.5 Fiscal Balances of Countries That Adopted Inflation Targeting	142

Figures

1.1 Global Indicators	3
1.2 Selected European Union Countries, Japan, and United States: Indicators of Consumer and Business Confidence	4
1.3 Financial Market Developments	5
1.4 External Vulnerabilities in Developing Countries	9
1.5 United States: Sharp Slowdown and Persistent Imbalances	12
1.6 Japan: Recovery Faltering	16
1.7 Euro Area: Growth Moderating, but Still Reasonably Robust	22
1.8 Selected Asian Countries: The Impact of Weakening External Demand	25
1.9 Western Hemisphere: Exposure to External Shocks	31
1.10 Sub-Saharan Africa: Why Has the Recent Expansion Slowed?	33
1.11 Middle East: Responding to Oil Price Volatility	38
1.12 Selected European Countries: Domestic Demand Growth and General Government Balances	44
1.13 Russia: Recovery Driven by Exchange Rate Depreciation and Oil Prices	47
1.14 Primary Commodity Prices and Selected Economic Indicators	48
1.15 West Texas Oil: Spot Price and Futures Contracts	49
1.16 Computer Chip Prices	51
1.17 Global Imbalances Adjustment Scenarios	52
2.1 Equity Price Indices	58
2.2 Stock Price Indices for Technology, Media, and Telecommunications (TMT) vs. Non-TMT Sector	59
2.3 Correlation Between Technology, Media, and Telecommunications (TMT) and non-TMT Returns Across Regions	60
2.4 Technology, Media, and Telecommunications (TMT) as a Share of GDP	61
2.5 NASDAQ Stock Price and Private Fixed Investment in Computers and Peripheral Equipment	64
2.6 The "New Economy" Cycle of the Late 1990s	64

CONTENTS

2.7	Movements of the Euro and Yen	67
2.8	Global Net Portfolio Flows to the United States by Asset Class	71
2.9	Net Portfolio Flows into U.S. Stocks from Euro Area and the Exchange Rate	73
2.10	The Euro and Long-Term Interest Rate Differential	74
2.11	Africa: Trade Indicators	76
2.12	African Trade Arrangements: Intra and Extraregional Trade, 1980-98	81
2.13	Africa: The Regional Trade Integration Quilt	83
3.1	Fiscal Trends in OECD Countries	85
3.2	Fiscal Developments in the OECD Area	87
3.3	Fiscal Developments in Groups of OECD Countries	88
3.4	Actual and Structural Balances in Groups of OECD Countries	89
3.5	Expenditure Developments in Groups of OECD Countries	93
3.6	Revenue Developments in Groups of OECD Countries	94
3.7	Elderly Dependency Ratios	106
3.8	Direct Effects of Aging on Government Finances	108
3.9	Employment—Population Ratios by Age, Selected Countries, 1999	110
3.10	Total Dependency Ratios	112
3.11	Saving, Investment, and Current Account Balances in the Reference Scenario	113
4.1	Inflation Over Time	118
4.2	Seigniorage in Emerging Market Economies, 1950–2000	122
4.3	Inflation and Its Determinants in Emerging Markets	128
4.4	Exchange Rate Pass-Through in Emerging Markets in the 1990s	130
4.5	Monetary Regimes in Emerging Market Countries	134
4.6	Foreign Currency Deposits	135
4.7	Selected Exchange Rate Stabilization Programs, 1985–98	137
4.8	Selected Monetary Stabilization Programs, 1975–90	139
	<i>World Economic Outlook and Staff Studies for the World Economic Outlook, Selected Topics, 1992–2001</i>	235



ASSUMPTIONS AND CONVENTIONS

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates will remain constant at their average levels during February 19–March 16, except for the currencies participating in the European exchange rate mechanism II (ERM II), which are assumed to remain constant in nominal terms relative to the euro; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary policies in industrial countries, see Box A.1); that the average price of oil will be \$25.50 a barrel in 2001 and \$22.50 a barrel in 2002, and remain unchanged in real terms over the medium term; and that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 4.5 percent in 2001 and 4.3 percent in 2002. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The estimates and projections are based on statistical information available through end-March 2001.

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

- . . . to indicate that data are not available or not applicable;
- to indicate that the figure is zero or negligible;
- between years or months (for example, 1997–98 or January–June) to indicate the years or months covered, including the beginning and ending years or months;
- / between years or months (for example, 1997/98) to indicate a fiscal or financial year.

“Billion” means a thousand million; “trillion” means a thousand billion.

“Basis points” refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to $\frac{1}{4}$ of 1 percentage point).

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

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

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



FURTHER INFORMATION AND DATA

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

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

World Economic Studies Division
Research Department
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431, U.S.A.
E-mail: weo@imf.org Telefax: (202) 623-6343



PREFACE

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

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

The country projections are prepared by the IMF's area departments on the basis of internationally consistent assumptions about world activity, exchange rates, and conditions in international financial and commodity markets. For approximately 50 of the largest economies—accounting for 90 percent of world output—the projections are updated for each *World Economic Outlook* exercise. For smaller countries, the projections are based on those prepared at the time of the IMF's regular Article IV consultations with those countries and updated during the WEO exercise.

The analysis in the *World Economic Outlook* draws extensively on the ongoing work of the IMF's area and specialized departments, and is coordinated in the Research Department under the general direction of Michael Mussa, Economic Counsellor and Director of Research. The *World Economic Outlook* project is directed by David Robinson, Assistant Director of the Research Department, together with Tamim Bayoumi, Chief of the World Economic Studies Division.

Primary contributors to the current issue include Luis Catão, Hali Edison, Maitland MacFarlan, James Morsink, Cathy Wright, Marco Cangiano, Markus Haacker, Michael Kell, Luca Ricci, Torsten Sløk, Arvind Subramanian, and Marco Terrones. Other contributors include Vivek Arora, Tim Callen, Giovanni Dell'Ariccia, Richard Hemming, Sanjay Kalra, Ken Kletzer, Charles Kramer, Prakash Loungani, Paolo Mauro, Blair Rourke, Abebe Selassie, and Mark Zelmer. Mandy Hemmati, Siddique Hossain, Yutong Li, Ning Song, and Bennett Sutton, provided research assistance, together with Rikhil Bhavnani and Estella Macke. Gretchen Byrne, Nicholas Dopuch, Staffan Gorne, Toh Kuan, Olga Plagie, Di Rao, and Anthony G. Turner processed the data and managed the computer systems. Celia Burns, Marlene George, Rochelle Gittens, and Lisa Nugent were responsible for word processing. Jeff Hayden of the External Relations Department edited the manuscript and coordinated production of the publication.

The analysis has benefited from comments and suggestions by staff from other IMF departments, as well as by Executive Directors following their discussion of the *World Economic Outlook* on April 5 and 6, 2001. However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities.