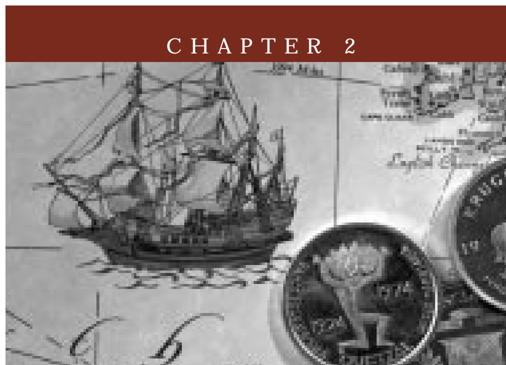


World Economic Outlook

The World Economic Outlook exercise forms an integral part of the Fund's ongoing surveillance of developments in the world economy and in the Fund's member countries. For this exercise, the staff generates detailed analyses, based on information gained during consultations with member countries, of the short-term and medium-term prospects for individual countries, for groupings of countries, and for the world economy as a whole. The Board reviews these studies biannually.

In the 1996/97 financial year, the Board held its discussions on the World Economic Outlook in September 1996 and in late March and early April 1997. Directors focused in their September discussion on the relation between inflationary pressures and monetary policy. In March–April, they gave special consideration to issues associated with globalization—that is, the rapid integration of the world economy. In March 1997 a conference on the role of European Economic and Monetary Union (EMU) in the international monetary system was sponsored by the Fund as a prelude to further Board discussion of the implications of EMU for the system and for the work of the Fund (Box 2).

Global Situation

In their assessment of the global economic situation in September 1996, Directors agreed that world economic growth was likely to continue at a satisfactory pace during 1996–97. The easing of monetary policy throughout Europe was expected to help growth to revive, although the strength of the revival was subject to considerable uncertainty. The Board was also encouraged by more widespread growth among developing countries and transition economies. Recovery in the developing countries of the Western Hemisphere was expected to gain momentum, and growth prospects in Africa were anticipated to improve further. The Board envisioned a more moderate but robust increase in output in Asia. Aggregate output was expected to stabilize in the transition economies and could even show positive growth for the first time since the transition began.

In their March–April 1997 review, Directors agreed that conditions remained generally favorable for the continued satisfactory expansion of world output and trade. Inflation remained subdued in the advanced economies, and price pressures were expected to ease further in the developing and transition economies. Fiscal imbalances were being reduced. Movements in exchange rates among the major currencies had generally been supportive of macroeconomic policy objectives. And structural reforms were enhancing the role of market forces in many countries, deepening integration of economies through trade and payments, and strengthening the basis for sustainable growth.

Despite these many encouraging signs, some Directors cautioned that the outlook was not without risk. High unemployment and weak growth persisted in much of continental Europe. Difficulties for European Union members in meeting the Maastricht fiscal deficit targets and uncertainty over monetary union could lead to turbulence in financial markets. Fragile banking systems in a number of emerging market countries were regarded as a significant point of vulnerability. Moreover, while acknowledging that global economic performance had generally improved, Directors observed that differences in economic performance across countries had widened in recent years. In many of the advanced economies, long-standing differences in the ability to achieve and maintain satisfactory levels of employment had become more pronounced. For the low-income countries, notwithstanding clear improvement in economic conditions in many cases, living standards in some of the poorest countries had been falling further behind. And in the transition countries, the contrast in performance had sharpened between some of the early and more consistent reformers and countries that had initiated adjustment later and with less commitment.

Box 2

Role of EMU in the International Monetary System

The role of European Economic and Monetary Union (EMU) in the international monetary system was featured at a conference held at the Fund on March 17–18, 1997. Participants included academics and government officials from around the world, as well as members of the Fund's Board and staff. There was a broad consensus on several issues, but it was also agreed that there would be considerable uncertainty even after the start of monetary union.

Most participants considered that EMU was likely to start as scheduled on January 1, 1999, although there was some risk of a postponement if key countries were unable to satisfy the criteria for monetary union on the basis of their 1997 data. It was generally accepted that the euro, the designated currency for participants in the EMU, would most likely be a strong currency, backed by conservative fiscal policies and a monetary policy oriented toward price stability. There was concern, however, that the dollar would be more volatile against the euro than it currently was vis-à-vis the European currencies. Some participants pointed to the dangers of instability resulting from the European Central Bank (ECB) being less concerned about the exchange rate because the external trade of the euro area would be a small share of its GDP. Other participants were concerned about the consequences of a sharp shift of portfolios out of the dollar and into euro-denominated assets. Several participants noted the difficulties of managing a single currency with inadequate labor market flexibility and uncoordinated fiscal policies.

It was generally agreed that the attractiveness of the euro would be determined mainly by the macroeconomic policy stance in Europe and, in particular, by the success of the ECB in achieving low inflation. There was also general agreement that the ECB would follow the Bundesbank's example of dedication to price stability and would remain independent of political interference as provided for in its statutes. Other factors, including the development of integrated, liquid, and efficient European financial markets, would also be important determinants of the euro's international use. Reserve currency use was likely to evolve slowly, but the euro would start out as the second most important reserve currency and could, over time, rival the dollar. However, it was pointed out that this would no more confer any special economic benefits on Europe than had been the case for the United States over the past fifty years.

Creation of the euro was viewed as having generally positive effects on neighboring countries, provided that the euro was stable and neither too strong nor too weak, but negative effects if it were volatile. It was hoped that European integration would increase cooperation between the European Union and neighboring countries and that the euro would become an important pole for exchange rate stability.

The prospects for international economic policy coordination were considered in some detail at the conference. The two aspects of this issue that received the most attention were what EMU would mean for the effectiveness of coordination by the Group of Seven industrial countries and how the Fund would need to adapt its procedures and relationships with its European Union members when the ECB became responsible for monetary policy and the euro replaced national currencies.

As regards the relationship between the Fund and its members, although it was clear that EMU would not affect the rights and obligations of members under the Articles of Agreement, the transfer of monetary policy responsibilities to the ECB and the replacement of existing currencies by the euro raised a number of issues, including how surveillance was to be carried out, whether and how Fund resources could be made available to EMU members, how Fund quotas might be affected, whether the composition of the SDR needed to be redefined, and how the euro would be used in Fund operations. No simple answers were yet available, and work on these questions was urgently needed.

Advanced Economies

During the September 1996 discussion, a number of Directors cautioned that, although inflation had remained low, monetary policy would need to be tightened to prevent an emergence of inflationary pressures in the United States, where growth had been buoyant. Directors considered Japan's monetary stance appropriate, but some did not rule out additional fiscal stimulus to sustain the recovery. In continental Europe, despite isolated signs of pickup in economic activity, notably in Germany, the Board did not discern a broad economic revival. With regard to the high unemployment that continued to afflict many industrial countries, especially in Europe, Directors noted the challenge of promoting labor market flexibility and building a social consensus for change. In their view, greater attention should be given to the scope for upward income mobility, such as through education and training.

In their March–April 1997 discussion, the Board expected growth in the United States during 1997–98 to continue at about the rate of potential. Despite the high utilization of resources, inflation remained low. Nonetheless, noting that a pickup in inflation remained a risk, Directors welcomed the recent preemptive tightening of monetary conditions by the Federal Reserve Board. Notwithstanding significant progress in recent years, Directors considered that continued effort was needed to achieve a balanced budget in the medium term and to prevent a growing deficit in the longer run, given the projected rapid growth in spending on

pensions and health care for the elderly. Directors also discussed the possibility of a major correction in the stock market, but most believed that, should it occur, it would not necessarily be destabilizing or entail significant adverse consequences for the U.S. or the world economy. In the case of the United Kingdom, the relatively advanced cyclical position of the economy and the associated risk of overheating was seen by some Directors as warranting an increase in interest rates, although it was noted that the strength of the exchange rate had to some extent alleviated that risk.

Japan's economic recovery, which had fluctuated around a moderate underlying pace since 1995, was expected to continue in 1997. Some Directors considered that the pace of fiscal consolidation should be slowed if the recovery exhibited signs of faltering. Several other Directors, however, thought that the recovery was sufficiently strong not to require easing the pace of fiscal consolidation or saw little scope for fiscal easing, even if activity did turn out weaker than expected. They regarded steady fiscal consolidation as crucial for financial market confidence and for preparing for the needs of an aging population. Several Directors were concerned about elements of fragility in Japan's financial sector, and most speakers stressed the central role of structural reform, including deregulation, in Japan's medium- and long-term economic outlook.

Growth in continental Europe in 1996 was viewed by the Board as disappointing, but policy achievements associated with the Maastricht convergence process were setting the stage for stronger economic performance in the future. The run-up to EMU was exacting a toll both because of continuing uncertainties that had been dampening business and consumer confidence and contributing to weak demand and activity and because of the short-term consequences of fiscal consolidation in some countries. Several speakers stressed that it was critical to get through this period promptly by bringing the project to term within the agreed time frame and, to that end, urged governments to follow through on their policy commitments in both the fiscal and structural areas. They expressed concern about the risk of turbulence in financial markets if perceptions grew that the launch date might be postponed. More fundamentally, it was agreed that the failure to tackle adequately structural rigidities in European labor and product markets was a key reason for the lack of economic dynamism and the high level of structural unemployment.

As regards fiscal policy in Europe, although structural deficits had been brought down significantly, imbalances were viewed by Directors as still excessive in some countries: further durable reductions of budgetary imbalances thus remained a priority. A number of Directors welcomed the easing of monetary conditions in Germany and in other countries participating in the ERM. Some Directors, while agreeing that monetary policy in Germany had been accommodative, considered that there was scope for further reductions in interest rates. A few other Directors, however, felt that monetary conditions in Germany did not constitute an impediment to growth and underscored that a cautious and prudent monetary policy was essential to maintain confidence during the run-up to EMU.

The Board agreed that the primary policy action to strengthen economic performance in Europe, and also in Japan, was structural reform. There had been some progress, although it was not yet sufficient. They urged countries to build up the necessary social consensus for such policies. In most of Europe there was a need to reform the complex system of regulations, benefits, and taxes that discouraged job creation and job search, while safeguarding a reasonable level of social protection and meeting legitimate equity objectives. Reducing unemployment would of itself alleviate a major source of income inequality, as well as improve fiscal performance. Several Directors pointed to the lessons to be drawn from the encouraging experience of countries (for example, Denmark, Ireland, the Netherlands, New Zealand, the United Kingdom, and the United States) with more flexible labor markets. In Japan, there was a particularly pressing need for further deregulation of sectors producing for the domestic market, which remained overregulated, noncompetitive, and inefficient.

Developing Countries

During their September 1996 discussion, Directors welcomed the continuing solid expansion in many developing countries, as well as the strengthening of capital flows into Latin America following the resolution of the Mexican crisis. They were also encouraged by the continuation of large capital inflows to many other emerging market countries, which was helping to ease financing constraints and enhance growth prospects in the recipient countries. They expected growth to improve among the developing countries of the Western Hemisphere and were optimistic about the prospects for growth in Africa. In Asia, they anticipated that the pace of expansion would slow to a more sustainable, though still robust, rate following a tightening of policies in several countries in response to concern about overheating.

When they again discussed the outlook for developing countries in March–April 1997, Directors felt that the abatement of overheating pressures in many of the most successful developing countries since the September 1996 discussion had enhanced the chance that their expansion would be sustained. Concern remained about speculative movements in the financial and exchange markets in several emerging market

economies and about the sustainability of their large current account deficits, which required careful implementation of policies. Growth in the developing countries of the Western Hemisphere was expected to gain momentum, and inflation to moderate further. In the Middle East, recently introduced economic reforms should help to sustain growth, although the need remained for further structural reforms to lessen dependence on oil revenues and enhance long-term growth prospects. Directors were particularly heartened by Africa's overall growth performance and were cautiously optimistic that growth in 1997 would remain close to its rate in 1996, the region's best in more than two decades.

Transition Economies

During their March–April 1997 discussion, Directors also welcomed continued progress in macroeconomic stabilization by countries in transition as reflected in reduced inflation and resumed growth in most countries. They remarked, however, that performance in countries that were earlier and more consistent in adopting reforms continued to contrast sharply with performance in countries that had instituted reform later and with less commitment. Emphasizing the importance of policy complementarities, a number of Board members cautioned that the slow pace of structural reform in several transition countries could jeopardize the achievements of stabilization policies. Sustained growth required well-functioning market-based institutions, an efficient state administration of public business, including fiscal transparency and effective revenue collection, the strengthening of property rights, and adherence to the rule of law. The Board emphasized that in all transition economies, including the most advanced, much remained to be done to complete the process of structural reform. In particular, further progress was needed in restructuring and privatizing key enterprises and in reorganizing the banking sector. Directors regarded structural reforms, along with improved education and training, as essential to address the problem of high unemployment that was accompanying transformation in these countries.

Inflation and the Role of Monetary Policy

In addition to their evaluation of the outlook for the world economy in the September 1996 discussion, Directors focused in some detail on the relationship between inflation and monetary policy. They noted that many countries, in all regions of the world, had in the past few years succeeded in reducing inflation, in many cases to the lowest level in decades. The Board viewed this development as a result of determined policy action, especially of monetary policy focused on its primary task of achieving and maintaining price stability.

Directors observed that, despite the increased importance of bond and stock markets in some countries, the development of new financial instruments, and the increased openness of economies to capital inflows, monetary policy remained an effective tool of macroeconomic policy. Nevertheless, since structural changes had lengthened the lag with which monetary policy operated, preemptive action against prospective inflation had become even more important, as had the need for coherence and credibility in macroeconomic and structural policies. In particular, flexible labor markets, competitive product markets, and openness to trade and capital flows helped to complement anti-inflationary monetary policies. Some Directors also supported the view that monetary accommodation of adverse supply shocks needed to be limited, since inflation tended to be built into expectations and to become persistent.

Globalization

The thematic focus of the Board's March-April 1997 discussion shifted to the issue of globalization and particularly to the consequences and policy implications of the rapid integration of national economies worldwide through trade, financial flows, technology spillovers, information networks, and cross-cultural currents. Directors agreed that globalization had contributed enormously to global prosperity. Countries aligning their policies with the forces of globalization by embracing reforms, liberalizing markets, and pursuing sound macroeconomic policies had generally fared well. Directors stressed that the challenge to governments was not how to resist the forces of globalization, but rather how to enable their economies to benefit from these forces. Although globalization might adversely affect employment opportunities and wages in some segments of society in the short run while the economy adjusted, it had not been the principal force behind the unfavorable developments in employment and income distribution observed in some advanced economies. Board members noted that governments should make greater efforts to explain what globalization does and does not do. Public debate often focused excessively on perceived negative aspects of globalization, especially the presumed adverse affects on employment and real wages, particularly of the low-skilled.

There was widespread agreement with the staff's analysis that increased trade with low-income countries had not contributed significantly to the declining share of employment in manufacturing in advanced economies. Nor did it explain much of the relative decline in wages of low-skilled workers. Deindustrialization (the decline in the share of manufacturing employment in total employment) appeared to be attributable mainly to the relatively rapid growth of

labor productivity in manufacturing, which was associated with technical progress. Technological change also appeared to have affected wage differentials. A number of Directors emphasized that improvements in education and training should have high priority in dealing both with the transfer of employment to the expanding services sector as economies matured and with the tendency of wage differentials to widen as technical progress demanded new skills. Some speakers thought it appropriate for governments to provide temporary measures to compensate those affected by globalization; others thought that market forces, by providing new opportunities, would be more effective in assisting displaced workers.

Board members generally disagreed with the notion that globalization made it more difficult for governments to achieve the desirable aims of economic policy, even though, at times, large short-term capital flows could be destabilizing and asset prices could become misaligned. Globalization did, however, limit the scope for countries to pursue policies incompatible with medium-term financial stability. Although globalization increased the costs of economic distortions and imbalances, it clearly enhanced the rewards of sound policies. With policies adapted to meet the requirements of competitive world markets, all countries should be better able to develop their comparative advantages.

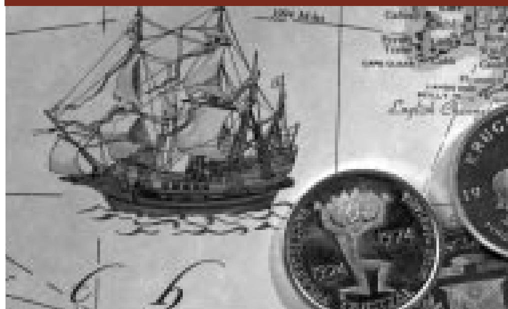
While standards of living had improved remarkably in most developing countries over the past thirty years, the Board expressed disappointment that per capita income levels in many developing countries were not converging toward advanced-economy levels. Per capita incomes in many developing country regions had actually been declining relative to those in advanced economies. Countries that had aligned their policies with the forces of globalization had generally performed quite well and tended to be on paths of convergence with the advanced economies. Openness to trade was strongly correlated with growth in per capita income. Open economies were in a position to benefit from trade expansion, to gain global market share, and to be increasingly rewarded with larger flows of foreign investment. In contrast, countries that had not aligned their policies with the forces of globalization were likely to experience declining shares of world trade and private capital flows, and to find themselves falling behind. Countries resisting globalization faced increased risk of becoming marginalized.

Directors noted the staff analysis of the experience of a large number of developing countries, highlighting the importance of policy complementarities. They agreed that a combination of good policies was usually important in leading to a favorable growth outcome. Poor performance in one policy area tended to retard growth, even if other policies were successful. The best outcomes were usually achieved when there was success across most policy fronts.

The Board also considered the benefits and challenges of the transition economies' reintegration into the world economy. It was encouraged by the progress being made in reorienting trade toward a market-determined distribution of exports and imports, and by the accompanying growth in productivity and wages. Directors observed that the transition economies that had enjoyed the most rapid integration into the global trading system had generally been those that early on had pursued successful stabilization policies. They also welcomed the budding reintegration of those countries into international financial markets.

Directors expressed concern about the implications of volatile capital flows for developing and transition countries. They recognized that the constraints imposed by globalization were usually best addressed not by imposing restrictions on the free flow of capital but rather by adopting sound, transparent, and sustainable macroeconomic policies that guarded against sudden changes in market sentiment.

CHAPTER 3



International Capital Markets

In July 1996 the Board conducted its annual review of developments in the international capital markets.[3] In welcoming the opportunity for the review, Directors discussed how to broaden the application of sound supervisory and regulatory banking standards to a larger number of countries and the role of the Fund in that area. They also commented on how to reduce further the potential for disruptions in global foreign exchange markets.

Capital Flows to Emerging Markets

Directors remarked upon the speed with which net capital flows to emerging markets had recovered from the disturbances associated with the Mexican financial crisis in early 1995. There was general agreement that investors had become more aware of the risks associated with investing in emerging markets. Notably, there had been a greater reliance on a wider range of macroeconomic, financial, and banking soundness indicators in assessing both economic conditions and investment opportunities in developing markets. In particular, Directors pointed to evidence of keener investor discrimination with regard to both the nature of investments and their destination, as shown in the decline in the importance of more volatile portfolio flows, the increase in foreign direct investment and cross-border lending in most regions, and the changes in the proportion of flows to different regions as well as between countries within regions.

Risk Management

Directors welcomed the positive impact of these developments on market stability, but they cautioned against complacency. They felt that considerable progress still had to be made before the quality and availability of economic and financial data on emerging markets—and thus the supporting analysis—could compare favorably with what was available on industrial country markets.

Some Directors expressed concern, in particular, about the shift toward bonds denominated in yen and deutsche mark. To the extent that the exchange risks were not adequately hedged, borrowers might be incurring more exchange rate risk than they could manage. Lenders could also be incurring more credit risk than they fully appreciated. Directors suggested that this aspect of liability management required monitoring in several emerging market countries.

In discussing the rapidly growing size and complexity of the foreign exchange markets, Directors noted the central position of these markets in the international monetary system. The recent initiatives of the Group of Ten industrial countries in encouraging the improvement of private risk management in reducing settlement risks were praised. It was emphasized that reduction in settlement risk was primarily a task for the private sector.

Surveillance of Global Financial Markets

In reviewing trends and developments in major industrial country markets, it was observed that the evolution of international financial markets since the early 1990s provided evidence that international capital markets had become more resilient. Despite this, Directors thought it was premature to conclude that financial institutions were able to respond easily and effectively to most kinds of disturbances, including unanticipated and sharp changes in interest and exchange rates. Here again, caution would be well advised.

Directors noted that banking systems in major industrial countries had made significant progress in improving their financial condition, performance, and risk management. But some countries still had problems, and the possibility of financial stress owing to

[3]The background paper prepared by the staff was subsequently published as *International Capital Markets: Developments, Prospects, and Key Policy Issues* (September 1996), in the Fund's series of World Economic and Financial Surveys.

increased global competition—and the growth of new and unfamiliar financial transactions—could not be ruled out. In developing countries, the importance of improving regulatory and market infrastructure was emphasized; national authorities would have to strengthen the supervision and surveillance of their respective financial sectors.

Directors discussed existing arrangements that safeguard the stability and efficiency of international markets. They observed that the initiatives by the Group of Ten countries to coordinate and harmonize their supervisory and regulatory activities—principally through the Basle Committee on Banking Supervision—shed light on a range of important issues. In particular, Directors noted the recent guidelines on minimum capital requirements for market risk incurred by international banks; the principles on which the division of supervisory responsibility between home and host countries would be based; and the understandings regarding the sharing of supervisory information. There was broad agreement that current supervisory and regulatory arrangements had been generally successful in coping with changes in the international financial system.

Despite these successes, Directors observed that important challenges remained. The approach taken by the Group of Ten to the formulation and implementation of supervisory and regulatory policy needed to be adapted and applied to a larger group of countries. This would not only be important in safeguarding the stability of the international financial system, but also in contributing to the effectiveness of domestic banking institutions in developing countries.

Role of the Fund

Directors welcomed the efforts of the Basle Committee and the Bank for International Settlements (BIS) in reaching out to regional associations of supervisors—besides individual countries that were not members of the Group of Ten—in formulating and implementing more effective supervision and regulation. In this context, they felt that there was no need for any new institutional structure. Members of the Board, however, emphasized that the Fund, with its universal membership, could play a critical role in promoting banking soundness and adherence to internationally agreed standards in emerging markets, transition economies, and other developing countries.

Internationally agreed supervisory and regulatory minimum standards would need to be developed, Directors said. These standards should cover key aspects of prudential rules, the architecture of the regulatory environment, and the international division of supervisory responsibility and exchange of supervisory information. As part of its responsibility, the Fund could contribute to the dissemination of such standards; the Fund could also help to monitor progress in adapting and adhering to those standards.

In subsequent discussions (see Chapter 4, the section on Banking Soundness), Directors emphasized that the Fund should draw, inter alia, on the set of core principles for effective bank supervision being developed by the Basle Committee and should collaborate closely with other international organizations and groups, including the Basle Committee and the World Bank.