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Assumptions and Conventions

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates will remain constant at their average levels during July 18–August 14, 1997 except for the bilateral rates among the European exchange rate mechanism (ERM) currencies, which are assumed to remain constant in nominal terms; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary polices in industrial countries, see Box 1); that the average price of oil will be $19.39 a barrel in 1997 and $19.03 a barrel in 1998, and remain unchanged in real terms over the medium term; and that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 5.9 percent in 1997 and 6.3 percent in 1998. 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 generally based on statistical information available at the end of August 1997.

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 (e.g., 1996–97 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (e.g., 1996/97) 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 (e.g., 25 basis points are equivalent to ¼ of 1 percentage point).

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.

Preface

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

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

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

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

Primary contributors to the current issue are Donogh McDonald, Francesco Caramazza, Staffan Gorne, Mark De Broeck, Paula De Masi, Jahangir Aziz, Kornélia Krajnyák, Ramana Ramaswamy, Phillip Swagel, Andrew Tweedie, and Cathy Wright. Other contributors include Adam Bennett, Andrew Berg, Thomas Krueger, Guy Meredith, Blair Rourke, Karen Swiderski, Christopher Towe, and Milan Zavadjil. Chapter III was written in close collaboration with the IMF's European I Department. The authors of the annexes are indicated on the first page of each. The Fiscal Analysis Division of the Fiscal Affairs Department computed the structural budget and fiscal impulse measures. Sungcha Hong Cha, Mandy Hemmati, Michelle Marquardt, and Anthony G. Turner provided research assistance. Allen Cobler, Nicholas Dopuch, Isabella Dymarskaia, Gretchen Gallik, and Yasoma Liyanarachchi processed the data and managed the computer systems. Susan Duff, Caroline Bagworth, Margaret Dapaah, and Helen Hwang were responsible for word processing. Juanita Roushdy 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 August 27 and 29, 1997. However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities.

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I

Global Economic Prospects and Policies

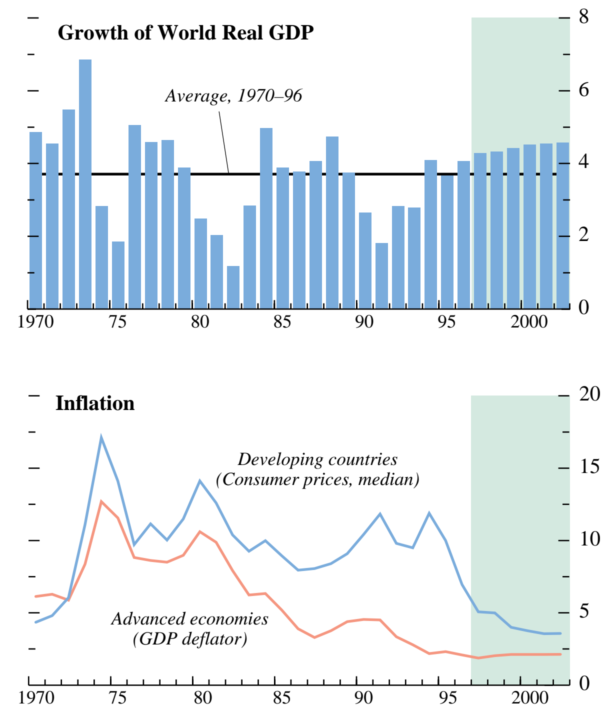
With world output expected to expand by some 4¼ percent in both 1997 and 1998, the strongest pace in a decade, the global economy is enjoying the fourth episode of relatively rapid growth since the early 1970s (Figure 1). The expansion is underpinned by continued solid growth with low inflation in the United States and the United Kingdom; a strengthening recovery in Canada; a broadening of recovery across continental western Europe, notwithstanding persistent weakness in domestic demand in some of the largest countries; robust growth trends in most of the developing world, particularly in China and much of the rest of Asia even though some countries are likely to experience a setback associated with recent turmoil in financial markets in Southeast Asia; and evidence of an end to the decline in output, and perhaps a beginning of growth, in Russia and in the transition countries as a group. It is worth recalling, however, that each of the three previous episodes of relatively rapid growth was followed by widespread slowdown and even recession in many countries. Taking account of this earlier experience, is there a danger that the present expansion may soon run out of steam and give way to a new global downturn?

Although a moderation of world growth is indeed likely to occur at some point, there are reasons to believe that the current expansion can be sustained, possibly into the next decade. First, there are relatively few signs of the tensions and imbalances that have usually presaged significant downturns in the business cycle: global inflation remains subdued and commitments to safeguard progress toward price stability are perhaps stronger than at any other time in the postwar era; fiscal imbalances are being reduced with increasing determination in many countries, which is helping to contain inflation expectations and real interest rates; and exchange rates among the major currencies, taking account of relative cyclical conditions, are generally within ranges that appear to be consistent with medium-term fundamentals. Second, cyclical divergences have remained sizable among the advanced economies, and there are still considerable margins of slack to be taken up in Japan and continental Europe. Stronger growth during the period ahead in these countries should help support global demand and activity as growth slows to a more sustainable pace in those countries that have already reached a mature stage in their expansions, especially the United States,

Figure 1. World Output and Inflation[1]

(Annual percent change)

The expansion of world output is expected to continue above trend, while inflation should remain contained.



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

the United Kingdom, and several of the smaller advanced economies. Third, the recovery that is in progress in the transition countries seems likely to continue to strengthen at the same time as the growing number of successful economies in the developing world are also providing both new markets and increased production capacities; these developments are stimulating trade and growth worldwide while helping to dampen price pressures. Taking into account the combination of the strong catch-up potential of the developing and transition countries and the beneficial effects on productivity of technological advances and increasing globalization, the sustainable rate of world output growth may now in fact be somewhat stronger than in the quarter century since the first oil shock. This view is embodied in the IMF staff's medium-term scenario, which points to a trend growth rate of world GDP of about 4½ percent between 1996 and 2002 compared with an average rate of expansion of 3¾ percent since 1970.

This generally positive assessment of the global outlook should not lead to complacency because there is a wide range of risks and fragilities that confront individual countries and may affect regional and world economic and financial conditions. The main areas of concern relating to prospects over the short to medium term include the following:

- *Risks of overheating*. Although world inflation has subsided to the lowest rates seen since the early 1960s, inflationary pressures could reemerge, especially in countries that have reached high levels of resource use. Effective policy to prevent inflation rising requires vigilance not only against overheating in product and labor markets but also in asset markets, and it requires preemptive action when warning signs appear. Problems stemming from large swings in asset prices emerged in the late 1980s and the early 1990s in a number of countries, most notably in Japan but also in Australia, Sweden, the United Kingdom, and the United States, with repercussions on the soundness of financial systems in some cases. More recently, several emerging market countries, especially in Southeast Asia, have experienced similar difficulties in their real estate sectors. Despite some correction in August, there is also reason for concern about the strength of world stock prices, which may to some extent be based on unrealistic expectations about prospects for future profit growth and low interest rates. A more substantial correction in stock prices, were it to occur, could adversely affect confidence and economic activity.

- *Uncertainties about the Economic and Monetary Union (EMU) in Europe*. The marked convergence of interest rates among the prospective members of the monetary union seems to suggest that financial markets expect the project to go ahead in accordance with the agreed timetable, which calls for the new currency, the euro, to be in place by January 1999. Investor sentiment may still change, however, if the feasibility of the timetable was perceived to be threatened. In that case, interest risk premiums might again widen for some countries, while the currencies of others might be subject to unwelcome upward pressure. Also, should growth prove insufficient to permit progress in reducing record levels of unemployment in much of Europe, confidence would remain weak; in some cases there might be a risk of resort to counterproductive fiscal policies incompatible with the requirements of EMU.

- *Sustainability of capital flows to emerging market countries*. Several factors have contributed to record capital inflows into many emerging market countries and an associated compression of yield differentials in recent years, including the trend toward a more open global financial system and the increasingly successful economic policies pursued in many recipient countries. But the availability of these flows and their costs are also influenced by global cyclical conditions and are vulnerable to higher interest rates in world financial markets as well as to perceptions that large current account deficits—the counterpart to capital inflows—may not be sustainable in all cases. The crisis in Mexico late in 1994 and more recently the financial pressures that have affected Thailand and a number of countries in Southeast Asia underscore the importance of disciplined macroeconomic policies and robust financial sectors. They also have highlighted the risk and costs of potentially disruptive changes in market sentiment, including the danger of very strong reactions in financial markets and serious spillovers to other countries when critical policy weaknesses are not addressed in a timely manner.

The rest of this chapter summarizes the IMF staff's near-term projections and policy assessments and identifies some key policy concerns that need to be addressed in order to strengthen medium-term economic prospects in all countries in accordance with the guidelines set out by the Interim Committee in its September 1996 "Declaration on Partnership for Sustainable Global Growth."[1] Other issues discussed include the prospects for EMU and its potential longer-term implications for Europe and the world economy, the critical need for labor market reforms in Europe, lessons from recent exchange market crises and the trend toward greater flexibility of exchange rate regimes in developing countries, the challenges facing monetary policy in the transition countries in

[1]See *World Economic Outlook*, October 1996, p. xii.

safeguarding progress toward macroeconomic stability, and the need for so-called second-generation reforms to sustain high quality growth in all regions.

Advanced Economies

The high degree of price stability remains an impressive achievement shared by almost all of the advanced economies. In 1996, the rate of consumer price inflation averaged 2½ percent, and only four countries experienced inflation above 5 percent; measured by GDP deflators, a broader measure of the price level, average inflation was just 2 percent. In terms of output and employment, the picture is much more mixed as underscored by sharp divergences in labor market performance in recent years. Whereas a number of economies including the United States, the United Kingdom, and several of the smaller advanced economies are operating at relatively high levels of resource use, the three major continental European countries have suffered protracted economic weakness that has been accompanied by a dramatic rise in unemployment to postwar record levels. Conditions for recovery have gradually improved, but few forecasters expect the upswing to make more than a modest dent in unemployment. In Japan, the recovery has also proven quite hesitant, as discussed below and in Chapter II in greater detail.

The unsatisfactory economic performance of the three major economies of Germany, France, and Italy cannot be blamed on the external environment. In fact, external markets have been expanding strongly and exports have been the main source of stimulus in recent years. Thus, between 1992 and 1997, the real foreign balance is estimated to have improved by 1¼ percent of GDP in Germany (most of this occurring in 1996 and 1997), 3½ percent of GDP in France, and 5½ percent of GDP in Italy. This clearly indicates that the sources of weakness have been internal, and in fact domestic demand has expanded by less than 1 percent a year in these three countries combined over the past five years.

There are at least four sets of factors that need to be considered in explaining this exceptional sluggishness.

(1) *Fiscal consolidation*. Since 1992, there has been a substantial effort in many countries to reduce fiscal imbalances that had reached unsustainable levels; although beneficial for growth in the longer run, those efforts have tended to weaken aggregate demand in the short run notwithstanding offsetting effects from lower interest rates and exchange rates. In continental Europe as a whole, however, fiscal policy (measured by changes in cyclically adjusted balances) has not been substantially tighter than in the United States or the United Kingdom. Differences in fiscal stance therefore clearly cannot by themselves explain the differences in growth performance.

(2) *Labor market rigidities*. The lack of flexibility of continental European labor markets has undoubtedly exacerbated the weakness of economic activity at the same time as product market rigidities may have impeded the private sector's adjustment to the withdrawal of fiscal stimulus. Some labor market measures, such as work sharing and early retirement, which were intended to reduce open unemployment, may actually have served to dampen growth by reducing the supply of skilled labor and increasing tax burdens and labor costs.

(3) *Confidence factors*. Although such influences are difficult to assess in isolation from other forces, delays in addressing the root causes of structural unemployment and fiscal imbalances may well have affected business confidence, while labor shedding in response to high labor costs has increased job insecurity and undermined consumer confidence. Excessive reliance on revenue increases to reduce fiscal deficits rather than reform-based reductions in expenditures may also have discouraged both investment and consumption. Recurrent uncertainties about the feasibility of the timetable for EMU have probably added to hesitation in business investment.

(4) *Monetary policy*. The progressive easing of monetary conditions in Germany and the rest of Europe during 1993 and early 1994, and generally declining risk premiums in long-term interest rates, played a significant role in the first phase of recovery in 1994. As this initial pickup failed to turn into a self-sustained expansion, owing in part to the effects of an overly strong deutsche mark in early 1995, official interest rates were reduced further during 1995 and early 1996. However, while the stance of monetary policy since the latter part of 1993 has supported demand, a somewhat faster and ultimately more pronounced easing of monetary conditions would have helped put the recovery on a stronger footing without jeopardizing price performance. The timing of such easing was constrained by the rise in long-term interest rates in 1994, but an easier monetary stance was justified subsequently by the absence of inflationary pressures, the prevalence of significant cyclical unemployment, the large withdrawals of fiscal stimulus, and depressed levels of consumer and business confidence. As of August 1997, with the further weakening of the currencies participating in the European exchange rate mechanism (ERM) vis-à-vis the U.S. dollar and the pound sterling providing additional stimulus, monetary conditions in continental Europe appear to be sufficiently supportive of the emerging recoveries.

Movements of major currency exchange rates since the spring of 1995 have corrected earlier misalignments, and the present configuration is generally helpful and appropriate in view of relative cyclical positions. Specifically, the present relatively strong values of the currencies of the United Kingdom and the United States in comparison with the currencies of Japan and continental Europe are helping to restrain

potential inflationary pressures where capacity utilization is high while providing support to recovery where slack remains considerable. Over the medium term, while some of these recent movements in exchange rates point to a potential widening of external imbalances, they can be expected to be reversed as cyclical conditions become more balanced.

Already in the seventh year of its expansion, the *United States* economy has continued to combine solid growth of output and employment with low inflation and a diminishing fiscal imbalance. These achievements are a reflection of prudent macroeconomic policies together with an exceptionally dynamic private sector and a responsive labor market. Although there has been a tendency since around 1994 for wage increases to edge up, wage pressures have been less pronounced than in preceding cycles, and a number of other factors have helped to dampen inflation. Most of these factors, however, are likely to be temporary. The Federal Reserve has tightened monetary policy moderately but the continued surge in the stock market and the strength of consumer and business confidence suggest that the risk of overheating is still present. Further monetary tightening is therefore likely to be necessary and is assumed in the projections (Box 1), which indicate a moderation of real GDP growth to 2½ percent in 1998 after 3¾ percent in 1997. Inflation is expected to change little provided growth slows to the more sustainable pace projected.

Substantial and steady reductions in the actual and structural budget deficits have been achieved between 1992 and 1996, and continued improvement in the former is expected in 1997, largely owing to higher tax revenue generated by the strong economy. The balanced-budget agreement enacted in August 1997 promises to bring overall balance in 2002. In view of longer-term fiscal pressures arising from the aging of the population, a more substantial fiscal effort will be needed to raise national saving and help to reduce the external deficit. Preliminary steps have been taken to address these problems, and prompt action to put the necessary measures in place would avoid more draconian measures in the future and spread the burden more equitably across generations. Another important policy challenge facing the United States is to sustain a higher growth rate of income for those whose living standards have stagnated or declined in the past two decades. This will require a strengthening of investment in education and training.

In *Canada*, the recovery has gained momentum since mid-1996, spurred by strengthened confidence, marked declines in both short-term and long-term interest rates, and improved external competitiveness following the depreciation of the Canadian dollar during the early 1990s. The fall in interest rates bottomed out late last year, reflecting the improved confidence in the recovery, and in late June official rates were increased modestly. Providing a strong stimulus to business and residential investment, the decline in interest rates in recent years has been made possible by an impressive improvement in fiscal performance, and a high degree of price stability well within the inflation target range of 1 to 3 percent. Unemployment has fallen from around 10 percent in late 1996 to 9 percent in July 1997. With still some slack in the labor market, there is continued scope for solid growth with little risk of higher inflation. As the labor market tightens, however, monetary policy will need to move gradually toward a firmer stance. The recent agreement on pension reform should help safeguard the strengthened fiscal outlook over the medium to longer run.

In *Japan*, the recovery strengthened in late 1996 and early 1997 due to a pickup in domestic demand, and net exports also began to recover reflecting a lagged response to the correction of the yen from its excessively appreciated level in early 1995. Subsequently, however, economic activity fell sharply in the second quarter following the increase in the consumption tax on April 1. Although a rebound in output can be expected in the second half of the year, growth for 1997 as a whole is now estimated at 1 to 1¼ percent, substantially weaker than projected in the May 1997 *World Economic Outlook*. Should growth fail to pick up in the second half of 1997 some fiscal measures will need to be considered to help underpin the recovery. In 1998, with a slower pace of fiscal consolidation, growth is expected to accelerate to some 2 to 2¼ percent, although repercussions of the recent financial crises in Southeast Asia constitute a continued downside risk. Given the absence of underlying inflationary pressures and uncertainties regarding the effects of the recent tax increases, official interest rates are not expected to be raised until recovery is firmly established. The exchange rate remains broadly consistent with current fundamentals including Japan's relatively weak cyclical position. As the recovery proceeds, the yen can be expected to strengthen—as is indicated by interest differentials in favor of assets denominated in other currencies; this will help contain the widening of the external surplus that is projected on the assumption of unchanged real exchange rates (Box 2).

The authorities recently have adopted a medium-term fiscal consolidation plan that includes a commitment to reduce the general government deficit, excluding social security, to not more than 3 percent of GDP by FY 2003 (compared with a deficit of over 7 percent of GDP in 1996). In addition to the need to restore a sustainable fiscal position notwithstanding pressures from a rapidly aging population, Japan faces major challenges in the area of structural policies. Despite some reforms, nontradable sectors have remained overregulated, are subject to a low degree of competition, and are relatively inefficient. The government is strongly committed to building on the growing consensus for reform and has announced important steps to reform Japan's financial system—the

"big bang"; new reform proposals have also been put forward for transportation, telecommunications, and power generation. Steps taken in some other areas remain more tentative, however. Greater efforts are clearly needed to enhance the efficiency of the nontraded goods and services sectors as the economy continues to mature and the importance of the industrial sector diminishes, as in other advanced economies.

In *Germany* and *France*, growth appears to be picking up after a disappointing performance in 1995 and 1996. Exports are providing much of the strength, with domestic demand so far remaining relatively weak. Construction is especially depressed in both countries. While the business climate has improved, consumer confidence has remained low due to various factors, including record unemployment, continued fiscal restraint, and job insecurity linked in part to significant restructuring needs. However, the stimulus from exports and a supportive stance of monetary policy suggest that the recovery should gradually gain momentum and contribute to a strengthening of confidence. The current projections indicate that the 3 percent Maastricht deficit targets may be exceeded by small margins in 1997 in both countries. Significant reform-based consolidation efforts are needed to firmly keep the fiscal deficits on a decreasing path in 1998 and beyond. Moreover, fundamental labor market reforms (discussed below) remain essential to restore satisfactory economic performances. In France, however, plans for public sector job creation and other labor market proposals may complicate fiscal consolidation efforts and hamper economic growth.

Interest rates were appropriately lowered in both Germany and France during 1995–96 to support economic activity, and the effective depreciation of the deutsche mark and the franc since mid-1995 has also helped to ease monetary conditions (broadly defined to include the exchange rate). The accommodative monetary stance has clearly not undermined the credibility of monetary discipline: inflationary pressures remain virtually absent and long-term interest rates have fallen significantly below those in the United States after being above them through most of 1995 and in early 1996. Under present circumstances, a tightening of monetary conditions should be avoided until a robust recovery is firmly established.

Economic activity in *Italy* has been particularly subdued owing to the necessary efforts to restore balance in public finances, with private sector confidence and behavior also being affected by the awareness that permanent measures will be needed in 1998 to replace the one-off measures introduced in 1997. Output increased by only ¾ of 1 percent in 1996, and growth is likely to remain modest in 1997, even though recent indicators point to a pickup in the course of the year. The fiscal consolidation efforts, if sustained by means of an early agreement on structural cost savings on pension and welfare spending, will substantially enhance Italy's medium-term economic and financial outlook. Reflecting Italy's determination to qualify for participation in EMU, the fiscal deficit is expected to be reduced from 6¾ percent of GDP in 1996 to close to the Maastricht reference value in 1997, while inflation is projected to decline to 1¾ percent. In this context, the long-term interest rate differential vis-à-vis Germany has narrowed sharply during the past year. Official interest rates have also been eased progressively and there should be scope for further easing as fiscal consolidation proceeds.

In contrast to the difficulties that have characterized the major continental European economies in recent years, the *United Kingdom*'s economic expansion has permitted a progressive narrowing of the output gap and significant reductions in unemployment since 1993. Growth is expected to be stronger in 1997 than in 1996, with buoyant domestic demand more than offsetting the effects of the appreciation of sterling. The welcome decision to grant the Bank of England operational independence in monetary policy to meet the inflation target—now set by the Chancellor of the Exchequer at 2½ percent—had a clear impact on the authorities' anti-inflation credentials as indicated by an immediate narrowing of long-term interest rate differentials vis-à-vis Germany from about 180 to about 140 basis points. With the increases in short-term interest rates since May, and the strong appreciation of the exchange rate, monetary conditions have tightened significantly. The fiscal deficit has been reduced in recent years from the unsustainable levels reached in 1992–94. The July budget accelerated the pace of fiscal consolidation, with the deficit set to decline by a further 4 percentage points of GDP over this year and next. Policies thus appear well geared to alleviate inflationary pressures but will need to pay close attention to signs of excessive strength in domestic demand.

With a few exceptions, the smaller and medium-sized advanced economies are also enjoying relatively solid economic growth with moderate inflation. *Ireland* continues to grow at more than double the pace of the rest of Europe, and *Denmark,* the *Netherlands*, and *Norway* have also reached mature stages of their expansions with high levels of resource use; in all four cases, because of exchange rate constraints, fiscal policy will need to bear the brunt of the policy tightenings that are warranted to reduce the risk of overheating. *Finland*'s and *Sweden*'s strong fiscal consolidation efforts have been rewarded by improvements in confidence and their recoveries are expected to continue during the period ahead. *Spain* and *Portugal* have also witnessed marked improvements in economic and financial conditions and a pickup in growth, which should facilitate the achievement of fiscal deficit targets. *Austria*, *Belgium*, and especially *Switzerland* continue to lag in the cycle and their expected recoveries will remain sensitive to economic conditions in Germany and France.

Box 1. Policy Assumptions Underlying the Projections

Fiscal policy assumptions for the short term are based on official budgets adjusted for any deviations in outturns as estimated by IMF staff and also for differences in economic assumptions between IMF staff and national authorities. The assumptions for the medium term take into account future policy measures that are judged likely to be implemented. Both short-term and medium-term projections are generally based on information available through August 1997. In cases where future budget intentions have not been announced with sufficient specificity to permit a judgment about the feasibility of their implementation, an unchanged structural primary balance is assumed, unless otherwise indicated. For selected advanced economies, the specific assumptions adopted are as follows (see Tables 3, 11, and A14–A16 in the Statistical Appendix for the projected implications of these assumptions).

United States: The fiscal projections through 2002/03 are based on revised U.S. Congressional Budget Office (CBO) budget estimates released in early September, which are adjusted for differences in the IMF staff's forecasts for key U.S. economic variables and the forecast underlying the CBO estimates. These projections assume that the terms of the Balanced Budget and Taxpayer Relief Acts of 1997 enacted in August 1997 are implemented as envisaged. New caps established for discretionary spending (defense and nondefense spending that must be appropriated by Congress annually) would reduce such expenditure by a total of about $90 billion over the next five fiscal years. Mandatory spending (i.e., expenditures that are required under current law and are not part of the annual appropriations process) would be reduced by nearly $110 billion over the next five years, largely reflecting cuts in Medicare and in Medicaid. The Taxpayer Relief Act also provides for net tax cuts totaling $80 billion over five years. As a result of the measures enacted, the budget is now expected to be in surplus by $40 billion (0.4 percent of GDP) in 2002/03.

Japan: The projections take account of the 1997 budget and existing plans with regard to spending in the 1998/99 budget and 1999/2000 investment spending. No further consolidation measures are assumed, and general government investment is assumed to rise by 5 percent a year after 1999/2000. As a result, public investment is projected to total ¥530 trillion between 1995/96 and 2004/05, compared with ¥630 trillion assumed in the medium-term public investment plan currently being reconsidered. While the cabinet has approved medium-term fiscal consolidation targets for the general government balance (excluding social security), these targets have not been incorporated into legislation, as the government has not detailed the policies by which such targets will be attained.

Germany: The fiscal projections for 1997 take into account the federal government's consolidation package; the supplementary federal budget, which includes a spending freeze and additional privatizations; the 1997 Tax Act; and the July projections of the Financial Planning Council for the deficits of lower levels of government. The fiscal data and projections incorporate the intended exclusion of public hospitals from the general government sector (in accordance with EUROSTAT rules), which reduces the general government deficit by 0.2 percentage point of GDP from 1996 onward. The difference with the official deficit projection of 3.0 percent of GDP in 1997 is due to a slightly weaker macroeconomic environment. For 1998, the projections incorporate federal draft budget and official tax estimates, adjusted for the IMF staff's macroeconomic projections; for the medium term, the projections assume an unchanged structural primary balance.

France: The projection for 1997 takes account of measures announced through August and of revised projections for taxes and public expenditure in 1997. The projection for 1998 entails a decline in the ratio of revenue to GDP, essentially equivalent to the adjustment made for the one-off transfer from France Télécom received in 1997. On the spending side, it reflects the impact of expenditure decisions made in August 1997 that seek to hold constant in the 1998 budget real outlays of the state; but it does not take into account new measures that the authorities may implement to reduce social security expenditure. Beyond 1998, the ratio of revenue to GDP is assumed to be constant. Wages in the public sector are projected to grow at the same pace as in the private sector, with personnel constant. The assumed growth of social security spending is determined by present entitlements; and other primary expenditure in the public sector is assumed to increase at about the same rate in real terms as potential output.

Italy: The projections take into account measures included in the 1997 budget and the corrective package of March 1997. For 1998–2000, the projections are based on IMF staff estimates for the "current services" budget (*tendenziale*), corrected for the measures announced in the three-year plan for those years. It is assumed that the plan's measures are fully implemented and yield the officially estimated amounts. Projections beyond 2000 assume an unchanged structural balance.

United Kingdom: The budgeted spending ceilings for 1997–98 and 1998–99 are assumed to be observed. Thereafter, noncyclical spending is assumed to grow in line with potential GDP. For revenues, the projections incorporate, for 1997–98 and 1998–99, the announced commitment to raise excise taxes on tobacco and road fuels each year in real terms; thereafter, real tax rates are assumed to remain constant.

Canada: Federal government outlays for departmental spending and business subsidies are assumed to conform to the commitments announced in the February 1997 budget, with the exception that the medium-term floor for transfers to the provinces under the Canada Health and Social Transfer program would be raised beginning in 1997/98. Other outlays and revenues are assumed to evolve in line with the IMF staff's macroeconomic projections. The projections include contingency reserves of $3 billion for 1997/98 and 1998/99, and assume a reduction of 10 cents in the employment insurance premium in 1998 and a reduction of 5 cents in each year thereafter. The fiscal situation of the provinces is assumed to be consistent with their stated medium-term targets.

Australia: Projections are based on the Commonwealth government's 1997–98 budget, adjusted for differences between the economic projections of the IMF staff and the authorities. Unchanged policies are assumed for the state and local government sector from 1997.

Belgium: The 1997 projections are based on the 1997 budget, on developments since the budget in the public finances and in interest rates, and on the IMF staff's macroeconomic projections. For 1998, an allowance is made for some slippage in social security expenditure, which is only partially offset by lower interest payments and a narrowing of the output gap. Beyond 1998, the structural primary balance is assumed unchanged.

Greece: Projections for 1997 reflect the IMF staff's assessment of the outcome of the official budget. Measures to meet the targets of the convergence plan are still being defined in the 1998 budget under preparation, and the projections at this stage are based on IMF staff's estimates on a current services basis.

Israel: The fiscal assumptions are in line with the government's medium-term fiscal plan, which establishes annual targets for the central government budget deficits until 2001.

Korea: Projections for 1997–2002 assume that the central and general government budgets will be broadly in balance.

Netherlands: The 1997 projections are based on implementation of the 1997 budget, and the IMF staff's macroeconomic projections. The 1998 projections reflect existing expenditure policies and take into account announced tax cuts. Beyond 1998, the primary structural balance strengthens slightly, reflecting the continuation of current expenditure policies.

Portugal: The 1997 projections are based on policies adopted through late July 1997, and include a number of unbudgeted items, notably a capital transfer from Banco Nacional Ultramarino (BNU) and overruns in health spending. For 1998, the projections assume a decline in total revenues as a share of GDP due to the nonrecurrent nature of the BNU transfer and a declining yield of the tax arrears recovery plan. Expenditure projections are based on unchanged policies. For 1999 and beyond, an unchanged structural primary balance is assumed.

Spain: Fiscal projections for 1997 assume that the budget is implemented as passed by parliament but allow for differences in macroeconomic assumptions and some expenditure overruns that are partially offset by lower interest payments. For 1998 and beyond, it is assumed that there is no major change in tax policy, that the wage freeze ends, that public sector wages grow at roughly the rate of increase of wages in the private sector, and that goods and services purchases remain constant as a share of GDP.

Sweden: The projections are based on the authorities' fiscal objectives set out in the 1997 Spring Budget Bill, which includes a balanced budget in 1998 and an average surplus of 2 percent of GDP over the cycle starting in 2001.

Switzerland: The projections for 1997–2000 are in line with official current service estimates. Beyond 2000, the general government's structural primary balance is assumed to remain unchanged.

* * *

Monetary policy assumptions are based on the established framework for monetary policy in each country. In most cases this implies a nonaccommodative stance over the business cycle, so that official interest rates will firm when economic indicators suggest that inflation will rise above its acceptable rate or range, and ease when indicators suggest that prospective inflation will not exceed the acceptable rate or range, that prospective output growth is below its potential rate, and that the margin of slack in the economy is significant. It is assumed that Economic and Monetary Union in Europe will be implemented from the start of 1999, in accordance with the agreed timetable. Until then, for the exchange rate mechanism (ERM) countries of the EU, which use monetary policy to adhere to exchange rate anchors, official interest rates are assumed to move in line with those in Germany, except that progress with fiscal consolidation may influence interest differentials relative to Germany. On this basis, it is assumed that the London interbank offered rate (LIBOR) on six-month U.S. dollar deposits will average 5.9 percent in 1997 and 6.3 percent in 1998; on six-month Japanese yen deposits will average 0.7 percent in 1997 and 1.2 percent in 1998; and on six-month deutsche mark deposits, 3.3 percent in 1997 and 4.0 percent in 1998. Changes in interest rate assumptions compared with the May 1997 *World Economic Outlook* are summarized in Table 1.

Box 2. Alternative Exchange Rate Assumptions for Japan

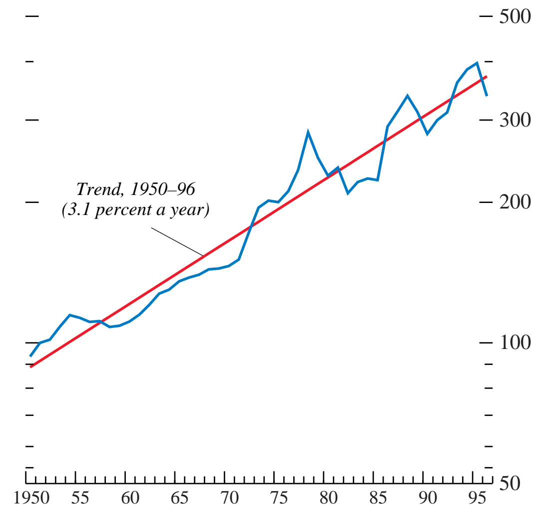
The *World Economic Outlook* projections are based, among other things, on the assumption that real effective exchange rates remain constant at the values observed in a recent historical "reference period." For the current *World Economic Outlook*, for instance, exchange rates are set at their average levels during July 18–August 14, 1997. This convention avoids the need to make judgmental projections of exchange rates, which would be particularly problematic given the need to maintain consistency across countries in the *World Economic Outlook*'s assumptions for external variables. At the same time, however, it may be inconsistent with market expectations of future exchange rate movements, and also lead to tensions among various elements of the IMF staff's forecast.

These issues are particularly relevant for Japan. Although it is difficult to directly measure longer-term market expectations, interest rates on yen assets are currently well below those on assets denominated in other major currencies. As well as reflecting lower inflation expectations for Japan, this interest differential is, in part, attributable to Japan's weak cyclical position relative to major trading partners, especially the United States. Given a high degree of international asset substitutability, and the likely course of inflation rates, the interest differential can be interpreted as reflecting market expectations of real yen appreciation over the medium term. In the event, recent interest differentials imply an expected appreciation of almost 3 percent a year in real effective terms.[1] It is interesting to note that this is similar to the trend real appreciation of the yen over a long historical period *(see first figure)*.

Regarding tensions in the projections, the assumption of a constant real exchange rate assumes away an important channel of macroeconomic adjustment. In particular, the projection for the external balance should be consistent both with the relationships determining trade flows and those determining the domestic saving-investment balance. Over the medium term, as the economy returns to potential output, movements in the exchange rate would normally play a key role in bringing the trade balance into line with the underlying saving-investment balance. In the assumed absence of such movements, tensions may exist between the projection for the trade balance and those for saving and investment. Tensions of this type are evident for Japan. Specifically, the assumption of an unchanged real exchange rate leads to a gradual rise in the external surplus over the medium term to about 2½ percent of GDP. In contrast, the structural determinants of saving and investment—and especially the shift toward a more elderly population—point to a gradual decline in Japan's underlying saving-investment balance and a corresponding reduction in the external surplus. This inconsistency raises the question of what will happen to reduce the external surplus, raise domes-

Japan: Real Effective Exchange Rate

(Based on consumer price indices, 1951 = 100)



[1]The nominal interest differential on five-year government bonds between other major industrial countries (weighted-average basis) and Japan stood at about 4¼ percent in mid-1997, while medium-term "consensus" forecasts by the private sector indicated a gap in projected inflation rates of about 1½ percent. The expected real appreciation is taken as the difference between these two numbers.

Outside Europe, in *Australia* and *New Zealand* growth moderated during 1996 due in part to preemptive monetary tightening; as inflation risks have abated, monetary conditions have eased and growth is expected to accelerate in the period ahead. Relatively large external deficits point to the need for prudent fiscal policies over the medium term in both countries. In *Israel*, growth is expected to slow in 1997 and there remains a need for greater fiscal discipline to support anti-inflationary monetary policy. Among the newly industrialized economies in Asia, *Hong Kong, China*'s economic performance remains impressive as the changeover to Chinese sovereignty has proceeded smoothly; the authorities plan to increase land supply to alleviate pressures in the real estate sector.[2] *Taiwan Province of China* is also enjoying continued rapid growth and modest inflation. In *Singapore*, a modera-

[2]In view of Hong Kong's return to the People's Republic of China on July 1, 1997 as a Special Administrative Region of China, references to this economy appear in the current *World Economic Outlook* as "Hong Kong, China."

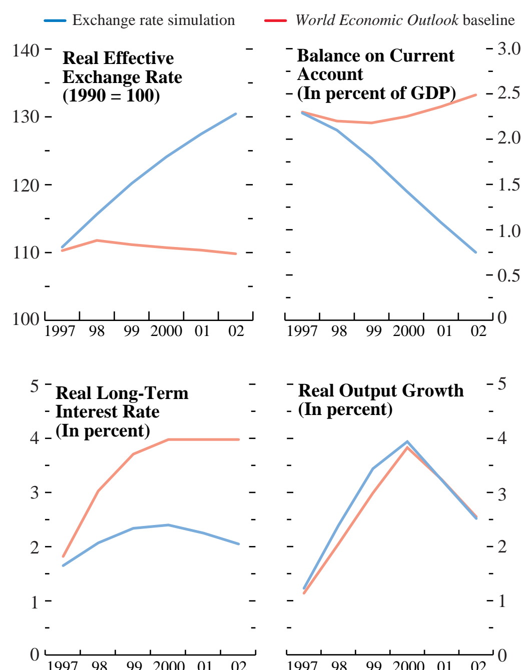
tic saving, or lower domestic investment in the period ahead.

To examine the implications of an alternative exchange rate path for the projection for Japan, a simulation was performed using the Japanese block of the IMF's multi-country simulation model, MULTIMOD. The simulation was constructed such that the path for the yen was fully consistent with projected interest rate differentials—in other words, in each future period, the yen appreciates in line with the differential between interest rates in partner countries and Japan.[2] This assumes that returns on assets denominated in yen and in other currencies are equalized: asset holders do not require a "risk premium" to hold one currency rather than another.

The *second figure* compares the results of this alternative scenario with the baseline projection. In the alternative scenario, the real effective value of the yen rises steadily to stand about 17 percent above baseline by 2002, implying an average rate of appreciation of just over 3 percent a year—similar to the market-based real interest differential discussed above. The current account surplus falls from about 2 percent of GDP in 1998 to less than 1 percent of GDP by 2002, as opposed to rising in the baseline. Offsetting the effect on aggregate demand of the higher real exchange rate, the real long-term interest rate in Japan stabilizes at around 2 percent, compared with the gradual increase to 4 percent in the baseline. Indeed, the near-term effects on demand of lower real interest rates dominate those of the higher exchange rate, and output grows somewhat more quickly in the alternative scenario during the first few years of the simulation. Output growth in both scenarios converges over time as the economy returns to potential.[3]

These results illustrate the sensitivity of some key elements of the projection for Japan—most notably for the external balance—to alternative exchange rate assumptions. Of course, this analysis is subject to a number of caveats. Shifts in Japan's trade behavior in recent years and the prospect of structural changes in the economy over the medium term may make past trends in the exchange rate an unreliable guide to the future. In addition, real interest differentials have often not provided an accurate forecast of subsequent developments in exchange rates, raising the question of whether they provide a suitable proxy for market expectations. Nevertheless, the results underscore the need to view the medium-term *World Economic Outlook* baseline as a conditional projection, as opposed to an unconstrained, fully consistent forecast for all macroeconomic variables.

Japan: *World Economic Outlook* Baseline and MULTIMOD Simulation Results



[2]Foreign interest rates were held exogenous in the simulation, while domestic interest rates reflected the assumed response of the monetary authorities to developments in activity and prices.

[3]The *level* of potential output is somewhat higher in the alternative scenario, however, as lower real interest rates crowd in domestic investment, raising potential GDP.

tion of growth in 1996 has helped alleviate inflation risks and exports have picked up after last year's slowdown. In *Korea*, economic growth is expected to slow somewhat further in the near term partly as a result of uncertainties stemming from weaknesses in the corporate and financial sectors.

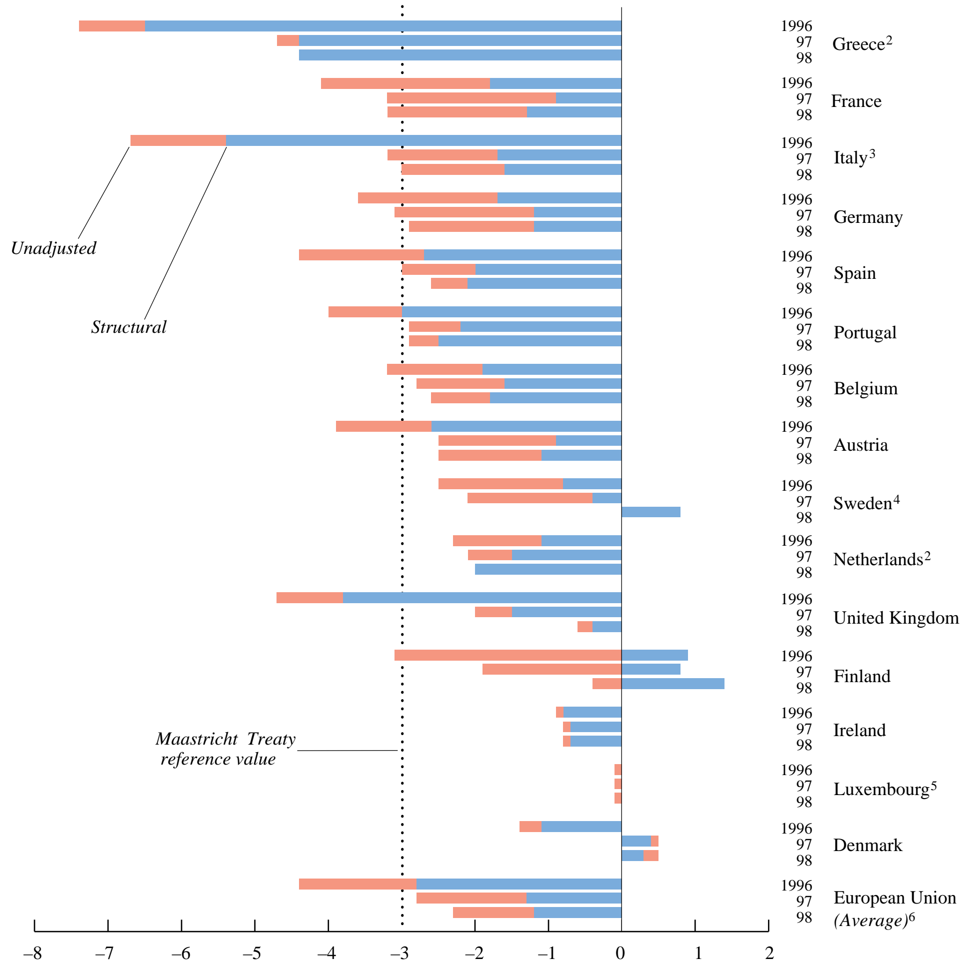
EMU and the World Economy

In the spring of 1998, the member countries of the European Union (EU) will decide on the initial group of participants in the planned euro area. The establishment of EMU will be a milestone in the 40-year-long quest to strengthen economic and monetary integration in Europe. It will also constitute the largest change to the international monetary system since the breakup of the Bretton Woods par value system, with the emergence of a new international currency whose role may eventually match that of the U.S. dollar as a means of payment and as an international reserve asset. And it promises to promote a more stable financial climate in Europe.

Figure 2. European Union: General Government Budget Positions[1]

(In percent of GDP)

Expected progress toward reducing underlying budgetary imbalances is masked to some extent by large cyclical components in fiscal deficits.



[1]The detailed assumptions underlying the fiscal projections are set out in Box 1. The ordering of countries is based on the projected unadjusted budget positions for 1997, except that where the differences between projections are not significant the ordering is alphabetical.

[2]The unadjusted budget positions for 1998 are not shown separately for Greece and the Netherlands because their structural balances exceed the unadjusted balances.

[3]The projection for 1998 incorporates the recently announced three-year fiscal plan. It does not take into account any possible effects of the announced review of pension and welfare spending.

[4]The unadjusted budget position is projected to be in approximate balance in 1998.

[5]Structural budget positions are unavailable and unadjusted budget positions are expected to be in approximate balance in 1996–98.

[6]Excludes Luxembourg.

For Europe, it is to be hoped that EMU will herald a new era of stronger economic growth. A common currency shared by a majority of EU member countries, and potentially by all of them, would lower transaction costs and generally promote economic integration, generating long-term efficiency gains. In addition, the commitment to price stability and prudent fiscal policies underpinning the euro promises to produce lower real interest rates, on average, than have been observed in the past couple of decades; and the elimination of the exchange risk premiums associated with multiple EU currencies will also tend to lower real interest rates and promote investment.

Conditions for participation in EMU, as set out in the Maastricht Treaty, emphasize the need for a high degree of convergence of key economic and financial variables. Compliance with the inflation and interest rate criteria now appears to have been achieved by all those EU members that plan to participate initially. This has also fostered a high degree of stability within the exchange rate mechanism of the European Monetary System. Progress in meeting the fiscal criterion is more difficult to assess. Without additional measures, it seems likely that a number of candidates for membership, including France and Germany, may not strictly satisfy the 3 percent fiscal deficit target in 1997, partly owing to relatively large margins of economic slack, which have raised public expenditures and reduced tax revenues.

On a cyclically adjusted (or structural) basis, however, the IMF staff's estimates suggest that the deficits of all EU members aspiring to join EMU from the start will be within about 2 percent of GDP in 1997 (Figure 2). This clearly suggests that underlying fiscal positions have converged considerably and that fiscal imbalances pose less of a risk to macroeconomic and financial stability than might be inferred from the unadjusted deficits provided the excesses of the actual deficits over the reference value are indeed small, as expected. What is important at this stage is a clear commitment of those countries to go significantly further in their fiscal consolidation efforts in 1998 and beyond with greater emphasis on fundamental reforms. It should be the objective relatively soon to bring underlying budgetary positions broadly into balance in accordance with the objectives of the Stability and Growth Pact.

As a politically independent institution with a strong mandate for price stability as its primary objective, the European Central Bank (ECB) will clearly be well positioned to demonstrate through actual performance the dedication to economic stability that the participants in the monetary union desire and expect. A low-inflation environment will give the credibility needed to allow it to help stabilize output without jeopardizing inflation performance. The choice of an operational target for monetary policy needs to take into account the structural changes that are likely to take place in financial markets with the introduction of a common currency. In these circumstances, since it will be difficult to rely solely on a monetary target, an inflation target approach may be helpful by providing an anchor for price expectations and a yardstick for performance. The exchange rate of the euro will probably also help guide monetary policy even though exchange rate considerations naturally will be given a relatively small weight in the conduct of monetary policy in such a large currency area. In fact, the ECB, like other major central banks, will presumably use a wide range of indicators in assessing the appropriate settings of its policy instruments.

The rest of the world has a strong interest in a successful EMU and a solid euro. A successful EMU should lessen fears of globalization and the risk of a protectionist backlash to Europe's unemployment problem. It is likely to make Europe a better place to do business and to invest than has been the case in recent years. This in turn should boost the demand for euros and promote the new currency's success as an international transaction currency. How strong and stable the euro becomes will depend on many factors, in addition to the credibility and consistency of policies in the monetary union. There will naturally be a need to accept a reasonable degree of variability in the exchange value of the euro to reflect divergences in cyclical conditions across the major currency areas. The effectiveness of policy coordination with other major countries is also likely to influence the variability of the exchange rate. Ultimately, it is important that the value of the euro properly reflect the economic fundamentals of the participating countries. The anti-inflation mandate of the ECB and the prudent fiscal rule embodied in the Stability and Growth Pact suggest that the euro will have the key attributes of a strong reserve currency.

Enhancing Labor Market Flexibility in Europe

A particularly critical factor for the success of EMU, in addition to sound financial policies, will be the extent to which governments succeed in improving Europe's labor market performance. Comprehensive reforms to reduce structural unemployment would not only help boost medium-term growth and improve fiscal performance but would also help Europe adjust faster, and with less unemployment, to adverse economic disturbances, including those with asymmetric effects across countries. Conversely, a failure to implement such reforms could well result in further increases in unemployment, which ultimately could undermine public support for the project.

While macroeconomic policies affect labor market conditions in the short run, there is substantial evidence that by far the most important reason for continental Europe's lack of economic dynamism and persistent unemployment is the slow pace of structural

reform. In fact, in addition to a sizable cyclical component in total unemployment (which may also in part reflect the slow adjustment of the labor market), most of the continental European countries suffer from very high structural unemployment rates that may be on the order of 8 to 9 percent of the labor force in the three largest countries. International comparisons suggest that this is 3 to 3½ percentage points more than might be attributed to normal frictions and mismatches in the labor market. There is wide agreement on the root causes of this "excess" structural unemployment problem: the adverse (and unintended) consequences of elaborate job and income-protection arrangements that raise the cost of labor (including through high taxes needed to finance social safety nets), discourage job creation and job search, and favor substitution of capital for labor. Product market distortions also appear to have contributed by distorting relative prices, reducing efficiency, and impeding competition. In contrast, the forces of globalization and increased trade with low-wage countries seem to have played only a minor role as discussed in the May 1997 *World Economic Outlook*. There is also a wide measure of agreement on the potentially substantial benefits of reforms that would reduce the generosity of income replacement schemes, permit a lowering of taxes on labor (especially for the unskilled), alleviate the cost of redundancies (and thereby lessen an important obstacle to hirings), and generally make labor and product markets more responsive to market forces.

A wide variety of reforms have been implemented across Europe in recent years, but many have been postponed and some measures may in fact have exacerbated structural problems in labor markets.[3] A common problem has been the failure to implement sufficiently comprehensive labor market reforms because of strong opposition from *insiders*—those who have jobs and feel they benefit, rather than suffer, from existing labor (and product) market institutions and regulations. In fact, labor market policies have often sought to mask the underlying problems by promoting early retirement or work sharing. Such measures appear to be intended to reduce open unemployment not by increasing the demand for labor but by reducing labor supply. But with unreformed labor markets, such measures tend to improve the bargaining position of insiders and raise their real wages, with little benefit to outsiders who are likely to remain unemployed. Such measures also involve costs to producers or to government budgets. Instead, what is needed are reforms that give outsiders a better chance to compete for jobs, thereby raising the effective supply of labor, and that also increase labor demand. In addition to reducing unemployment on a durable basis, such reforms would have important positive effects on growth and public finances. They would in fact allow most of the remaining fiscal imbalances in Europe to be worked off through reduced costs of income support for the unemployed as well as higher tax revenues associated with rising employment and higher levels of national income. Failure to implement reforms that reduce structural unemployment would require much tighter fiscal policies over the medium term, reduce the scope for tax reduction and productive public expenditure, and in all likelihood permit only modest growth of output and real incomes—that is, a continuation of recent experience.

Despite the strong case for comprehensive product and labor market reform, and the promising examples of several countries that have been quite successful in enhancing the flexibility of their economies, including New Zealand, the United Kingdom, Denmark, and the Netherlands, most continental European countries continue to face major hurdles in their efforts to tackle these problems. In particular, the gradual approach favored by many governments often leaves particular groups with the impression that they are being unfairly targeted to give up their *acquis sociaux*. As such groups frequently succeed in winning general public sympathy for their cause, many selective reform measures have failed to gain sufficient political and public support. And even when selective reforms are adopted, the benefits are often insignificant because of lack of progress in other areas. This experience increasingly points to the need for governments to build a broad consensus for comprehensive reforms based on the fact that the economy and society as a whole will benefit from higher employment and lower tax burdens. To achieve such a consensus, governments need to enhance the public's understanding of the causes and costs of unemployment, the social costs of the protection of the interests of insiders, and the benefits of reform. This may not be easy, but the piecemeal approach is clearly not working.

Another problem for policymakers is the misperception that labor market reforms may conflict with Europe's traditional objectives of equity and solidarity, a view that is nourished by often-exaggerated claims that more flexible labor markets (as in the United States, the United Kingdom, and New Zealand) may entail a widening of the income distribution. There is growing evidence, however, that the observed tendency for wage differentials to widen in some countries reflects the effects of technological advances that particularly enhance job and income opportunities for skilled labor. This suggests that equity concerns can best be addressed through education and training that increase the adaptability of the labor force to changing circumstances. It is also appropriate to pursue policies whereby those who benefit the most from technological progress and the increasing division of

[3]Progress with labor market reform and country-specific additional reform needs are assessed in OECD, *Implementing the OECD Jobs Strategy—Lessons from Member Countries' Experience* (Paris, 1997).

labor among countries contribute to the assistance of those less well positioned. Indeed, as the example of the Netherlands demonstrates, there does not need to be a conflict between labor market flexibility and social cohesion. But in designing such policies it is important to avoid creating poverty traps while promoting incentives to enhance skills and to pursue better employment opportunities. In any case, enhancing the functioning of labor markets is the most effective way to alleviate the problem of persistent unemployment, which is a principal cause of inequality and social exclusion.

Developing Countries

Real GDP growth in the developing countries is expected to remain relatively buoyant at slightly over 6 percent in 1997 and similar growth is projected for 1998. While the rapid expansion in the Asian region is projected to moderate somewhat further, many countries in other regions that saw a marked strengthening of activity in 1996 are expected to sustain this improvement in the period ahead. In most developing countries, low or declining inflation and generally prudent fiscal policies suggest that threats to growth arising from policy imbalances have been significantly reduced. However, in a number of cases, large external imbalances and fragile banking systems have emerged and have affected investor confidence. These problems typically underscore both the presence of downside risks to the near-term growth outlook and the desirability of some cooling off of domestic demand pressures as well as the need for financial sector reforms. Provided macroeconomic stability is not jeopardized and the necessary reforms are implemented without undue delay, such short-term difficulties should not significantly affect the generally positive long-term prospects of these countries.

In the Western Hemisphere, both *Argentina* and *Mexico* have continued to recover following the 1995 crisis, and growth is expected to remain fairly strong during the period ahead. While Argentina is enjoying virtual price stability, Mexico's inflation rate will need to be reduced further through the pursuit of prudent fiscal and monetary policies; the adoption of additional structural reforms to foster saving and investment would also help ensure the sustainability of the expansion. *Venezuela* has also experienced a welcome turnaround following a drop in output in 1996 but inflation remains stubbornly high and the authorities will need to press on with continued reforms to strengthen performance of the non-oil sector.

In *Brazil*, inflation has continued to abate and is expected to fall below 8 percent in 1997, but the external deficit has been rising. A further tightening of the fiscal stance is needed to better balance the policy mix, reduce interest rates, and maintain market confidence. In *Chile*, growth and inflation have slowed somewhat as a result of measures to address the risk of overheating; healthy fundamentals point to continued medium-term growth in the range of 6 to 7 percent. While Chile's economy remains the strongest among the developing countries of the Western Hemisphere, there are encouraging signs that improved macroeconomic discipline and intensified structural reform efforts are improving the growth outlook for other countries in the region.

In Asia, despite the region's impressive growth performance in recent years, several countries have recently experienced financial market pressures linked to concerns about large external deficits; in many cases, currencies linked to the appreciating U.S. dollar have aggravated the tensions. The pressures have been most acute in *Thailand*, where fragilities in the banking system contributed to market concerns. After a series of attacks on the baht, a more flexible exchange rate regime was introduced in early July and there has since been a depreciation of over 30 percent vis-à-vis the U.S. dollar. Provided adequate measures are adopted to strengthen the financial sector and the balance of payments, confidence should be restored relatively quickly. Growth in Thailand is likely to slow significantly in the short run but should subsequently return to its quite strong longer-term trend. Spillovers from the crisis in Thailand were felt by several countries in the region, especially the *Philippines, Indonesia*, and *Malaysia*. In these countries, which are also likely to experience an economic slowdown in the near term, the authorities will need to contain external deficits and reduce the reliance on foreign borrowing in order to restore investor confidence. Following a fairly widespread slowdown in foreign demand in 1995–96, most of these economies have experienced a pickup in exports in the first half of 1997, in line with the general strengthening of world industrial activity and trade that began in the middle of 1996.

The soft landing of *China*'s economy has succeeded in alleviating inflationary pressures: consumer price inflation is expected to moderate to 4½ percent in 1997, a striking contrast with the 22 percent inflation rate registered in 1994. At the same time, growth has been maintained at over 9 percent, which seems to be close to China's potential growth rate. However, sustaining such rapid growth with low inflation will require restructuring and efficiency improvements in state enterprises (including through diversifying ownership), financial sector reforms, and a strengthening of budget revenues. The strong balance of payments position provides an opportunity to accelerate trade liberalization, which is also critical for China's longer-run growth prospects. Annex I discusses longer-term trends and policy challenges in China in greater detail.

Relatively solid growth is also projected to continue in *India* even though the pace of catch-up with advanced economy living standards remains substan-

tially slower than in China and below what India should be able to achieve. The reform process under way since 1992 has already produced notable results, raising annual growth to about 7 percent since 1994 compared with about 5 percent through the 1980s and early 1990s. But stronger efforts are needed to reduce the large fiscal deficit, which remains a risk factor for inflation and a constraint on growth. Further trade and capital account liberalization, deregulation of domestic product markets, and enterprise and financial sector reform are also needed to put India on a steeper sustainable growth path. In *Pakistan*, following severe balance of payments difficulties in late 1996, there is a continued need for strong stabilization measures to accompany the recent introduction of wide-ranging structural reforms.

Developing countries in the Middle East and Europe region have witnessed significant improvements in economic performance in recent years and average growth is expected to continue in the 4 to 5 percent range in 1997–98 despite a slight decline in oil prices. In *Egypt*, efforts to reduce inflation and strengthen the fiscal position together with extensive structural reforms have noticeably enhanced growth performance and the outlook. *Jordan* continues to reap the benefits of comprehensive policy reforms as underscored by robust economic growth, low inflation, and declining internal and external imbalances. Growth prospects have also improved for the *Islamic Republic of Iran*, assuming that broad-based structural reforms are introduced. Growth in *Turkey* has been stronger than expected but the persistence of large fiscal imbalances and very high inflation is unlikely to be compatible with sustained growth.

For Africa, the overall growth estimate for 1997 has been revised down to 3¾ percent compared with 4½ percent in the May 1997 *World Economic Outlook*. The downward revision appears disappointing following the relatively encouraging outcome for 1996. However, this result is strongly influenced by developments such as drought in *Morocco* and civil war and political turmoil in the *Democratic Republic of the Congo* and the *Republic of the Congo*. Elsewhere in Africa, many countries continue to benefit from the implementation of stronger macroeconomic and structural policies. For example, CFA franc zone countries such as *Côte d'Ivoire*, *Mali*, and *Senegal* are seeing continued recovery following the exchange rate adjustment in 1994 and accompanying policies. *Botswana, Malawi,* and *Uganda* are also enjoying robust growth as a result of market-oriented reforms and greater macroeconomic discipline, together with improved weather. *South Africa*'s growth has not yet responded to the authorities' policy reforms, and activity is expected to slow somewhat in 1997. However, with continued reform efforts, and the return of investor confidence, the outlook has begun to improve. *Nigeria*'s economic performance remains disappointing and the outlook uncertain due to persistent weaknesses in macroeconomic and structural policies. In *Algeria* and *Tunisia*, significant progress with privatization and structural reforms is expected to support continued growth at around 5 percent. Overall, while the fragility of Africa's recovery is highlighted by recent setbacks and political uncertainties, there are also a significant number of relatively successful economies that illustrate the region's potential for reversing the long-run decline in living standards during much of the past quarter century. In 1998, growth in Africa is projected to recover to about 5 percent.

Globalization of Financial Markets and Recent Exchange Market Turmoil in Asia

The weight of developing countries in the global economy is increasing rapidly (Figure 3). At the same time their growing integration into world financial markets poses significant challenges. Capital inflows, particularly of foreign direct investment, can substantially enhance countries' growth performance. However, there is also a risk that large capital inflows may become a substitute for domestic saving, contribute to overheating, result in excessive current account deficits, and strain the capacity of inadequately developed financial systems and the supervisory framework. While rapidly growing economies can often sustain relatively large external deficits for a period when the associated capital inflows are invested productively, experience shows that persistently large deficits are likely sooner or later to result in highly disruptive changes in market sentiment. Previous *World Economic Outlook* reports have discussed extensively the policy requirements for minimizing such risks, notably the frequent need to strengthen fiscal policy (even though the fiscal situation may be sound), and the need for prudential rules that limit the banking system's exposure to domestic loan problems and to foreign exchange and liquidity risks.[4] In addition, a gradual introduction of capital account convertibility would allow domestic investors greater opportunities to diversify their portfolios and help alleviate potential pressures on domestic asset prices.

The serious consequences of a significant shift in market sentiment have been underscored by the financial crises that have engulfed much of Southeast Asia in recent months. A number of factors explain the

[4]The need for an international banking standard applicable to both advanced and emerging market countries, particularly for internationally active financial institutions, has received considerable attention since the Mexican crisis in 1994–95. Substantial progress has now been made in formulating such a standard, which would include the "Core Principles for Effective Banking Supervision" recently put forward by the Basle Committee on Banking Supervision. See also David Folkerts-Landau and Carl-Johan Lindgren, *Toward a Framework for Financial Stability* (Washington: IMF, forthcoming).

emergence of speculative pressures in Thailand. The combination of a rising real effective exchange rate and a large current account deficit heightened the perceived risk of a crisis and prompted concerns about international competitiveness. Moreover, heavy reliance on external borrowing (denominated in foreign currency) increased the economy's exposure to exchange rate risk and perceived vulnerability to a sudden reversal of capital inflows. Also, and perhaps most important, there were serious fragilities in the financial sector (especially among Thai finance companies), linked in part to previous rapid growth in property-based lending, unhedged corporate foreign-currency indebtedness, and the economic slowdown. Finally, as these problems became more apparent and more widely perceived in financial markets, and as the need for decisive corrective action accordingly became more pressing, the initial response of the authorities did not allay growing concerns in financial markets. The result is a crisis that is deeper and more widespread than would likely have occurred if adequately forceful action had been taken at an earlier date. Indeed, the problem of confidence linked to much of the decline in Thailand's official reserves and the incurring of large volumes of forward contracts in foreign exchange probably could have been avoided or significantly alleviated if the present stabilization program had been put in place this spring.

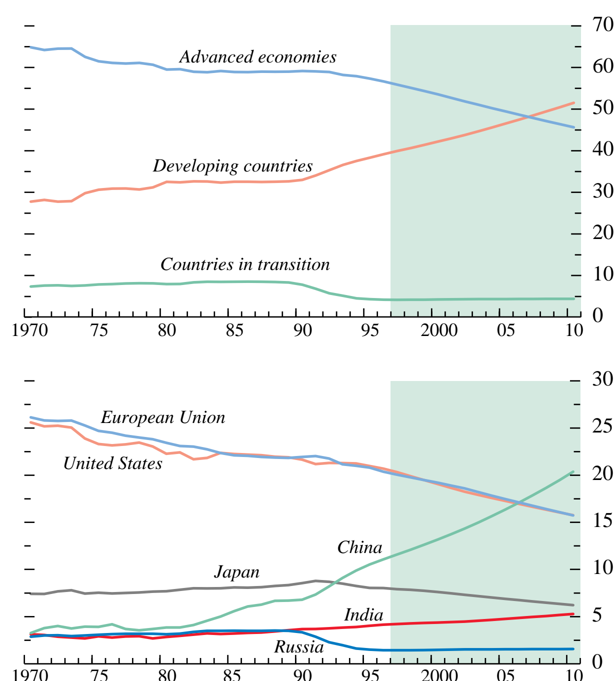
On the other hand, it does appear that private financial markets may have a tendency to react too late to prevent a costly adjustment, and then to overreact, when a country is beset by problems that turn into a foreign exchange crisis and related economic difficulties and when the full extent of these problems becomes apparent. In the case of Mexico, for example, the private market continued to channel large inflows of capital well into 1994 and then, following the December 1994 devaluation of the peso, underwent a collapse of confidence that led to massive nominal and real depreciation and very high levels of domestic interest rates. Concerns about the Mexican authorities' ability to implement a strong adjustment program, as well as the incomplete provision of data prior to the crisis, contributed to this adverse result. However, two and a half years later, it seems clear that the collapse of market confidence in Mexico was overdone. Unfortunately, the Mexican economy has probably suffered a more painful correction than was truly needed on the basis of an objective assessment of its economic situation and capacity for successful policy adjustment. Spillover effects to other economies in the region in 1995 also now appear to have been overdone. The international community was surely right to signal forcefully its support for Mexico's stabilization efforts and thereby to help to avoid larger unnecessary losses for Mexico and for other countries.

Similarly in the case of Thailand, now that the Thai authorities have committed themselves to a strong ad-

Figure 3. Changing Relative Positions in the World Economy[1]

(Shares of world output)

Rapid growth in the developing countries is projected to steadily raise their share of world GDP. China alone, provided the recent growth trend can be sustained, may match the shares of the United States and the European Union in about a decade.



Note: Aggregates are computed using weights based on purchasing power parity in accordance with standard practice in the *World Economic Outlook* (see Statistical Appendix). Projections to 2010 are based on extrapolations of the IMF staff's medium-term baseline projections shown in Statistical Appendix Table A45.

[1]Shaded areas indicate IMF staff projections.

justment program, the international community has provided its substantial endorsement. Adjustment is needed and is under way, and although economic difficulties will continue in the months immediately ahead there should be confidence that Thailand will gradually return to its characteristically strong economic performance.

A key lesson from these episodes is that even if markets on occasion may appear to overreact, at least when viewed with hindsight, investors may well be acting in a prudent manner, particularly when governments initially ignore the signals that markets provide. Indeed, markets clearly have a useful role to play in alerting governments to the need for timely action, and their strong reaction may be necessary to focus the attention of policymakers on the need for corrective measures. This further underscores the need for policy discipline to avoid adverse and costly market reactions.

As in the case of Mexico, developments subsequent to the recent floating of the Thai baht demonstrated the tendency for a crisis in one country to have spillover effects on other countries where similar risk factors are perceived by financial markets as being present. But while there are some parallels between Thailand and other east Asian countries, there are also some important differences. In particular, the economic fundamentals in Indonesia, Malaysia, and the Philippines were generally stronger than those in Thailand at the time of the crisis. While the Thai devaluation would imply a worsening of the competitive position of some of its neighbors, in terms of economic fundamentals, the extent of spillover effects would appear to be excessive even though policymakers need to make sure that economic weaknesses and fragilities are not left unaddressed. Overall, there are reasons to believe that the currency turbulence will eventually wane without greatly damaging the region's long-term prospects.

Recent events have also focused attention on the role of the exchange rate regime in developing countries. Since the 1970s, there has been a gradual but significant shift toward more flexible exchange rate arrangements. In a few cases, the authorities have opted for even greater fixity of their exchange rates than under the Bretton Woods regime of fixed but adjustable parities through the adoption of currency boards (as in Argentina and Hong Kong, China). More generally, countries have tended to move away from the pegs they originally adopted after the industrial countries switched to floating rates in the early 1970s, and have instead introduced arrangements that allow more frequent adjustments, such as exchange rate bands (with crawling central rates), managed floats, or floating exchange rates. In virtually all of those cases, however, the exchange rate appropriately remains a key concern of economic policy, with policy adjustments often being undertaken to limit exchange rate volatility.

Contrary to what might have been feared, the switch to more flexible exchange rate arrangements has not in general been associated with higher inflation. Although fixing the exchange rate to hard currency pegs (or a currency board) has often been an essential element in disinflation strategies, once the domestic sources of inflation—typically lax fiscal and monetary policies—have been brought under control, increased flexibility in exchange rate management appears in practice not to weaken macroeconomic policy discipline and may well be more helpful in the face of external shocks that require domestic policy adjustments. Indeed, while there are many examples of pegged exchange rate regimes functioning reasonably well for extended periods, there are also numerous examples of pegged exchange rates being adjusted too late in the face of capital inflows that ultimately proved destabilizing. Greater willingness to let the exchange rate move in response to changing circumstances may also help convey a more realistic perception of risk to both domestic and foreign investors. Nevertheless, despite the potential advantages of more flexible exchange rate regimes in dealing with balance of payments pressures, such regimes pose other challenges, especially the need to limit excessive exchange rate volatility.

Transition Countries

There are increasingly encouraging signs that the process of transition is working. Those countries such as *Poland*, the *Baltic countries*, the *Czech* and *Slovak Republics*, *Hungary*, and *Slovenia*, which have pursued comprehensive stabilization and reform policies, are experiencing relatively solid growth, moderate inflation, and good progress in their reintegration into the world economic and financial system. While growth may slow in the short run in the Czech and Slovak Republics as a result of recent exchange market pressures, the setback is expected to be temporary provided the needed policy adjustments are adopted. There are also indications that activity has bottomed out and may have begun to pick up in *Russia*, where the official statistics may still not fully capture the many new activities and enterprises that are emerging. Elsewhere in the region, progress is still mixed. In *Ukraine*, in particular, macroeconomic stability is a relatively recent achievement and lack of structural reforms continues to hamper growth. Other countries in the region that have maintained tight financial policies and proceeded with structural reform, including *Armenia, Azerbaijan, Georgia*, *Kazakhstan,* and the *Kyrgyz Republic*, are now benefiting from sustained growth and further declines in inflation. Despite slow progress in some cases, 1997 seems likely to be the first year for the transition countries overall to register positive growth.

It is clear, however, that many challenges remain to be addressed to safeguard and further extend the progress that has been achieved. In many of the less advanced transition countries, there remains a need to establish the institutions of a market economy, which are still rudimentary. Moreover, financial systems are generally underdeveloped and plagued by nonperforming loans, restructuring of former state-owned enterprises has not gone very far, and governments are often unable to honor obligations for lack of tax revenues. Appropriate reforms to deal with these problems remain essential for the transition to succeed.

In addition to fiscal and structural policy requirements, the transition countries generally face substantial challenges in the area of monetary policy. Although progress toward stabilization following the initial period of high inflation has been significant, macroeconomic stability is still fragile and can easily be reversed, as demonstrated by the recent financial crises in *Albania*, *Bulgaria,* and *Romania*. Further progress is also needed to put in place the framework of instruments and institutions through which monetary policy can be operated in a market economy. And monetary authorities will need to contain the potential inflationary risks associated with both actual fiscal deficits and quasi-fiscal imbalances in the form of budget arrears. A key priority is to foster the establishment of sound market-based banking systems. Fragile banking systems pose significant inflation risks to the extent that the government may feel obliged to bail out insolvent financial institutions; however, the banking systems in most transition economies are still so small that the fiscal costs of dealing with potential banking sector problems are likely to be smaller as a share of GDP than they have been in several recent banking crises in developing countries.

Economic policies in the most advanced transition countries are beginning to face additional challenges as part of a process that began with large capital inflows in the wake of the launching of adjustment and reform programs. While longer-term capital inflows are attracted by the strong growth prospects of the recipient countries, relatively high interest rates and perceptions that there might be potential for currency appreciation also seem to have played a role in attracting shorter-term financial investments. As witnessed in many developing countries, however, large-scale capital inflows are costly to sterilize and are typically associated with widening external imbalances, which eventually risk provoking sudden reversals of the short-term inflows. While both fiscal and monetary policies need to take into account the dangers from excessive external imbalances, there may also be a need in some countries to allow for greater flexibility in the exchange rate regime to help reduce the risk of speculative pressures. A key issue in this context is the timing of such a change. Also, such a shift in exchange rate regime needs to be supported by continued macroeconomic discipline. The adoption of a fixed exchange rate in the form of a currency board arrangement in Bulgaria reflected the need for a strong anchor for price expectations to help stabilize the economy and restore confidence under circumstances in which a more flexible exchange rate arrangement would not have been credible.

* * *

The robust growth trends in the developing world and increasingly also in many of the transition countries can be attributed to the success of a growing number of economies in establishing and maintaining macroeconomic stability and in pursuing outward-oriented, market-based reforms that are enabling them to integrate rapidly into the global economic and financial system. For those developing countries in the Western Hemisphere, the Middle East, the Indian subcontinent, and Africa where living standards have been growing only modestly, and where recent improvements in growth performance may still be fragile, there is considerable urgency in the need to introduce more comprehensive economic strategies aimed at addressing key policy weaknesses. This also applies to those countries in transition that continue to lag behind in the transformation process. Without more comprehensive strategies, the benefits of globalization are likely to be much smaller and the risk of marginalization from the mainstream of global economic progress greater.

While macroeconomic stability, trade liberalization, and the creation of the basic institutional framework of a market economy are essential for stronger growth, and often sufficient to enhance economic performance significantly for a time, broader-based reforms are necessary to sustain and enhance countries' longer-run growth performance and ensure that the benefits of reform are more widely shared. Such "second-generation" reform requirements, which also apply in many instances to the advanced economies, include the need to accelerate social progress and invest in human capital by increasing the quality of public expenditures; strengthen the efficiency and robustness of the financial sector, including through appropriate prudential oversight; reform and eventually privatize state-owned enterprises and generally reduce government intervention in the economy in areas where market forces provide for greater efficiency; address corruption and improve governance; and enhance the transparency of government budgets, and generally strengthen the quality and timeliness of economic data to help reduce the risk of disruptive changes in investor confidence when economic or financial problems eventually appear.