



II

Issues in the Current Conjuncture

Prospects for the global economy as a whole are little changed from the May 1997 *World Economic Outlook* (Table 1). World output growth is projected to edge up to 4¼ percent this year and in 1998, slightly slower than projected in May but still the fastest expansion in a decade. Inflation is again projected to remain subdued in the advanced economies, at average rates of 2–2¼ percent, and to decline further in the developing countries and the countries in transition. World trade volume is projected to expand by 7¾ percent in 1997 and 6¾ percent in 1998, rates that are somewhat faster than those in 1996 but below the exceptionally rapid growth rates of 1994–95.

The slight downward revision in projected global growth masks a number of significant changes in the IMF staff's projections for individual countries and country groups that are largely offsetting. The projections for growth in the group of advanced economies as a whole are in fact virtually unchanged, while there are more significant downward revisions for both the developing countries and the countries in transition.

In the *advanced economies*, the largest change has been the downward revision to growth in Japan by about 1 percentage point in both 1997 and 1998. In the United States and to a lesser extent in Canada, growth projections have been upgraded. Projected growth in the EU as a whole is virtually unchanged, although within the EU the growth outlook has deteriorated slightly in Germany and France while improving in some of the smaller economies (Table 2). For the newly industrialized countries of Asia, projected growth also remains broadly unchanged despite downward revisions to projections in some cases.

Recent developments have widened further the cyclical divergences among the major industrial countries, and these divergences are projected to narrow to only a limited extent over the next year or two (Figure 4). The United States and the United Kingdom, the major industrial countries closest to full capacity utilization, have continued to see buoyant growth in 1997. In the United States, growth in the first half of the year was about 4½ percent at an annual rate, far exceeding the economy's potential growth rate of about 2¼ percent. Unemployment fell below 5 percent during the second quarter, but even though most estimates of the nonaccelerating inflation rate of unem-

ployment (NAIRU) are around or above 5½ percent, there have been few signs of higher inflation (see below). The U.S. expansion has moderated somewhat since the first quarter, and growth is expected to be close to potential in the remainder of 1997 and 1998, reflecting a slowdown in both consumer spending and business investment, partly in response to some assumed further tightening of monetary conditions in the second half of the year. (The Federal Reserve has held the federal funds rate at 5½ percent since late March.) With the structural budget balance roughly unchanged during 1996–98, fiscal policy will have little effect on overall demand (Table 3). The United Kingdom also experienced continued above-potential growth (3¾ percent annualized) in the first half of 1997, but the expansion there also is projected to slow to more sustainable rates, owing to the strength of sterling, increases in short-term interest rates, and continuing significant fiscal consolidation. The recovery in Canada continues to gather strength with domestic demand expanding at a fairly robust pace. Unemployment fell to 9 percent during the second quarter, the lowest level since 1990.

In contrast, in Japan, following a strengthening of the recovery in late 1996 and early 1997, activity declined sharply in the second quarter partly owing to the unwinding of the first quarter surge in consumption, which had occurred in anticipation of the April increase in the consumption tax. The Japanese recovery is discussed in detail below.

Growth in the major economies of continental Europe in 1997 as a whole is projected to be below potential, as in 1996. There have, however, been a number of signs of more satisfactory growth emerging, and output in both Germany and France is projected to rise by 2¾ percent in 1998—growth that would narrow output gaps, though only modestly, for the first time since 1994. With unemployment having recently risen to postwar peaks in both countries, a dent in cyclical unemployment is badly needed; but structural reforms will also be needed to reduce joblessness toward more tolerable levels (see below). Among the factors stimulating recovery in continental Europe, perhaps the most important has been the easing of monetary conditions since early 1995, which has stemmed partly from further reductions in official interest rates, and partly from the depreciation in foreign exchange markets of the deutsche mark and the currencies closely

Table 1. Overview of the World Economic Outlook Projections*(Annual percent change unless otherwise noted)*

	1995	1996	Current Projections		Differences from May 1997 Projections	
			1997	1998	1997	1998
World output	3.7	4.1	4.2	4.3	-0.1	-0.2
Advanced economies	2.5	2.7	3.0	2.9	0.1	—
Major industrial countries	2.0	2.4	2.8	2.5	0.2	-0.1
United States	2.0	2.8	3.7	2.6	0.7	0.4
Japan	1.4	3.5	1.1	2.1	-1.1	-0.9
Germany	1.9	1.4	2.3	2.8	—	-0.2
France	2.1	1.5	2.2	2.8	-0.2	-0.2
Italy	2.9	0.7	1.2	2.1	0.2	-0.3
United Kingdom	2.7	2.3	3.3	2.6	—	-0.2
Canada	2.3	1.5	3.7	3.5	0.3	0.1
Other advanced economies	4.2	3.7	3.9	4.2	0.1	0.1
<i>Memorandum</i>						
Industrial countries	2.1	2.4	2.8	2.6	0.2	—
European Union	2.5	1.7	2.5	2.8	0.1	-0.1
Newly industrialized Asian economies	7.4	6.4	5.9	6.0	0.2	-0.1
Developing countries	6.0	6.5	6.2	6.2	-0.4	-0.3
Africa	2.8	5.2	3.7	5.0	-0.9	0.2
Asia	8.9	8.2	7.6	7.4	-0.6	-0.3
Middle East and Europe	3.5	4.8	4.6	4.2	0.7	0.3
Western Hemisphere	1.3	3.4	4.1	4.4	-0.3	-0.7
Countries in transition	-0.8	0.1	1.8	4.1	-1.2	-0.6
Central and eastern Europe	1.6	1.5	2.1	3.6	-0.9	-1.1
Excluding Belarus and Ukraine	5.0	3.3	2.8	3.9	-0.6	-0.8
Russia, Transcaucasus, and central Asia	-3.9	-1.9	1.5	4.9	-1.5	—
World trade volume (goods and services)	9.5	6.3	7.7	6.8	0.4	—
Imports						
Advanced economies	8.9	6.1	7.1	6.4	1.2	0.3
Developing countries	11.4	8.7	8.4	7.8	-2.4	-0.7
Countries in transition	17.0	6.7	9.5	8.5	-0.3	1.7
Exports						
Advanced economies	8.8	5.5	8.2	6.6	1.3	-0.1
Developing countries	10.5	8.6	7.5	7.0	-3.5	-0.9
Countries in transition	14.9	4.3	5.3	7.1	-1.6	0.1
Commodity prices						
Oil ¹						
(In SDRs)	1.9	24.3	0.3	-0.8	-1.1	5.5
(In U.S. dollars)	8.0	18.9	-5.1	-1.8	-1.5	4.9
Nonfuel ²						
(In SDRs)	2.1	3.1	2.8	-1.6	-2.4	-1.6
(In U.S. dollars)	8.2	-1.3	-2.7	-2.5	-2.7	-2.2
Consumer prices						
Advanced economies	2.5	2.4	2.2	2.3	-0.3	-0.2
Developing countries	22.7	13.2	10.0	8.9	0.3	0.4
Countries in transition	119.2	40.4	32.3	14.1	1.6	2.6
Six-month LIBOR (in percent)³						
On U.S. dollar deposits	6.1	5.6	5.9	6.3	-0.1	0.2
On Japanese yen deposits	1.3	0.7	0.7	1.1	-0.3	-1.6
On deutsche mark deposits	4.6	3.3	3.3	4.0	—	0.2

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during July 18–August 14, 1997, except for the bilateral rates among ERM currencies, which are assumed to remain constant in nominal terms.

¹Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil. The average price of oil in U.S. dollars a barrel was \$20.42 in 1996; the assumed price is \$19.39 in 1997 and \$19.03 in 1998.

²Average, based on world commodity export weights.

³London interbank offered rate.

Table 2. Advanced Economies: Real GDP, Consumer Prices, and Unemployment Rates*(Annual percent change and percent of labor force)*

	Real GDP				Consumer Prices				Unemployment Rates			
	1995	1996	1997	1998	1995	1996	1997	1998	1995	1996	1997	1998
Advanced economies	2.5	2.7	3.0	2.9	2.5	2.4	2.2	2.3	7.3	7.3	7.1	6.9
Major industrial countries	2.0	2.4	2.8	2.5	2.3	2.2	2.1	2.1	6.9	6.9	6.7	6.7
United States	2.0	2.8	3.7	2.6	2.8	2.9	2.4	2.8	5.6	5.4	5.1	5.3
Japan	1.4	3.5	1.1	2.1	-0.1	0.1	1.6	0.7	3.1	3.3	3.4	3.2
Germany	1.9	1.4	2.3	2.8	1.8	1.5	1.9	2.3	9.4	10.3	11.3	11.2
France	2.1	1.5	2.2	2.8	1.8	2.0	1.1	1.3	11.6	12.4	12.6	12.3
Italy	2.9	0.7	1.2	2.1	5.2	3.9	1.8	2.1	12.0	12.1	12.2	11.9
United Kingdom ¹	2.7	2.3	3.3	2.6	2.8	2.9	2.6	2.7	8.2	7.5	5.8	5.0
Canada	2.3	1.5	3.7	3.5	2.2	1.7	1.5	1.6	9.5	9.7	9.2	8.7
Other advanced economies	4.2	3.7	3.9	4.2	3.7	3.3	2.7	2.8	8.6	8.5	8.2	7.8
Spain	2.8	2.2	3.1	3.4	4.7	3.5	2.0	2.2	22.9	22.2	20.8	19.9
Netherlands	2.1	2.8	3.3	3.7	2.0	2.1	2.3	2.3	8.3	7.6	6.8	5.9
Belgium	2.1	1.5	2.2	2.6	1.5	2.1	1.6	1.9	12.9	12.6	12.8	12.6
Sweden	3.6	1.1	2.1	3.0	2.8	0.8	1.0	2.0	7.7	8.0	8.5	7.7
Austria	1.8	1.0	1.7	2.7	2.2	1.9	1.5	1.6	6.6	7.0	7.1	6.9
Denmark	2.6	2.7	3.0	2.7	2.0	2.2	2.5	2.6	10.1	8.7	7.8	7.7
Finland	5.1	3.3	4.7	3.5	1.0	0.6	1.3	2.3	17.2	16.3	14.8	13.9
Greece	2.0	2.6	3.5	3.5	8.9	8.2	5.7	4.7	10.0	10.0	9.6	9.2
Portugal	2.3	3.3	3.3	3.5	4.1	3.1	2.2	2.3	7.2	7.3	6.8	6.6
Ireland	10.4	7.7	7.3	5.8	2.5	1.6	1.7	2.1	12.2	11.2	10.3	10.3
Luxembourg	3.5	3.7	3.7	3.5	1.9	1.8	2.0	2.0	3.0	3.3	3.5	3.6
Switzerland	0.1	-0.7	0.7	2.0	1.8	0.8	0.7	1.0	4.2	4.7	5.5	5.5
Norway	3.6	5.3	3.8	3.2	2.5	1.3	2.5	2.5	4.9	4.8	4.0	3.8
Israel	7.1	4.4	3.1	4.2	10.0	11.3	8.1	7.0	7.0	6.7	7.3	7.0
Iceland	1.2	5.7	4.0	4.0	1.7	2.3	2.5	3.5	5.0	4.4	3.6	3.1
Korea	8.9	7.1	6.0	6.0	4.5	4.9	4.2	3.7	2.0	2.0	2.5	2.2
Australia ²	3.2	3.9	3.2	4.0	2.7	2.7	1.7	2.1	8.5	8.6	8.6	8.3
Taiwan Province of China	6.0	5.7	6.2	6.4	3.7	3.1	2.8	3.4	1.7	2.5	2.5	2.4
Hong Kong, China	4.5	4.9	5.3	5.0	8.7	6.0	7.1	6.5	3.2	2.8	2.6	2.5
Singapore	8.8	7.0	6.0	5.5	1.7	1.4	2.2	2.0	2.7	3.0	3.0	3.0
New Zealand ²	3.5	2.7	1.2	3.9	2.4	2.3	1.4	1.3	6.3	6.1	6.8	6.5
<i>Memorandum</i>												
European Union	2.5	1.7	2.5	2.8	2.9	2.5	1.9	2.2	11.2	11.4	11.1	10.7

¹Consumer prices are based on the retail price index excluding mortgage interest.²Consumer prices excluding interest rate components; for Australia also excluding other volatile items.

linked to it in the ERM (Figures 5 and 6). The expansionary influence of greater monetary accommodation and improved international competitiveness has been most evident in the performance of net exports. This has helped to offset the effects of continued budgetary consolidation aimed at the Maastricht targets and weakness in both consumer spending and business investment, which may partly reflect the adverse effects on confidence of uncertainties about employment prospects, fiscal adjustment, and economic policies generally. Consumer confidence has picked up somewhat since early 1996 in France and Germany, but remains weak, in marked contrast to the United States (Figure 7).

In the smaller economies of western Europe, growth performance has been generally better than in the largest continental European countries, with short-term prospects having improved in a number of cases,

including the Netherlands, Portugal, most of the Scandinavian countries, and Spain, reflecting easier monetary conditions and a strengthening of confidence. Ireland is projected to remain the fastest-growing advanced economy in Europe, although its expansion is projected to moderate next year to slightly below 6 percent. However, Austria, Belgium, and especially Switzerland continue to lag in the cycle. Unemployment in the EU as a whole is projected to decline to just below 11 percent next year from 11½ percent in 1996, with jobless levels remaining close to postwar peaks in Germany and France.

The broadly unchanged growth projections for the newly industrialized economies of Asia reflect the offsetting effects of the predominantly temporary nature of last year's export slowdown in that region—discussed in the May 1997 *World Economic Outlook*—and the downward revisions to growth as-

sociated with the recent turbulence in Asian currency markets.

For the *developing countries* as a whole, downward revisions to the projections in the May 1997 *World Economic Outlook* have left prospective growth in 1997 and 1998 above 6 percent, close to the rates at which growth has been running in most years since 1992, and clearly above the growth performance of the 1980s and early 1990s (Table 4). The downward revisions to growth projections for 1997 are largest in the case of Africa, but are quite widely spread except in the Middle East and Europe region. For 1998, the reductions in projected growth mainly concern Asia and Latin America.

In Africa, growth is now projected to weaken to below 4 percent in 1997 before recovering to 5 percent in 1998. A major factor underlying the temporary setback this year is severe drought in much of North Africa, which is now expected to cause activity in Morocco to decline by 1 percent; output in Algeria and Tunisia is also adversely affected. Growth projections for Nigeria have also been revised down, reflecting a slower-than-expected recovery in industrial output, while in South Africa, efforts to stabilize the economy and various structural weaknesses continue to constrain the pace of growth. In sub-Saharan Africa excluding Nigeria and South Africa, growth is expected to remain in the 5–5½ percent range. The growth outlook for Kenya now seems somewhat less favorable, given political uncertainties, a significant slowing of the reform effort, and adverse effects on private sector confidence. In a number of other African countries, however, including Côte d'Ivoire, other countries in the CFA franc zone, Ethiopia, and Uganda, performance and prospects have remained quite favorable.

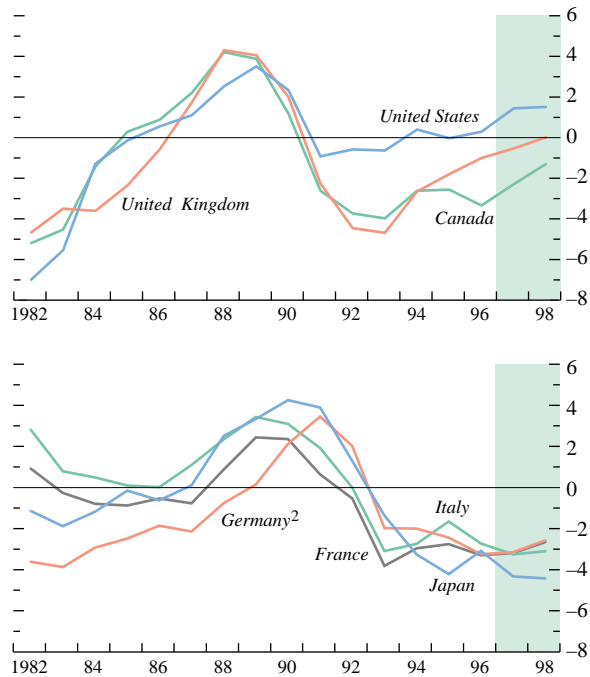
In the developing countries of the Western Hemisphere, the recovery of growth is still projected to continue in 1997 and 1998, but at a more gradual pace than envisioned in the May 1997 *World Economic Outlook*. The main downward revisions have been to the projections for Brazil and Colombia. For both countries, less sanguine assumptions have been made about fiscal adjustment. The revised projections for Brazil assume that higher real interest rates will be needed to rein in strong domestic demand. In Colombia, a slowdown in construction and manufacturing activity and political uncertainty have weakened growth. By contrast, projected growth in Argentina in 1997 has been revised up by 2½ percentage points to 7½ percent, reflecting continuing progress with reforms, the environment of stable prices, and associated gains in private sector confidence. The growth outlook for Mexico and Venezuela is broadly unchanged.

Asia is projected to remain the fastest growing region in the developing world, and even with the downward revisions to growth projections for 1997 and

Figure 4. Major Industrial Countries: Output Gaps¹

(Actual less potential, as a percent of potential)

Recently, greater differences have emerged in the relative cyclical positions of the major industrial countries.



¹Shaded areas indicate IMF staff projections. The gap estimates are subject to a significant margin of uncertainty. For a discussion of approaches to calculating potential output, see Paula De Masi, "IMF Estimates of Potential Output," *Staff Studies for the World Economic Outlook* (IMF, forthcoming).

²Data through 1991 apply to west Germany only.

Table 3. Major Industrial Countries: General Government Fiscal Balances and Debt¹*(In percent of GDP)*

	1980-90	1991	1992	1993	1994	1995	1996	1997	1998	2000	2002
Major industrial countries											
Actual balance	-2.9	-2.7	-3.8	-4.3	-3.5	-3.4	-2.9	-1.6	-1.3	-0.8	-0.5
Output gap	-0.2	0.6	-0.3	-1.8	-1.3	-1.6	-1.4	-0.9	-0.6	-0.2	—
Structural balance	-2.8	-3.1	-3.5	-3.3	-2.7	-2.6	-2.1	-0.9	-0.8	-0.6	-0.5
United States											
Actual balance	-2.6	-3.3	-4.4	-3.6	-2.3	-1.9	-1.1	-0.3	-0.3	—	0.6
Output gap	-0.8	-0.9	-0.6	-0.6	0.4	-0.1	0.2	1.4	1.5	0.8	—
Structural balance	-2.3	-3.0	-4.1	-3.3	-2.3	-1.9	-1.1	-0.8	-0.8	-0.3	0.6
Net debt	35.4	46.7	50.0	52.0	52.7	53.7	53.7	51.7	50.1	46.7	42.7
Gross debt	49.4	62.1	64.6	66.4	65.7	65.9	66.0	64.4	62.4	58.3	53.2
Japan											
Actual balance	-1.1	2.9	1.5	-1.6	-2.3	-3.7	-4.4	-2.7	-2.3	-1.9	-2.6
Output gap	0.3	3.9	1.3	-1.4	-3.3	-4.2	-3.1	-4.3	-4.4	-2.0	-0.1
Structural balance	-1.2	1.5	1.0	-1.1	-1.1	-2.0	-3.2	-1.0	-0.5	-1.1	-2.6
Net debt	20.9	4.8	4.2	5.2	8.0	11.8	15.9	18.2	20.2	22.8	26.1
Gross debt	66.5	66.7	70.0	75.1	82.4	90.1	95.6	100.4	104.6	109.3	114.7
<i>Memorandum</i>											
Actual balance excluding social security	-4.0	-0.8	-2.0	-4.8	-5.1	-6.5	-7.2	-5.3	-4.8	-4.8	-5.2
Structural balance excluding social security	-4.1	-2.0	-2.4	-4.3	-4.0	-5.1	-6.1	-3.9	-3.3	-4.2	-5.2
Germany²											
Actual balance	-2.1	-3.3	-2.8	-3.5	-2.4	-3.5	-3.6	-3.1	-2.9	-2.1	-1.5
Output gap	-1.3	3.4	2.0	-2.0	-2.0	-2.4	-3.2	-3.1	-2.6	-1.0	-0.1
Structural balance	-1.5	-5.4	-4.0	-2.5	-1.3	-2.2	-1.7	-1.2	-1.2	-1.4	-1.4
Net debt	21.0	21.4	27.7	35.4	40.7	49.1	51.9	53.4	53.9	54.3	53.7
Gross debt	40.1	41.1	44.1	48.2	50.4	58.1	60.7	62.2	62.7	63.1	62.5
France											
Actual balance	-2.0	-2.0	-3.8	-5.6	-5.6	-5.0	-4.1	-3.2	-3.2	-2.6	-1.7
Output gap	0.6	0.6	-0.5	-3.8	-3.0	-2.7	-3.3	-3.2	-2.6	-1.4	—
Structural balance	-2.3	-2.4	-3.4	-3.1	-3.5	-3.1	-1.8	-0.9	-1.3	-1.6	-1.7
Net debt ³	22.0	27.1	30.2	34.4	40.2	43.6	46.3	48.6	50.1	51.1	50.2
Gross debt	29.4	35.3	39.2	45.2	48.1	52.2	55.4	57.7	59.2	60.2	59.3
Italy											
Actual balance	-10.9	-10.1	-9.6	-10.0	-9.6	-7.0	-6.7	-3.2	-3.0	-2.1	-1.4
Output gap	2.6	1.9	—	-3.1	-2.7	-1.7	-2.7	-3.3	-3.1	-1.4	—
Structural balance	-12.0	-11.0	-9.6	-8.5	-8.2	-6.1	-5.4	-1.7	-1.6	-1.5	-1.4
Net debt	73.4	96.1	103.0	112.8	118.3	117.8	117.2	116.3	114.8	108.8	102.1
Gross debt	79.0	101.5	108.7	119.1	124.9	124.4	123.8	122.9	121.2	114.9	107.9
United Kingdom											
Actual balance	-2.0	-2.6	-6.3	-7.9	-6.9	-5.6	-4.7	-2.0	-0.6	0.4	0.7
Output gap	-0.6	-2.3	-4.5	-4.7	-2.7	-1.8	-1.0	-0.5	—	—	—
Structural balance	-1.3	-2.7	-3.9	-4.4	-4.1	-4.0	-3.8	-1.5	-0.4	0.4	0.7
Net debt	44.0	27.7	29.0	33.8	39.4	42.3	45.7	47.9	44.3	40.2	35.2
Gross debt	51.5	34.9	36.1	42.5	48.4	50.5	53.8	54.5	52.4	48.2	43.1
Canada											
Actual balance	-4.5	-6.6	-7.4	-7.3	-5.3	-4.1	-1.8	0.2	0.8	1.4	2.1
Output gap	0.1	-2.6	-3.7	-4.0	-2.6	-2.6	-3.3	-2.1	-1.1	—	—
Structural balance	-4.4	-4.9	-4.8	-4.6	-3.6	-2.7	—	1.3	1.4	1.5	2.1
Net debt	30.1	49.7	56.9	61.9	64.7	67.5	69.0	66.5	62.5	53.8	45.2
Gross debt	60.2	79.4	86.9	92.5	94.8	98.4	100.4	97.0	91.4	80.1	69.5

Note: The budget projections are generally based on information available through August 1997. The specific assumptions for each country are set out in Box 1.

¹The output gap is actual less potential output, as a percent of potential output. Structural balances are expressed as a percent of potential output. The structural budget balance is the budgetary position that would be observed if the level of actual output coincided with potential output. Changes in the structural budget balance consequently include effects of temporary fiscal measures, the impact of fluctuations in interest rates and debt-service costs, and other noncyclical fluctuations in the budget balance. The computations of structural budget balances are based on IMF staff estimates of potential GDP and revenue and expenditure elasticities (see the October 1993 *World Economic Outlook*, Annex I). Net debt is defined as gross debt less financial assets, which include assets held by the social security insurance system. Estimates of the output gap and of the structural budget balance are subject to significant margins of uncertainty.

²Data before 1990 refer to west Germany. For net debt, the first column refers to 1986-90. Beginning in 1995, the debt and debt-service obligations of the Treuhandanstalt (and of various other agencies) were taken over by the general government. This debt is equivalent to 8 percent of GDP and the associated debt service to ½ of 1 percent of GDP.

³Figure for 1980-90 is average of 1983-90.

1998 owing mainly to the recent currency turmoil in a number of east Asian countries, its expansion this year, by 7½ percent, will still significantly exceed average growth in the 1980s and early 1990s. For Thailand, projected growth has been downgraded by 3½–4 percentage points in the wake of the exchange market crisis, reflecting both the effects of the crisis itself, and the adjustment measures put in place. Spillover effects from the crisis were felt in Indonesia, Malaysia, and the Philippines and growth projections for all of these countries have been downgraded by ½ to 1½ percentage points. If the turbulence were to continue, all four countries might well experience a more significant slowdown. The financial crisis and its impact are discussed below. Among other developing countries in Asia, growth projections have also been revised downward for Pakistan where a significant slowdown in economic activity has followed in the wake of last year's balance of payments crisis and subsequent adjustment measures; a sustained pickup in growth is contingent on the implementation of sound macroeconomic policies and structural reforms as addressed below. In contrast, growth in China is expected to continue at about 9 percent, with inflation declining further, to below 5 percent next year on an annual average basis.

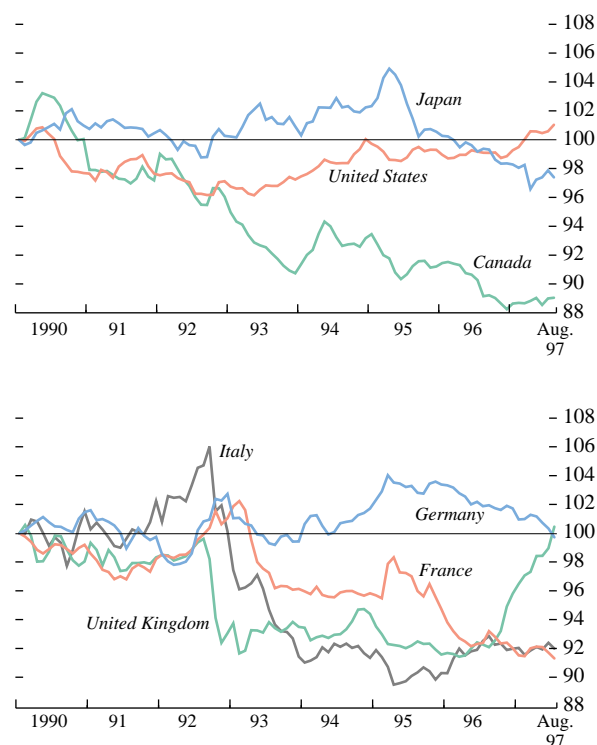
In the Middle East and Europe region, growth is now expected to be maintained at around 4½ percent in 1997 and 1998, with inflation remaining steady. The upward revisions to projected growth in the region are accounted for largely by developments in the Islamic Republic of Iran and Turkey. For the Islamic Republic of Iran, the projections assume an accelerated pace of economic reforms, laying the ground for a substantial improvement in growth performance, especially in the non-oil sector. In Turkey, growth has been stronger than expected previously, but with inflation remaining at about 80 percent, the economic situation is precarious, and the financial system fragile.

In the *countries in transition* as a group, output in 1997 is now projected to increase by 1¾ percent, still the first significant positive growth rate in eight years, but revised down by over 1 percentage point from the May 1997 *World Economic Outlook* (Table 5). In spite of a small downward revision for 1998, the growth rate next year is projected to rise above 4 percent. The downward revisions to projected growth are accounted for mainly by Russia, Ukraine, and a number of other countries in central and eastern Europe, including Albania, the Czech Republic, Moldova, and the Slovak Republic. In the Czech Republic and Poland, and to a lesser extent in the Slovak Republic, output growth this year could be adversely affected by extensive floods that occurred during May–July.

The countries more advanced in transition have generally continued to make progress in reducing inflation, while growth has picked up in a number of coun-

Figure 5. Major Industrial Countries: Monetary Conditions Indices¹

An easing of monetary conditions—broadly defined to include both interest rates and exchange rate changes—in Germany and France is expected to support a resumption of growth.

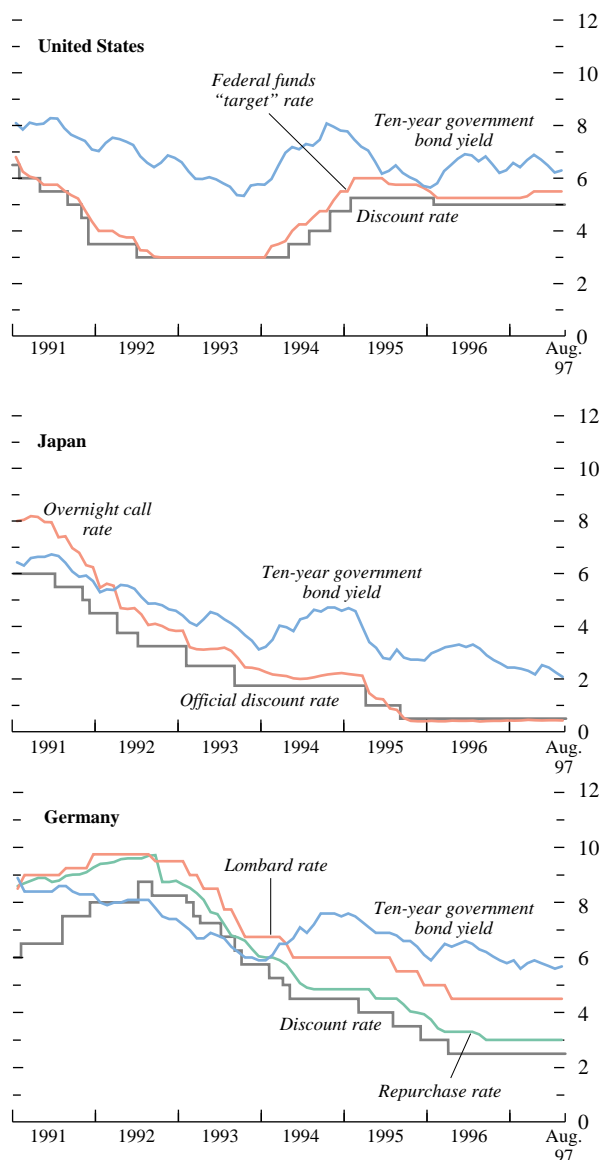


¹For each country, the index is defined as a weighted average of the percentage point change in the real short-term interest rate and the percentage change in the real effective exchange rate from a base period (January 1990). Relative weights of 3 to 1 are used for Canada, France, Italy, and the United Kingdom, 4 to 1 for Germany, and 10 to 1 for Japan and the United States. The weights are intended to represent the relative impacts of interest rates and exchange rates on aggregate demand; they should be regarded as indicative rather than precise estimates. For instance, a 3-to-1 ratio indicates that a 1 percentage point change in the real short-term interest rate has about the same effect on aggregate demand over time as a 3 percent change in the real effective exchange rate. Movements in the index are thus equivalent to percentage point changes in the real interest rates. The lag with which a change in the index may be expected to affect aggregate demand depends on the extent to which the change stems from a change in the interest rate or the exchange rate, and varies depending on the cyclical position; the lag also differs across countries. No meaning is to be attached to the absolute value of the index; rather, the index is intended to show the degree of tightening or easing in monetary conditions from the (arbitrarily chosen) base period. Small changes in the relative weights may affect the value of the index but not the qualitative picture.

Figure 6. Three Major Industrial Countries: Policy-Related Interest Rates and Ten-Year Government Bond Yields¹

(In percent a year)

Policy-related interest rates in Japan and Germany have fallen significantly over the past three years.



¹The U.S. federal funds "target" rate, Japanese overnight call rate, German repurchase rate, and all ten-year government bond yields are monthly averages. All other series are end of month.

tries, including Hungary, after slowdowns in 1996.⁵ Exchange market pressures related to large current account deficits have affected both the Czech and Slovak Republics (see below). In Poland, inflation on a 12-month basis has fallen below 15 percent. Output growth above 7 percent (annualized) in the first half of 1997, generated by strong domestic demand, led to a widening current account deficit. Import growth, however, has been skewed toward capital goods associated with investment rather than consumption, and capital inflows have consisted largely of foreign direct investment. In Hungary, growth has picked up after a pause in 1996, while inflation has continued to edge downward.

Among countries less advanced in transition, measures aimed at macroeconomic stabilization have led to a significant output decline in Bulgaria and to a milder recession this year in Romania, but also to promising developments in both cases. In Bulgaria, inflation fell rapidly from 400 percent in the first quarter of 1997 to about 4 percent in July, and yields on government securities declined substantially. The authorities' stabilization program is centered on a currency board arrangement, which went into effect on July 1 with a peg of 1,000 leva to the deutsche mark, supported by an acceleration of structural reforms and a budget that does not require net domestic bank financing. In Romania, monthly inflation fell below 1 percent in July after reaching a high of 31 percent, and the authorities' policy program includes fiscal austerity, price liberalization, banking reform, and industrial restructuring. Civil order remains to be fully restored in Albania in the wake of the crisis earlier in the year, and reforms, including measures to wind up pyramid financial schemes, remain to be enacted. Output in Albania is projected to drop by 10 percent in 1997 after four years of rapid growth.

In other countries less advanced in transition, Russia and most other countries of the former Soviet Union have made substantial progress in bringing down inflation. In the middle of 1997, 12-month inflation rates were in the single digits in Armenia, and Azerbaijan, below 15 percent in Georgia, Moldova, and Russia, and in the 20–25 percent range in Kazakhstan and Ukraine. Further reductions in inflation in these countries are expected, although fiscal imbalances or delays in structural reform pose risks to price performance. In Belarus, Turkmenistan, and Uzbekistan, however, financial policies have remained relatively loose, and these countries have failed to reduce inflation as rapidly as the other countries in the region.

Finally, turning to *balance of payments* developments, the current account imbalances of some of the

⁵For lists of countries considered to be more and less advanced in transition, see May 1997 *World Economic Outlook*, p. 94.

major industrial countries are projected to widen somewhat, but to remain generally smaller than the imbalances seen in some cases in the 1980s. The projected narrowing of cyclical divergences should help contain both the U.S. deficit and the surpluses of Japan and the EU (Table 6). In Japan, after declining to 1½ percent of GDP in 1996, the current account surplus is projected to increase as the depreciation of the yen since 1995 boosts exports. The current account deficit of the United States is expected to widen slightly in 1998 as strong economic activity and the recent appreciation of the dollar continue to spur import demand. After reaching virtual balance in 1996, the United Kingdom's current account is expected to move into moderate deficit in 1997–98, reflecting the recent appreciation of sterling and strong growth in domestic demand. The continuing growth of exports, against a background of weak domestic demand, is expected to virtually eliminate the current account deficit in Germany, and to increase France's current account surplus to about 2¼ percent of GDP by 1998. The current account surplus in Italy is expected to remain broadly unchanged.

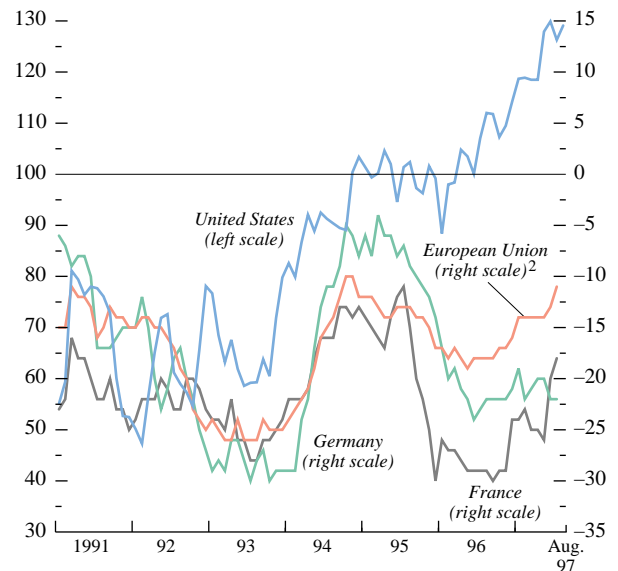
Among other advanced economies, already relatively large current account deficits are expected to widen somewhat further in Australia and in New Zealand. Korea's current account deficit, which reached 5 percent of GDP in 1996 is expected to narrow in 1997 with the slowing of import growth. In Singapore, despite the export slowdown, the current account surplus has remained at 15 percent of GDP, and is expected to remain at this level in the year ahead.

In a number of the developing countries of Asia, current account developments in 1996 reflected the partly offsetting effects of the slowdown in export growth in 1995–96 and policies to contain domestic demand and overheating. In Malaysia in 1996, the slowdown of domestic demand dominated, and the current account deficit declined significantly; it is projected to widen slightly in 1997, but to narrow to 4½ percent of GDP in 1998 in response to the depreciation of the exchange rate and moderating domestic demand growth. In Thailand, after reaching 8 percent of GDP in 1995–96, the current account deficit is expected to narrow this year to 5 percent as the pace of economic growth moderates further and macroeconomic adjustment measures put in place in the aftermath of the exchange rate crisis take effect. In Indonesia, the recent depreciation of the rupiah is expected to boost exports and contribute to a modest narrowing of the current account deficit in 1998. In the Philippines, the current account deficit is projected to remain roughly unchanged this year, but to narrow to 3½ percent of GNP next year. In China, the current account is expected to remain in approximate balance.

With significant capital inflows and growth picking up in Latin America, current account deficits have in-

Figure 7. European Union and the United States: Indicators of Consumer Confidence¹

Consumer confidence remains weak in the countries of the European Union.



Sources: For the United States, the Conference Board; and the European Commission.

¹Indicators are not comparable across countries.

²Percent of respondents expecting an improvement in their situation minus percent expecting a deterioration.

Table 4. Selected Developing Countries: Real GDP and Consumer Prices
(Annual percent change)

	Real GDP			Consumer Prices		
	1995	1996	1997	1995	1996	1997
Developing countries	6.0	6.5	6.2	22.7	13.2	10.0
Median	4.1	4.3	4.5	10.0	7.0	5.1
Africa	2.8	5.2	3.7	33.1	25.0	14.8
Algeria	3.9	4.0	4.5	21.9	15.1	7.0
Cameroon	3.3	5.0	5.1	30.9	6.4	4.2
Côte d'Ivoire	7.1	6.8	6.1	14.2	2.8	2.9
Ghana	4.5	5.2	3.7	59.5	46.6	27.3
Kenya	4.4	4.2	3.5	1.7	9.0	11.5
Morocco	-7.6	11.8	-1.1	6.1	3.0	3.6
Nigeria	2.3	2.4	3.6	70.0	29.3	18.0
South Africa	3.4	3.1	2.2	8.6	7.4	10.2
Sudan	4.5	4.3	5.0	85.0	94.0	103.0
Tanzania	3.8	4.5	4.7	34.0	25.7	15.0
Tunisia	2.4	6.9	5.1	6.2	3.7	3.9
Uganda	9.8	7.0	7.0	7.4	6.3	5.0
SAF/ESAF countries ¹	4.8	6.1	4.9	22.0	15.5	8.2
CFA countries	4.6	5.2	5.3	16.1	5.2	3.9
Asia	8.9	8.2	7.6	11.9	6.6	5.8
Bangladesh	5.2	5.6	5.5	6.3	3.9	4.9
China	10.5	9.7	9.5	14.8	6.1	4.5
India	7.4	6.9	6.6	10.2	7.3	7.1
Indonesia	8.2	7.8	7.0	9.4	6.6	7.3
Malaysia	9.5	8.2	7.5	3.4	3.5	3.9
Pakistan	5.1	5.1	3.1	12.4	10.4	11.2
Philippines	4.8	5.5	5.3	8.1	8.4	6.5
Thailand	8.7	6.4	2.5	5.8	5.9	7.0
Vietnam	9.5	9.5	9.5	12.8	6.0	7.0
Middle East and Europe	3.5	4.8	4.6	35.9	24.8	22.1
Egypt	3.2	4.3	5.0	9.4	7.2	6.2
Iran, Islamic Republic of	2.8	5.1	5.2	49.4	23.2	16.2
Jordan	6.9	5.2	6.5	2.4	6.5	4.0
Kuwait	1.6	1.6	1.2	2.7	1.8	1.2
Saudi Arabia	0.5	2.4	1.8	5.0	1.0	0.7
Turkey	7.5	7.1	5.4	93.6	82.3	78.6
Western Hemisphere	1.3	3.4	4.1	41.7	20.5	13.5
Argentina	-4.6	4.4	7.5	3.4	0.2	1.0
Brazil ²	4.2	2.9	3.5	...	11.1	7.8
Chile	8.5	7.2	5.5	8.2	7.4	6.0
Colombia	5.4	2.1	2.0	20.9	20.8	18.8
Dominican Republic	4.8	7.3	8.0	9.2	3.8	10.0
Ecuador	2.3	2.0	2.8	22.9	24.3	26.8
Guatemala	4.9	3.1	4.0	8.4	10.6	9.5
Mexico	-6.1	5.1	4.5	35.0	34.4	20.4
Peru	7.0	2.8	5.0	11.1	11.5	9.4
Uruguay	-1.9	5.0	4.0	42.2	28.3	19.6
Venezuela	3.4	-1.6	3.7	59.9	99.9	47.3

¹African countries that had arrangements, as of the end of 1996, under the IMF's Structural Adjustment Facility (SAF) or Enhanced Structural Adjustment Facility (ESAF).

²"Consumer prices" are based on a price index of domestic demand, which is a weighted average of the consumer price index, the wholesale price index, and a price index for construction activity. The average year-on-year increase in 1995 in this price index was 59.6 percent, which largely was the result of carryover effects from the high inflation rate prevailing prior to the introduction of the real on July 1, 1994. Consequently, the inflation rate from December 1994 to December 1995, which was 14.8 percent, better reflects the underlying rate during 1995. The December 1995 to December 1996 inflation rate was 9.3 percent; on the same basis, the inflation rate is projected to be 6.6 in 1997.

Table 5. Countries in Transition: Real GDP and Consumer Prices*(Annual percent change)*

	Real GDP			Consumer Prices		
	1995	1996	1997	1995	1996	1997
Countries in transition	-0.8	0.1	1.8	119	40	32
Median	2.3	2.7	3.5	46	24	15
Central and eastern Europe	1.6	1.5	2.1	70	32	41
Excluding Belarus and Ukraine	5.0	3.3	2.8	25	24	43
Albania	8.9	8.2	-10.0	8	13	52
Belarus	-10.4	2.6	5.0	709	53	76
Bulgaria	2.1	-10.9	-7.4	62	123	1,059
Croatia	2.4	4.7	5.5	2	3	4
Czech Republic	4.8	4.1	2.0	9	9	9
Estonia	4.3	4.0	5.0	29	23	12
Hungary	1.5	1.0	3.0	28	24	18
Latvia	0.4	2.8	4.0	25	19	10
Lithuania	3.1	3.6	4.5	39	25	10
Macedonia, former Yugoslav Rep. of	-1.4	1.1	5.0	16	-1	2
Moldova	-3.4	-8.0	1.4	30	24	11
Poland	6.5	5.5	5.5	28	20	15
Romania	7.1	4.1	-1.5	32	39	109
Slovak Republic	6.8	6.9	4.5	10	6	6
Slovenia	4.1	3.1	4.0	13	10	9
Ukraine	-12.0	-10.0	-3.0	376	80	17
Russia	-4.0	-2.8	1.5	190	48	16
Transcaucasus and central Asia	-3.7	1.6	1.3	260	70	43
Armenia	6.9	5.8	5.8	177	19	8
Azerbaijan	-11.0	1.3	5.7	412	20	7
Georgia	2.4	10.5	10.0	163	40	12
Kazakhstan	-8.9	1.1	1.5	176	39	20
Kyrgyz Republic	5.4	5.6	6.9	53	30	27
Mongolia	6.3	2.6	3.0	57	49	51
Tajikistan	-12.5	-7.0	-5.3	610	443	32
Turkmenistan	-8.2	-3.0	-18.5	1,005	992	96
Uzbekistan	-0.9	1.6	2.2	305	54	70

creased. Mexico's current account deficit is expected to reach 2¼ percent of GDP by 1998, as domestic demand continues to strengthen. Current account deficits are also expected to increase in Argentina, to just above 3 percent of GDP in 1997 and in Brazil, to 5 percent of GDP in 1998.

In a number of African countries, current account deficits widened in 1996 owing to declines in commodity prices, and a slight further deterioration is expected for the region in 1997. Current account deficits are projected to widen somewhat in Ethiopia, but to narrow or remain unchanged in a number of the CFA franc zone countries, Kenya, South Africa, Tanzania, Uganda, and Zimbabwe. The recent decline in oil prices is expected to shrink current account surpluses in Algeria and Nigeria.

Current account deficits in many countries in transition increased in 1996, and relatively wide deficits

are expected to persist. In the Czech and Slovak Republics, deficits increased to over 8 percent of GDP in 1996, reflecting strong import demand and appreciated currencies. Buoyant domestic demand in Poland is expected to contribute to a significant widening of its current account deficit in 1997.

Capital flows to developing countries, which reached a record high in 1996, have, according to all indications, remained strong during 1997 in most developing countries (Table 7). Some countries, however, whose currencies have recently come under attack—as discussed below—may experience a decline in net inflows for the year as a whole.

* * *

The remainder of this chapter addresses some of the main issues that arise in relation to the forces acting on the economic conjuncture.

Table 6. Selected Economies: Current Account Positions*(In percent of GDP)*

	1994	1995	1996	1997	1998
Advanced economies¹					
United States	-1.9	-1.8	-1.9	-2.2	-2.4
Japan	2.8	2.2	1.4	2.3	2.2
Germany	-1.0	-1.0	-0.6	-0.5	—
France	0.5	1.1	1.3	1.9	2.2
Italy	1.4	2.5	3.4	3.2	3.4
United Kingdom	-0.2	-0.5	-0.1	-0.3	-1.0
Canada	-2.7	-1.0	0.5	-1.1	-0.8
Australia	-5.0	-5.3	-3.7	-3.5	-4.0
Austria	-0.9	-2.0	-1.8	-1.6	-1.4
Finland	1.3	4.2	3.3	3.5	3.6
Greece	-1.0	-2.7	-3.5	-4.2	-5.0
Hong Kong, China	1.6	-3.2	-0.7	-1.0	0.1
Ireland	2.7	2.8	2.0	2.1	1.3
Israel	-3.1	-4.5	-5.1	-3.6	-3.0
Korea	-1.2	-2.0	-4.9	-3.5	-2.5
New Zealand	-2.5	-3.7	-4.1	-5.2	-5.6
Norway	2.4	3.4	7.1	8.1	9.0
Singapore	17.0	16.9	15.0	15.0	14.8
Spain	-1.4	0.2	0.3	0.9	0.5
Sweden	0.4	2.1	2.4	3.7	4.4
Switzerland	6.9	6.9	7.0	7.1	7.1
Taiwan Province of China	2.6	1.9	3.8	3.4	3.0
<i>Memorandum</i>					
European Union	0.3	0.6	1.0	1.1	1.2
Developing countries					
Algeria	-5.4	-5.3	2.7	0.3	0.2
Argentina	-3.7	-1.5	-1.9	-3.2	-2.9
Brazil	-0.3	-2.5	-3.2	-4.5	-5.0
Cameroon	-4.2	-0.4	-2.4	1.3	-2.3
Chile	-1.2	0.2	-4.1	-3.4	-4.1
China	1.4	0.2	0.5	0.3	—
Côte d'Ivoire	-1.0	-5.0	-4.7	-5.1	-4.1
Egypt	0.4	2.3	-0.3	0.8	-0.4
India	-1.0	-1.5	-1.3	-1.6	-1.9
Indonesia	-1.7	-3.4	-3.5	-3.5	-3.2
Malaysia	-6.3	-8.5	-5.2	-5.8	-4.4
Mexico	-7.0	-0.6	-0.6	-1.5	-2.2
Nigeria	-2.6	-0.9	2.3	0.5	0.3
Pakistan	-3.6	-4.0	-6.8	-6.7	-5.3
Philippines	-4.6	-4.4	-4.3	-4.3	-3.6
Saudi Arabia	-8.7	-5.5	-0.2	-1.5	-3.7
South Africa	-0.3	-2.1	-1.6	-1.1	-1.2
Thailand	-5.6	-8.0	-7.9	-5.0	-3.0
Turkey	2.0	-1.4	-0.8	-1.3	-0.8
Uganda	-2.5	-2.0	-1.1	-1.2	-0.8
Countries in transition					
Czech Republic	-1.9	-2.7	-8.1	-7.2	-6.9
Hungary	-9.5	-5.6	-3.8	-3.9	-4.5
Poland ²	2.3	3.3	-1.0	-4.9	-5.5
Russia	3.7	1.1	0.5	0.5	-0.8

¹For European Union (EU) countries, transfers from the EU budget that finance capital outlays are considered to be capital transfers in accordance with standard national accounts and balance of payments methodologies; such transfers are not included in the current account of the balance of payments.

²Based on data for the current balance, including a surplus on unrecorded trade transactions, as estimated by IMF staff.

Table 7. Capital Flows to Developing Countries, Countries in Transition, and Newly Industrialized Economies¹*(In billions of U.S. dollars)*

	1983–88 ²	1989–95 ²	1991	1992	1993	1994	1995	1996
Total								
Net private capital flows ³	11.7	116.8	135.2	123.6	160.0	148.1	188.7	249.0
Net direct investment	11.9	47.2	32.3	37.4	55.5	78.1	92.9	117.1
Net portfolio investment	4.2	51.4	39.6	57.8	106.5	98.0	30.7	57.8
Other net investments	...	...	...	...	...	...	...	...
Net official flows	27.9	21.5	20.8	13.7	21.2	8.4	41.5	-18.4
Change in reserves ⁴	-8.6	-65.6	-63.3	-67.1	-73.2	-67.0	-111.3	-103.9
Developing countries								
Net private capital flows ³	15.8	103.3	131.3	118.7	140.9	117.4	147.3	207.4
Net direct investment	10.3	42.5	26.9	33.8	48.8	72.1	78.2	100.8
Net portfolio investment	3.5	43.6	36.1	51.6	88.9	84.1	15.6	43.2
Other net investments	2.1	17.2	68.3	33.3	3.2	-38.8	53.5	63.3
Net official flows	27.3	21.2	18.9	14.0	20.1	19.7	33.7	-8.6
Change in reserves ⁴	10.1	-41.8	-46.8	-45.1	-39.1	-37.9	-62.3	-93.7
Africa								
Net private capital flows ³	3.9	4.2	4.0	0.2	2.3	9.6	10.6	10.7
Net direct investment	1.1	2.2	2.3	2.0	1.7	3.8	2.8	5.0
Net portfolio investment	-0.9	-0.2	-1.6	-0.7	0.8	0.4	1.9	0.6
Other net investments	3.7	2.2	3.3	-1.0	-0.2	5.4	5.9	5.1
Net official flows	5.0	6.8	5.3	8.2	5.9	7.5	6.2	3.2
Change in reserves ⁴	0.3	-1.9	-3.0	1.9	-0.7	-5.2	-1.4	-5.9
Asia								
Net private capital flows ³	11.9	43.4	32.3	20.9	53.2	62.3	88.8	98.4
Net direct investment	3.6	25.1	12.1	17.6	34.1	43.6	49.5	58.2
Net portfolio investment	1.2	4.9	0.5	1.0	11.7	10.0	9.3	8.0
Other net investments	7.1	13.4	19.6	2.3	7.4	8.7	29.9	32.2
Net official flows	7.6	8.4	10.5	10.7	10.0	6.0	5.9	7.8
Change in reserves ⁴	-2.2	-23.0	-26.7	-15.1	-25.3	-41.5	-28.4	-48.1
Middle East and Europe								
Net private capital flows ³	2.1	22.4	70.1	42.8	22.6	-1.0	12.1	18.5
Net direct investment	1.0	1.5	1.6	1.3	1.8	1.8	1.4	1.2
Net portfolio investment	4.2	13.4	22.4	21.0	15.3	12.5	11.6	6.8
Other net investments	-3.1	7.5	46.1	20.5	5.4	-15.3	-0.9	10.5
Net official flows	4.9	0.7	-0.3	-3.3	4.3	10.5	-1.6	-6.9
Change in reserves ⁴	11.6	-4.5	-1.1	-10.8	6.7	-1.9	-9.0	-17.5
Western Hemisphere								
Net private capital flows ³	-2.0	33.3	25.0	54.8	62.9	46.4	35.8	79.7
Net direct investment	4.7	13.7	10.9	12.9	11.2	23.0	24.4	36.5
Net portfolio investment	-1.1	25.5	14.7	30.4	61.1	61.1	-7.2	27.8
Other net investments	-5.7	-5.9	-0.6	11.5	-9.4	-37.6	18.6	15.5
Net official flows	9.7	5.3	3.3	-1.6	-0.1	-4.3	23.2	-12.6
Change in reserves ⁴	0.4	-12.5	-16.1	-21.1	-19.7	10.7	-23.6	-22.2
Countries in transition								
Net private capital flows ³	-4.5	11.0	-1.4	7.4	10.8	17.0	28.7	26.1
Net direct investment	-0.2	4.5	2.4	4.2	6.0	5.4	13.0	12.4
Net portfolio investment	—	1.5	0.8	-0.8	3.6	2.9	3.7	2.1
Other net investments	...	...	...	...	...	...	...	...
Net official flows	1.5	1.1	1.7	-0.1	3.0	-11.0	8.5	-9.1
Change in reserves ⁴	-3.4	-8.6	0.4	-6.0	-12.7	-8.0	-34.5	2.9
Newly industrialized economies⁵								
Net private capital flows ³	0.4	2.5	5.3	-2.5	8.3	13.6	12.6	15.5
Net direct investment	1.9	0.3	3.0	-0.6	0.8	0.6	1.7	3.9
Net portfolio investment	0.7	6.4	2.8	7.1	14.0	11.0	11.3	12.5
Other net investments	-2.2	-4.2	-0.5	-9.0	-6.5	2.1	-0.4	-1.0
Net official flows	-0.8	-0.8	0.2	-0.3	-1.9	-0.3	-0.7	-0.6
Change in reserves ⁴	-15.2	-15.2	-16.8	-16.0	-21.4	-21.1	-14.5	-13.2

¹Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing.

²Annual averages.

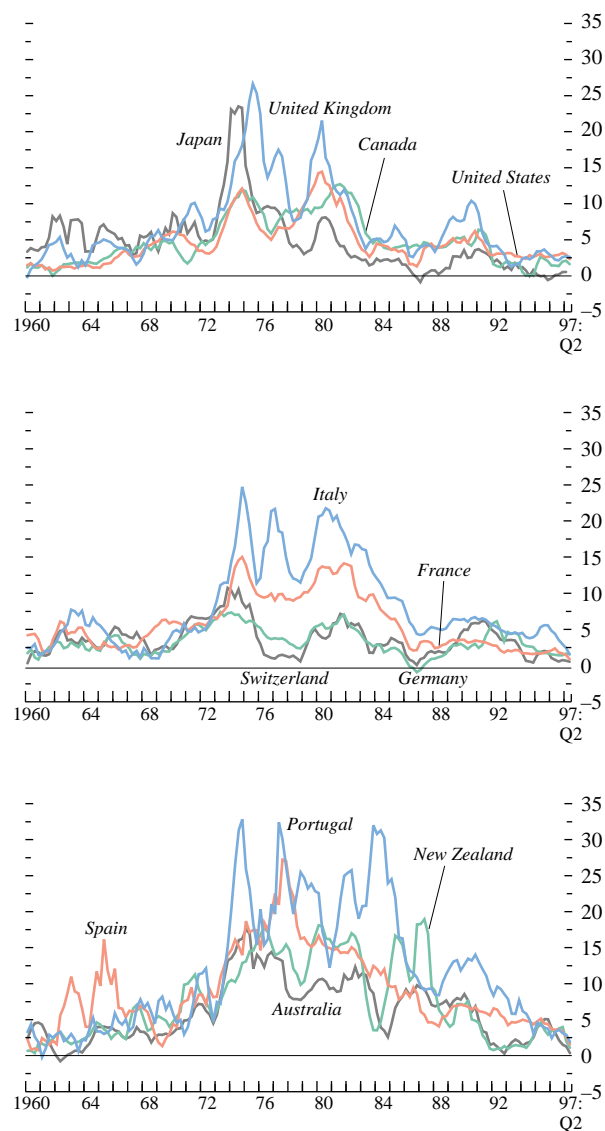
³Because of data limitations other net investment may include some official flows.

⁴A minus sign indicates an increase.

⁵Hong Kong, China; Israel; Korea; Singapore; and Taiwan Province of China.

Figure 8. Selected Advanced Economies: Inflation*(Annual percent change)*

Inflation in most of the advanced economies has stabilized at low levels or has continued to fall in 1997.



Global Issues

How Great Is the Risk of Inflation?

A feature of economic developments in the 1990s has been the fall in world inflation to levels not seen for several decades. This trend has largely continued in 1997 (Figure 8). Among the advanced economies, inflation in the United States and the United Kingdom has remained in the narrow range observed since the early 1990s, notwithstanding tight labor markets and output growth above estimated potential (Table 8). Inflation in most other European countries has either stabilized at low levels or continued to fall, notably in Italy, Portugal, and Spain, with a further marked convergence of inflation rates across Europe. In Japan, the hike in the consumption tax in April had a one-time effect on the price level, but there are no indications of more general upward price pressures. Also, Canada has kept inflation well within its official target range of 1–3 percent. The 1990s have also seen impressive gains by many developing countries in reducing inflation, such that the gap in performance between the advanced and developing countries has narrowed substantially (Figure 9). By mid-1997, inflation had fallen to 5 percent or below in many developing countries in Asia. In Latin America, prices have been essentially stable in Argentina, and inflation has slowed to near 5 percent in Chile and to single digits in Brazil and Peru.

The evidence of continuing low or declining inflation across a broad range of countries appears to have increased financial market confidence that the recent benign inflation environment will continue. Long-term interest rates in the advanced economies have been on a broad downward trend since early 1995, notwithstanding significant short-term fluctuations (Figure 10). In this period, bond yields have fallen by 150–300 basis points in most major industrial countries, and by 500–600 basis points in Italy and other higher-yielding markets in Europe. Except in Japan, yields rose moderately in the first quarter of 1997 on concerns about monetary tightening in the United States but subsequently declined again as these concerns eased. The decline in bond yields primarily reflects the fall in inflation: in nominal terms, long-term interest rates have fallen to their lowest levels since the 1960s, but real yields are still close to their average levels over the past decade in a number of countries.

As was seen in the 1980s, inflationary pressures may be reflected in price movements in equity and real estate markets before they become apparent in increases in the less flexible prices of goods and services.⁶ In the recent period, the most notable devel-

⁶See Annex I of the May 1993 *World Economic Outlook* for a discussion of this experience.

Table 8. Major Industrial Countries: Questions About Inflationary Pressures¹

	Canada	France	Germany	Italy	Japan	United Kingdom	United States
1. Is inflation outside a range the country's authorities consider to be consistent with price stability?	No	No	No	No	No	No	No
2. Does the IMF forecast that inflation will pick up in 1998?	No	Only slightly	Only slightly	Only slightly	No	Only slightly (excluding mortgage interest)	Only slightly
3. Do private forecasters expect inflation to pick up in 1998? ²	Only slightly	Only slightly	Only slightly	Only slightly	No	Only slightly (excluding mortgage interest)	Only slightly
4. Is there concern about money growth?	No	No	No	No	No	Yes	No
5. Has the output gap been closing?	Yes	No	No	No	Yes, but remains relatively large	Yes	Yes
6. Is excess capacity being taken up too quickly?	No	No	No	No	No	Perhaps	Little, if any, remaining slack
7. Are labor market conditions tight?	No	No	No	No	No	Increasingly	Yes
8. Do yield curves or changes in market interest rates suggest a rise in inflation expectations?	No	No	No	No	No	No	No
9. Is exchange rate weakness stimulating inflation?	No	Only slightly	Moderately	No	No	No	No
10. Do external accounts show signs of overheating?	No	No	No	No	No	No	No
11. Have equity prices risen rapidly?	Yes	Yes	Yes	Yes	No	Yes	Yes
12. Have real estate prices recently been rising rapidly?	No	No	No	No	No	Yes	No

¹This table is intended to provide a broad cross-country survey of inflationary pressures and reflects IMF staff judgments. For individual countries, various indicators will differ in the extent to which they contribute to the inflationary process.

²*Consensus Forecasts*, August 11, 1997 (London: Consensus Economics, Inc., 1997).

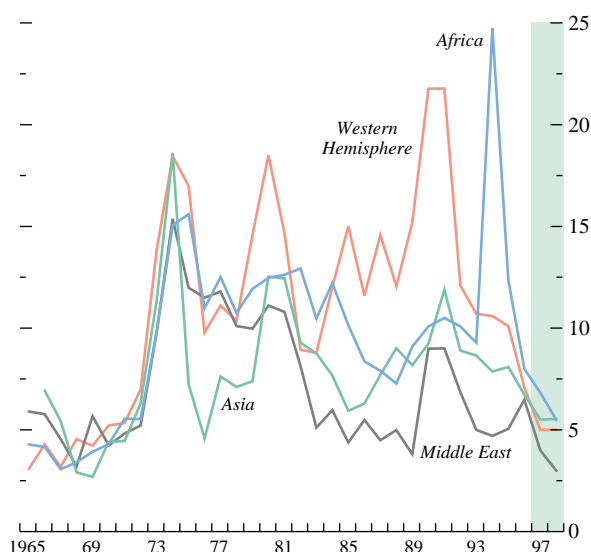
opment in this context has been the strong rise in equity prices in the advanced economies since the end of 1994, with most markets recording gains of 50–100 percent. Equity price gains in the developing countries were generally more subdued in 1995 in the wake of the Mexican crisis, but prices in Latin America have largely recovered their earlier losses in U.S. dollar terms, while markets in some other individual countries have recorded spectacular increases over the past year (Figure 11). While a significant part of these gains can be attributed to fundamental factors in these economies themselves, they may also be indicative of declines in nominal asset yields in the advanced economies associated with lower inflation

and the relatively accommodative stance of monetary policy. In real estate markets, although there are no signs of the broadly based boom conditions that characterized the late 1980s, there have been significant price increases in the United Kingdom and some smaller advanced economies and indications of property market bubbles in a number of Asian economies. On balance, therefore, even though there have been signs of pressure in some asset markets, developments overall do not point unambiguously to a prospect of rising inflation.

IMF staff projections broadly reflect the view that global inflation is likely to remain subdued in the period ahead, with low and stable inflation in the ad-

Figure 9. Developing Countries: Inflation¹
(Median; annual percent change)

During the 1990s, many developing countries have made progress in reducing inflation.



¹Shaded area indicates IMF staff projections.

vanced economies and further declines in the developing countries. What is the basis for the expectation that low inflation will continue? And how does the current situation differ from the period of rising global inflationary pressures in the late 1980s? A key consideration is the increased commitment on the part of governments and central banks to achieving and maintaining low inflation, which has been a major factor behind the improved global inflation performance in recent years. This trend reflects accumulated experience from past inflation episodes that high inflation imposes a significant cost in terms of lost output and is difficult to reduce. As a reflection of the growing importance assigned to low inflation, a number of countries in the 1990s have adopted official inflation targets and institutional frameworks designed to strengthen the credibility of those targets, including increased central bank independence.⁷ Associated with this trend has been the widespread recognition of the importance of early policy actions to address a buildup in inflationary pressures before they are reflected in significantly higher measured inflation. The benefits of such an approach were demonstrated by the preemptive monetary tightening in the United States, the United Kingdom, and Australia in 1994, which contained excess demand pressures without jeopardizing the ongoing economic expansion. More recent examples have been the moves this year to tighten monetary policy in the United States and the United Kingdom when data indicated that actual (as opposed to prospective) inflation had been broadly stable or declining. Indeed, in the United States especially, the approach has helped to sustain the expansion for six years, to reduce unemployment to low levels, and to maintain subdued inflation.

A second reason for expecting global inflationary pressures to remain moderate in the short term is the continued divergence in the cyclical positions of the major industrial countries. In contrast to the late 1980s, when the major economies were all experiencing sustained above-potential growth, pressing on productive capacity, only the United States and the United Kingdom are currently operating above or close to potential, and large output gaps remain in much of continental Europe, as well as in Japan and Canada. Notwithstanding the recoveries proceeding in these latter countries, IMF staff projections suggest that output gaps will be narrowed only modestly in the next two years. In labor markets, historically high unemployment in most of continental Europe, Canada, and Japan has contributed to low wage growth in recent years; and particularly in continental Europe, labor

⁷See the October 1996 *World Economic Outlook*, Chapter VI. In the United Kingdom, the decision in May by the new government to grant operational independence to the Bank of England resulted in an immediate reduction in long-term interest rates of 30–40 basis points, indicating a significant impact on inflation expectations.

market conditions are expected to remain relatively weak in the period ahead (Figure 12). But even in the United States and the United Kingdom, where labor markets are already tight, wage increases have remained below the wage inflation seen in the late 1980s, although they have picked up somewhat over the past year as unemployment has declined. In the United States, increased job insecurity may have been a factor dampening wage demands in the current cycle. Employment costs in the United States have also been held down in the 1990s by slower growth of benefits, largely reflecting the one-time effects of declines in medical benefit costs. Unit labor costs may also have been held down by stronger growth in labor productivity than official estimates suggest.

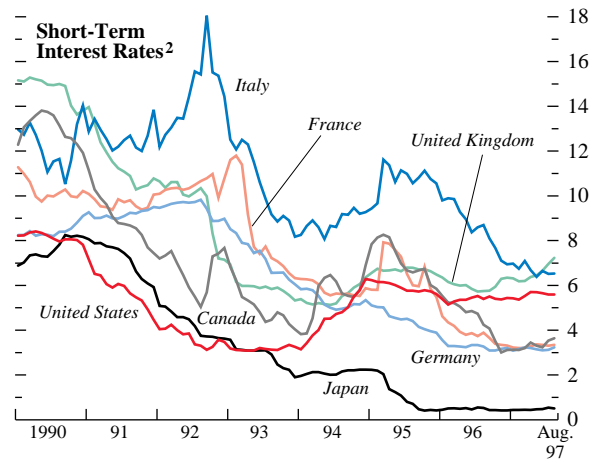
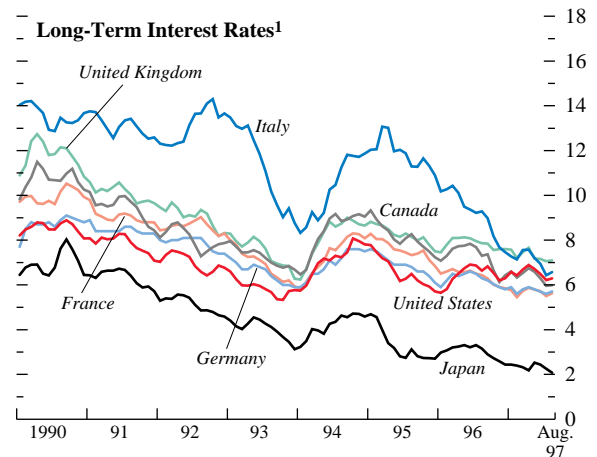
In goods markets, relatively weak output growth in the advanced economies as a group compared with the mid- to late 1980s has helped to dampen inflationary pressures. Industrial sector capacity utilization rates in the major industrial countries generally remain below the levels reached in the late 1980s, suggesting that capacity constraints may not be a source of broadly based price pressures in the near term. Even in the United States, where the cycle is at a mature stage, buoyant investment in new capacity has helped to keep utilization rates moderately below previous cyclical peaks, while in the United Kingdom, price pressures have been evident mainly in the services sector, as traded goods prices have been held down by sterling's appreciation. In fact, exchange rate movements among the major countries over the past two years have been another factor helping to dampen inflationary pressures in those countries where growth has been the strongest, without contributing to inflation risks elsewhere. In the United States, lower inventory levels and reduced transportation costs have also been cited as possible factors exerting downward pressure on inflation.

In addition to the sustained pursuit of low inflation by central banks, favorable global cyclical conditions, and various one-time influences, several other factors have probably contributed to the recent fall in world inflation. Progress with fiscal consolidation in the advanced economies of North America and Europe has helped to dampen inflation expectations, and this is expected to continue in most countries in the period ahead. Beyond these macroeconomic influences, the closely linked processes of globalization and technological advance have also helped to transmit efficiency gains across countries and limit the scope for excessive increases in wages and other costs in recent years. Since these processes are likely to continue, they may be expected also to have a favorable effect on inflation in the future. Finally, overall commodity prices have been relatively stable in dollar terms in 1996 and 1997. This stability partly reflects the strength of the U.S. dollar, and in SDR terms commodity prices have risen more significantly

Figure 10. Major Industrial Countries: Nominal Interest Rates

(In percent a year)

In most countries, long-term interest rates have been on a downward trend, and short-term rates have remained relatively steady.



Sources: WEFA, Inc.; and Bloomberg Financial Markets.

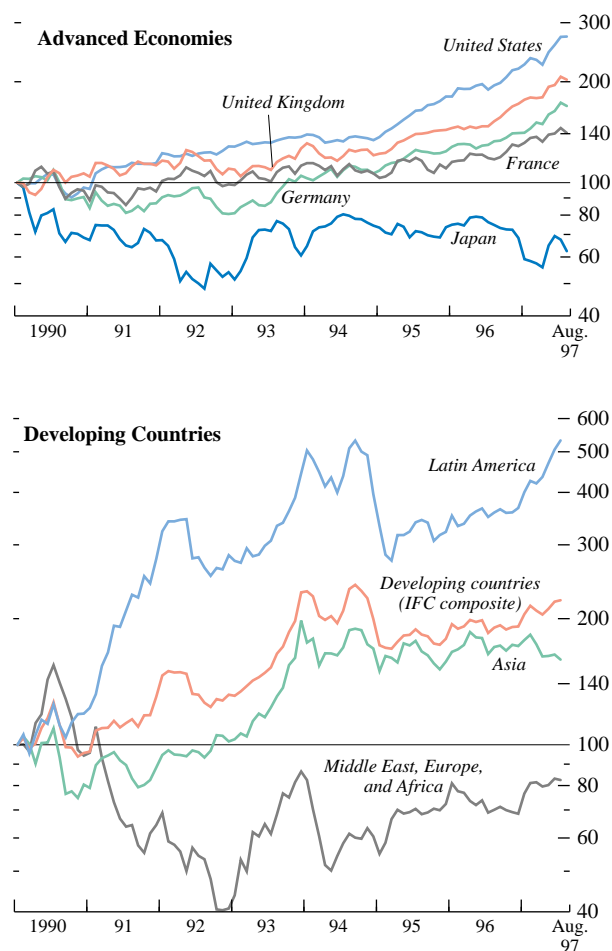
¹Yields on government bonds with residual maturities of ten years or nearest.

²Three-month maturities.

Figure 11. Equity Prices

(In U.S. dollars; logarithmic scale; January 1990 = 100)

Equity prices have recorded further strong advances in many advanced economies and developing countries.



Sources: WEFA, Inc.; and International Finance Corporation, Emerging Markets Data Base.

(Figure 13).⁸ This seems to reflect pressures in particular markets—notably, petroleum and cereals in 1996 and coffee in the first half of 1997—rather than any broad-based upswing in commodity prices that might signify general inflationary pressures.

While there are therefore a number of reasons to expect global inflation to remain low, there are also some areas of risk. Inflation risks have increased over the past year in those countries where domestic demand growth has been strong and resource use is high. In general, financial markets have largely dismissed these risks as incoming data have continued to show little evidence of rising inflation and in view of the demonstrated willingness of central banks to act in a preemptive manner. However, the possibility of an inflation surprise on the upside in these countries in particular clearly calls for special vigilance. The risks of a more generalized rise in global inflation would seem to depend importantly on the future path of demand in the world's largest economies. While IMF staff and most private sector forecasters envisage a slowing of growth in the United States and the United Kingdom, these forecasts are subject to upside risks. Specifically, domestic demand growth remains strong in the United Kingdom, while in the United States, consumer confidence is at a 28-year high, and employment growth remains robust. Any generalized tendency for the strength of expansion to surprise on the upside may produce a less benign environment for world inflation than currently appears to be in prospect. Finally, the risk exists that recent broadly based increases in equity prices and indications of tightness in real estate markets in a number of countries may also be a signal of rising inflationary pressures.

Have Recent Exchange Rate Movements Among Major Currencies Been Consistent with Fundamentals?

The main developments since the spring in the exchange rates of the major currencies have been a recovery of the Japanese yen and a further moderate rise in the U.S. dollar against most currencies except the yen (Figure 14). After falling to ¥127 per U.S. dollar at the end of April, the yen rebounded sharply, by some 14 percent, in May and early June to reach a high of ¥110 per dollar, its highest level since November 1996. The rise was broadly based and reflected similar gains against all other major currencies as well as those of Japan's major trading partners in Asia. Subsequently, the yen fell back again against the dollar and, to a lesser extent, on a multilateral basis, de-

⁸The IMF's index of commodity prices in U.S. dollar terms rose by 5 percent during 1996 and 1 percent over the first half of 1997. The corresponding increases in SDR terms were 10 percent and 6 percent, respectively.

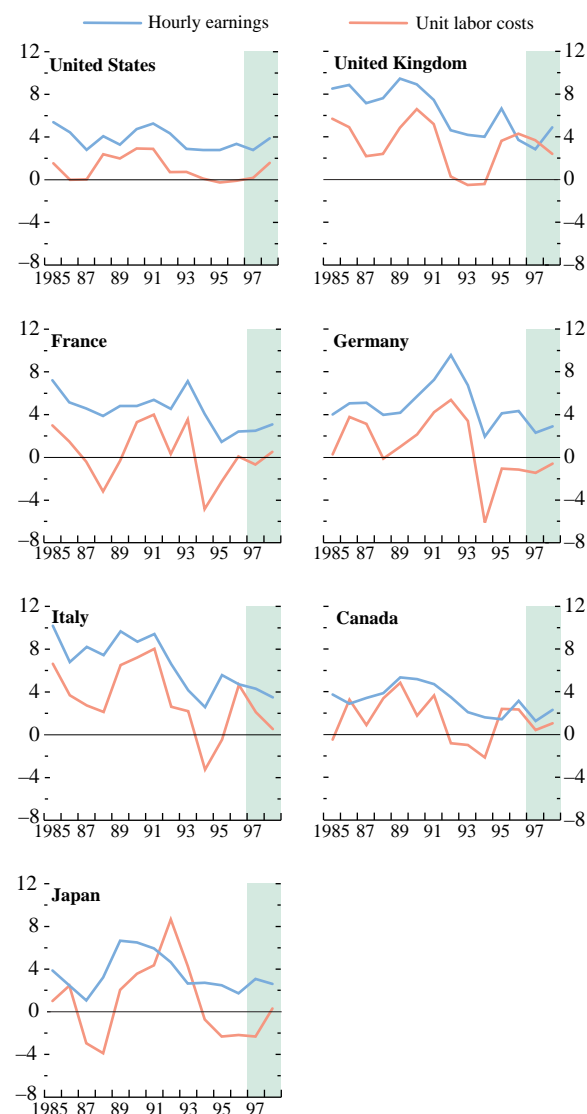
clining to ¥121 per U.S. dollar in early September. Among other major currencies, the pound sterling initially continued the strong advance that began in August 1996, rising by a further 12 percent against the deutsche mark between April and early August before a partial correction. In contrast, the German, French, and other closely linked currencies weakened against other major currencies in the period until early August partly due to perceptions that cyclical divergences between continental Europe and the United States had continued to widen. Concerns about a possible tightening of monetary policy in Germany subsequently prompted a moderate rebound in these currencies. Reflecting these divergent movements, the U.S. dollar has weakened moderately on balance against the yen since the spring but strengthened further against major continental European currencies.

An important factor underlying recent movements in the yen has been changes in the market's assessment of progress in Japan's economic recovery and of prospects for a narrowing of the divergence between the cyclical positions of the Japanese and U.S. economies. Earlier in the year, the yen weakened further as growth strengthened in the United States and concerns continued about prospects for sustained economic recovery in Japan. Reflecting these developments, long-term interest rate differentials between the two countries widened to 480 basis points in early April, as yields fell to new historic lows in Japan at the same time as concerns about a need for monetary tightening contributed to rising yields in the United States. In late April, however, market sentiment about the economic outlook in Japan began to improve, and Japanese bond yields rose, reflecting expectations that the Bank of Japan might raise official interest rates later in the year. At the same time, early indications that U.S. growth had slowed in the second quarter led to reduced expectations of further increases in the federal funds rate, and long-term interest differentials between the United States and Japan narrowed to less than 400 basis points by early July. In addition to these factors, the rise in the yen came shortly after the finance ministers and central bank governors of the seven major industrial countries in a public statement reaffirmed their view that major misalignments had been corrected and emphasized the importance of avoiding exchange rates that could lead to the reemergence of large external imbalances. Indications of a widening in Japan's trade surplus also may have contributed to the rebound. Subsequently, however, doubts about the strength of the Japanese recovery reemerged amid signs that household spending was taking longer than expected to rebound from the April tax hike, and Japanese bond yields retraced the increases of the spring to reach new lows. These developments, combined with renewed signs of strength in the U.S. economy, and concerns about the effects of currency turmoil in Southeast Asia, saw the yen fall

Figure 12. Major Industrial Countries: Average Earnings and Unit Labor Costs in the Manufacturing Sector¹

(Annual percent change)

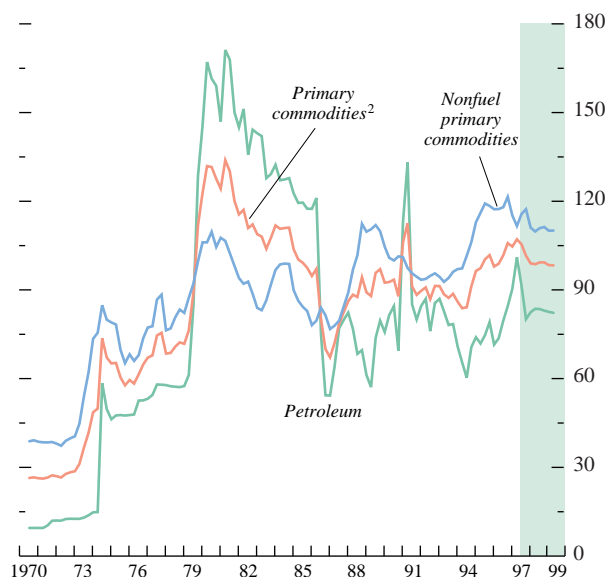
Wage growth has remained low relative to the late 1980s, particularly in continental Europe, Canada, and Japan where unemployment is high.



¹Shaded areas indicate IMF staff projections.

Figure 13. Commodity Prices¹*(In U.S. dollars; 1990 = 100)*

In the first half of 1997, the price of petroleum decreased sharply, but the price of nonfuel primary commodities increased.



¹Shaded area indicates IMF staff projections.

²The weights are 57.7 percent for the index of nonfuel primary commodities and 42.3 percent for the index of petroleum prices.

back again by early September, particularly against the U.S. dollar, though it remained significantly above its earlier lows on a multilateral basis.

In the case of the U.S. dollar, the overall effect of bilateral exchange rate movements between April and early September largely netted out such that the dollar appreciated only modestly on a nominal effective basis. While the dollar depreciated against the yen, it appreciated moderately in terms of the currencies of most other industrial countries. The dollar also strengthened against the currencies of developing countries in Asia, while weakening slightly against those of other developing countries. Taking a somewhat longer-term perspective, the nominal and real effective values of the U.S. currency in August remained above their levels at the end of 1996 and were moderately above their 1990–96 ranges. If the dollar were to remain near or above recent levels for an extended period, the U.S. current account deficit would be likely to widen again over time, which could raise concerns about the growth of U.S. external debt and medium-term sustainability. For the short run, however, the dollar's continued strength is a reflection of the relative cyclical position of the U.S. economy and is helpful to the containment of demand and inflationary pressures.

Short-term cyclical factors also provide a major part of the explanation for the steep rise in the pound sterling in the year to early August 1997, when it reached levels moderately above its trading range against the deutsche mark in the early 1990s prior to its withdrawal from the ERM. On a real effective basis, the pound sterling strengthened by about 25 percent over this period, reaching its highest level since the early 1980s in July. Beginning in early August, there was a moderate correction prompted by diminished expectations of further U.K. monetary tightening and concerns about export competitiveness. Sterling's appreciation since the middle of 1996 has been helpful from the viewpoint of dampening near-term inflation risks in the United Kingdom, but it has adversely affected the United Kingdom's international competitiveness and is expected, if sustained, to lead to a reversal in the period ahead of the recent improvement in its current account balance. Existing long-term interest differentials suggest that market participants expect sterling to depreciate somewhat over the medium term against other major currencies, a view that seems broadly consistent with an assessment of the requirements of external and internal balance in the economy over the longer term.

Prior to the yen's rebound in May, it had fallen by more than 30 percent in both real and nominal effective terms from its April 1995 peak, to its lowest level since early 1993. While a major part of this decline reflected an appropriate correction of the yen's earlier overshooting, the fall in the yen has also provided an important boost to the traded goods sector at a time

when the Japanese economy has been struggling to recover from its prolonged slowdown. Nonetheless, the continued depreciation in the first four months of 1997 appeared to take the yen to a level that, if maintained, was likely to bring a widening current account surplus that might not have been well justified by Japan's underlying economic fundamentals. From a medium-term perspective, therefore, the moderate net strengthening of the yen since the spring seems appropriate (see also Box 2).

For Germany, while bilateral movements in the deutsche mark against the dollar and the yen in recent years have been quite large, they have to a significant degree been mutually offsetting, and the fluctuations in real effective terms have been relatively modest, reflecting also the large weight given to Germany's major European trading partners. In 1997, the deutsche mark has weakened moderately in both nominal and real effective terms, continuing a trend evident since early 1995. However, it has generally remained above its levels of the early 1990s in real effective terms. On this basis, the continued downward movement in the deutsche mark may be viewed partly as a continuation of the reversal of the appreciation that came in the wake of German unification. It appears to be broadly consistent with the relative cyclical position of the German economy, without raising significant concerns from a medium-term perspective.

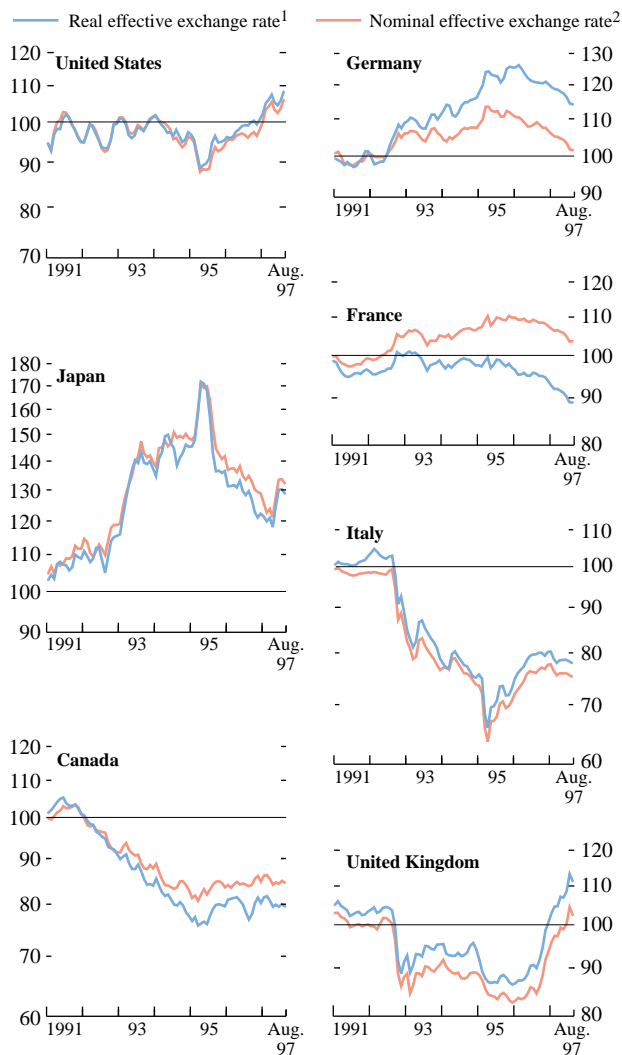
What Factors Are Behind Recent Speculative Attacks on the Currencies of Some Emerging Market Economies?

In recent months, the currencies of several developing and transition economies in Asia and eastern Europe have come under severe downward pressure. In Asia, the strongest pressures emerged initially in Thailand where concerns about the sustainability of the existing exchange rate peg to a basket dominated by the U.S. dollar prompted a run on the currency in mid-May. Thailand had encountered periodic episodes of speculation against the baht over the previous year, but on this occasion there were significant spillover effects on other countries in the region, notably Indonesia, Malaysia, and the Philippines. In eastern Europe, the currencies of the Czech and Slovak Republics came under attack in April, with limited spillover effects on some neighboring countries. In each case, the authorities sought initially to defend the currency concerned through a combination of exchange market intervention and domestic interest rate hikes. In addition, administrative restrictions aimed at limiting the scope for exchange market speculation by nonresidents were introduced in some cases. Except in the Slovak Republic, these measures were not sufficient to ward off the exchange market pressures and the respective authorities were forced to abandon their

Figure 14. Major Industrial Countries: Effective Exchange Rates

(1990 = 100; logarithmic scale)

After declining to the level of early 1993, the yen rebounded sharply in late spring; the U.K. pound has continued the strong advance that began in August of 1996.



¹Defined in terms of relative normalized unit labor costs in manufacturing, as estimated by the IMF's Competitiveness Indicators System, using 1989–91 trade weights.

²Constructed using 1989–91 trade weights.

previous exchange rate arrangements and allow their currencies to depreciate. The Czech authorities abandoned the band for the koruna in late May, and in early July the Thai baht and, shortly thereafter, the Philippines peso were allowed to float. Pressures subsequently intensified on the Malaysian ringgit and the Indonesian rupiah, both of which depreciated sharply in July and August; the Indonesian authorities abandoned their band for the rupiah in mid-August.

What factors explain the emergence of speculative pressures in these countries? Looking first at Thailand and the Czech and Slovak Republics, where the initial exchange rate pressures were most severe, all three had been running very large external current account deficits—ranging from 8 to 10 percent of GDP in 1996. Moreover, like a number of other countries in Asia and eastern Europe, all three had recently experienced sluggish export growth, so that a significant narrowing of their external deficits was not expected in 1997. Neither theory nor experience suggests some definitive threshold level for the current account deficit that may be expected to trigger an external crisis.⁹ Rather, the trigger point is likely to depend upon the circumstances and characteristics of the economy in question, including its exchange rate policy, its degree of openness, its saving and investment behavior, the nature of the capital flows financing its balance of payments deficit, and the health of its financial system. In addition, changes in the external environment—for example, a rise in global interest rates—and contagion effects from disturbances elsewhere can play an important role.

While the parallels between Thailand and the Czech and Slovak Republics should not be overstated, there are also some other noteworthy common characteristics. All three had recently experienced a sustained real effective exchange rate appreciation, reflecting domestic inflation above that of major trading partners, combined in the case of Thailand with a nominal effective appreciation resulting from the baht's close link to the U.S. dollar. The combination of a rising real effective exchange rate and a large and widening current account deficit may have increased the perceived risk of a crisis, and prompted concerns about medium-term sustainability. The composition of recent external financing also appears to have been a contributing factor in these cases. Private foreign borrowing constituted the major source of external financing, with foreign direct investment playing a relatively minor role, especially in Thailand (albeit only in recent years) and the Slovak Republic. A reliance on external borrowing (denominated in foreign currency) increases the econ-

omy's exposure to exchange rate risk and may also make it more vulnerable to a sudden reversal of capital inflows, particularly if there is heavy reliance on short-term borrowing. On the domestic front, as far as saving-investment balances are concerned, fiscal imbalances do not appear to have been an important contributing factor in these cases, though there has recently been a weakening in the budget of the Slovak Republic. However, economic growth had slowed recently in Thailand and the Czech Republic, which may have raised doubts about the authorities' continued willingness to support the exchange rate by maintaining high interest rates. Finally, there have been concerns in all these countries about financial sector fragility. These concerns reflected ongoing issues linked to the reform process in eastern Europe, whereas in Thailand they were related partly to the previous rapid growth in property-based lending, large unhedged corporate foreign indebtedness, and the effects of the economic slowdown.

As in the Mexican crisis, recent developments demonstrate the tendency for a crisis in one country to have spillover effects on other countries where common risk factors are perceived by financial markets as being present. This phenomenon has been dramatically illustrated by the recent experience of Indonesia, Malaysia, and the Philippines. All three countries have been growing strongly and, until recently, had been the recipients of large private capital inflows. However, developments in Thailand focused market attention on the existence of common risk factors in these countries, including real currency appreciation against a background of relatively inflexible exchange rate arrangements and sizable although significantly smaller current account deficits, large external indebtedness, and rapid domestic credit growth linked in part to booming property and construction sectors. Contagion effects from the difficulties in Thailand surfaced initially in equity markets, particularly in Malaysia and the Philippines, which turned down early in 1997. However, the pressures spread quickly to exchange markets in July and August after the large depreciation of the Thai baht put in question the sustainability of existing exchange rates in neighboring countries. Thereafter, the downward pressures on financial markets in the region became self-reinforcing to some extent, partly reflecting uncertainties about the effects on growth of the combination of exchange rate weakness, higher interest rates, and falling asset prices.

As of early September, broader spillover effects from the recent currency crises on other emerging market economies remained fairly limited. In Asia, the Singapore dollar weakened moderately in July and August, and there were smaller declines in the New Taiwan dollar and the Korean won. The Hong Kong dollar also briefly came under pressure in mid-August. Equity prices generally weakened across the region in

⁹For example, see Gian Maria Milesi-Ferretti and Assaf Razin, "Current Account Sustainability," *Princeton Studies in International Finance*, No. 81 (Princeton, New Jersey: Princeton University, October 1996).

July and August. In eastern Europe, the Polish zloty weakened in mid-July on concerns about flood damage and a deterioration in the current account position against a background of rapidly expanding domestic demand. Of note, however, is that Hungary avoided significant adverse effects; this appears to reflect the success of the policies the authorities have implemented since 1994 to correct an earlier, unsustainably large current account deficit.

Despite the recent difficulties experienced in some individual cases, there have been no indications so far of a broad-based disruption of capital flows to developing countries, which reached a record high in 1996 and remained strong in the first seven months of 1997. Notably, flows to Latin America appear to have been relatively unaffected, reflecting a general improvement across the region in terms of the vulnerability factors that sparked the Mexican crisis, although current account positions have weakened in some cases. Flows to other developing countries have also remained strong. While the overall outlook for capital flows to developing countries remains broadly positive, recent events should serve as a further warning of the potential for sudden reversals in cases where markets perceive that the external position has become unsustainable. The trigger point for such reversals is difficult to predict in advance, depending on country-specific factors as well as external developments and market sentiment. But the best defense against such developments is the pursuit of policies that address the emergence of imbalances before they reach levels that may be perceived as unsustainable.

Advanced Economies

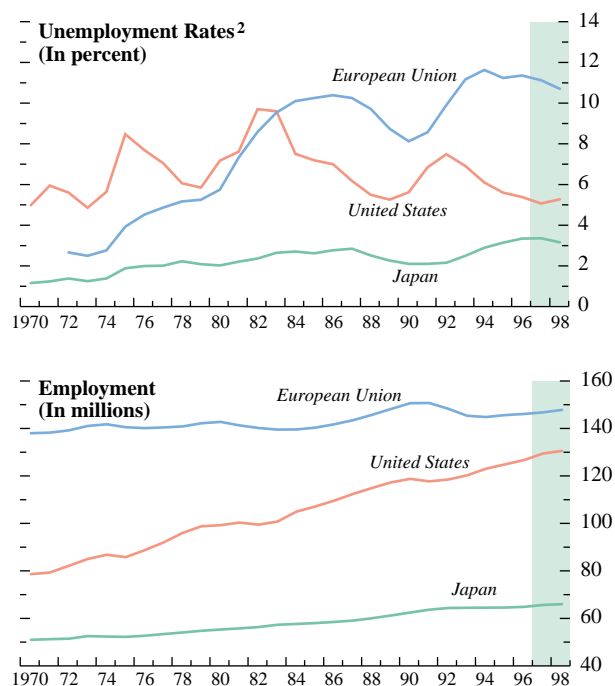
What Are the Prospects for a Decline in European Unemployment?

Unemployment in the European Union has continued on its upward trend and is currently at 11¼ percent—more than twice the unemployment rate in the United States and more than three times the rate in Japan. These contrasts in unemployment levels are mirrored in differences in job creation. Civilian employment in both the United States and Japan increased by more than 50 percent between 1970 and 1996, whereas employment in the EU barely budged (Figure 15).

While average labor market performance in the EU has been dismal over the last two decades, over the past five years unemployment in some EU countries has declined significantly (Figure 16). Unemployment has fallen most sharply in the United Kingdom, to 5½ percent in July from a peak above 10 percent in 1993, but also noticeably in the Netherlands, Denmark, and Ireland. Labor market developments in these countries provide a striking contrast with those in, for instance,

Figure 15. Selected Advanced Economies: Employment and Unemployment¹

The European Union's labor market performance since the mid-1990s has been weak compared with the United States and Japan.



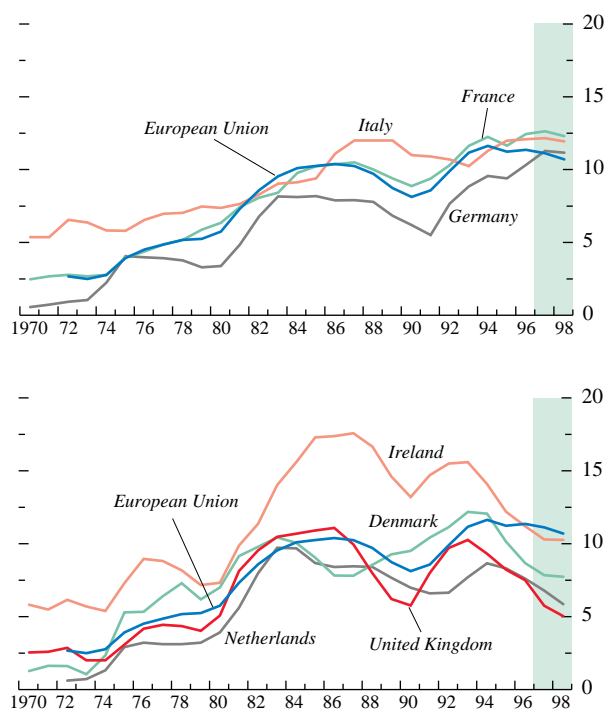
¹Shaded areas indicate IMF staff projections.

²Based on national definitions.

Figure 16. Selected Advanced Economies: Unemployment Rates¹

(In percent)

Unemployment has reached new peaks in the European Union, and in Germany, France, and Italy. In the United Kingdom, the Netherlands, Denmark, and Ireland, however, unemployment has declined.



¹Based on national definitions. Shaded areas indicate IMF staff projections.

Germany, France, and Italy, where unemployment has continued to rise through the 1990s to postwar peaks.

The declines in unemployment in the former group of countries have been due in part to cyclical developments. In Ireland, in particular, the rapid growth of output—about 7 percent a year—has been the primary source of the sharp fall in unemployment since 1994. In Denmark and the United Kingdom, declines in labor force participation rates have also contributed to the reductions in joblessness in this period.¹⁰ In these cases, while labor market performance has clearly improved, the declines in unemployment that have occurred exaggerate the degree of structural improvement. Nevertheless, in the United Kingdom and also in the Netherlands, structural unemployment (which may be defined as that rate of unemployment at which inflation would be stable) has declined, as a result of comprehensive labor market reforms.¹¹ Further modest declines in unemployment are projected for the United Kingdom (to 5 percent on average in 1998) and the Netherlands (to just under 6 percent). In contrast, despite a strengthening of economic growth to somewhat above potential rates in the year ahead, unemployment is projected to decline only slightly in Germany, France, and Italy (see Figure 16). For the EU as a whole, unemployment is forecast to decline only slightly, to just under 11 percent on average in 1998, indicating that for the area as a whole the combination of growth and labor market reforms will be insufficient to make a significant dent in unemployment in the short to medium term; little increase is projected in total employment.

High structural unemployment in the EU has been attributed to a variety of labor market laws and norms that have had the effect in many countries of discouraging both employers from hiring workers and workers from actively seeking employment. High unemployment benefits paid for relatively long spells and minimum social benefits of often unlimited duration tend to discourage workers from actively seeking employment, and in some instances from accepting employment when job offers are made; minimum wages that are set too high hamper the employment

¹⁰In Denmark, participation rates have fallen owing to increased early retirement of older long-term unemployed persons before the elimination of a special early retirement scheme, and also as a result of provisions for sabbatical, parental, and educational leave. In the United Kingdom, in the current cyclical upswing since 1992 labor force participation has declined reflecting both increased early retirement and increased participation in higher education.

¹¹According to IMF staff estimates, structural unemployment declined in the United Kingdom from 8½ percent in 1985 to 5¾ percent in 1997 and in the Netherlands from about 7½ percent in 1985 to about 6¼ percent in 1996. An important feature of developments in the Netherlands is that while the labor force participation rate has risen gradually over the past decade, from around 56 percent in the mid-1980s to about 62 percent, it is still significantly lower than in most other advanced economies. See also in this context, the discussion in OECD, *Implementing the OECD Jobs Strategy*.

prospects of young workers and unskilled workers; and restrictive rules concerning hiring, firing, and the nature of work contracts that employers can offer, together with high payroll taxes, tend to lower the incentives for employers to expand employment. In some EU countries, centralized wage negotiations that compress wage differentials tend to have adverse effects on the employment prospects of unskilled workers, and also on productivity growth, because employers are constrained from offering remuneration schemes that correspond to their individual needs. Moreover, because of such laws and norms, increases in unemployment resulting from adverse shocks tend to become entrenched. In the meantime, efforts to reduce unemployment through work sharing and early retirement are further strengthening the bargaining position of insiders at the expense of outsiders. Thus, each negative shock raises the unemployment rate a notch further, and leaves in its wake a pool of long-term unemployed.¹²

Several countries in the EU have made attempts to reform their labor markets. Arrangements for the indexation of wages in Italy were eliminated in the early 1990s, and the replacement ratio for unemployment benefits was reduced in France in 1993 and in Germany in 1994. Except in a few countries, however, of which the United Kingdom and the Netherlands are the clearest examples, there has been very little success in reducing structural unemployment. How does one explain the persistence of labor market problems in most EU countries despite attempts at reform? One reason for the lack of success appears to be the piecemeal nature of the labor market reforms undertaken in many countries. The solution to the EU's structural unemployment problem appears to lie in comprehensive reforms of policies and institutions affecting the labor market. For instance, policies to reduce unemployment benefits, without simultaneous liberalization of the rules for hiring and firing, or reduction in payroll taxes, may bring little benefit in terms of lower unemployment. This is because while workers may tend to seek employment more actively because the benefits regime has been tightened, employers may still be reluctant to hire many more workers even at the lower wages now acceptable to them because their own incentives to provide jobs have not changed. In a similar vein, policies to increase education and training may

make little dent in youth unemployment if minimum wages are set too high.¹³

In contrast to the piecemeal nature of labor market reforms in most EU countries, comprehensive reforms were introduced in both the United Kingdom and the Netherlands, beginning in the early 1980s. The reforms instituted in the United Kingdom in stages through the 1980s were probably the more comprehensive. The Employment Acts of 1980 and 1982, and the Trade Union Act of 1984 progressively reduced the bargaining power of trade unions at both the national and the industry level. Hiring and firing laws were liberalized, and secret balloting of employees was made mandatory before strikes. Further, minimum wage laws were abolished for all categories of workers except agricultural workers, unemployment benefits were reduced to one of the lowest rates in Europe, and changes to other income support measures were designed to increase incentives to seek employment.¹⁴

The Netherlands also began reforming its labor markets in the early 1980s. The replacement ratio for unemployment benefits was reduced from 80 percent to 70 percent and the eligibility requirements for receiving benefits were tightened. The requirements for receiving disability benefits were also made more stringent in the mid-1980s. Further, minimum wages were reduced for both adult and young workers, with the result that by 1996 the gross real minimum wage for adults was 22 percent lower than in 1979, while the gross minimum wage at age 18 was 43 percent lower. As in the United Kingdom, measures were taken in the early 1980s to decentralize wage bargaining. However, the extent of decentralization is debatable; and wage moderation appears to be attributable mainly to a change in industrial relations that was sustained by government policies, rather than reforms of the bargaining system per se. Other measures to reform the labor market include measures taken in the 1990s to reduce nonwage labor costs, especially for low-skilled workers. More recently, employers' social contributions for low-skilled workers, who had previously been long-term unemployed, have been virtually eliminated. Despite significant progress with labor market reforms in the Netherlands, replacement ratios remain high relative to other advanced economies and labor force participation rates remain relatively low.

In both the Netherlands and the United Kingdom, unemployment fell sharply during the years of rapid growth in the 1980s, in contrast to the experience in many other EU countries. The contrast between the

¹²This phenomenon of trend unemployment ratcheting up with each adverse shock is referred to as "hysteresis." See the discussions in P.R.G. Layard, S.J. Nickell, and Richard Jackman, *Unemployment, Macroeconomic Performance and the Labour Market* (Oxford, England; New York: Oxford University Press, 1991); Olivier Blanchard and Lawrence Summers, "Hysteresis and the European Unemployment Problem," *NBER Macroeconomics Annual* (Cambridge, Massachusetts: MIT Press, 1986), pp. 15–78; and Charles R. Bean, "European Unemployment: A Survey," *Journal of Economic Literature*, Vol. 32 (June 1994), pp. 573–619.

¹³David T. Coe and Dennis Snower, "Policy Complementarities: The Case for Fundamental Labor Market Reform," *Staff Papers*, IMF, Vol. 44 (March 1997), pp. 1–35.

¹⁴For a more detailed discussion see Ramana Ramaswamy and Eswar Prasad, "Shocks and Structural Breaks: Labor Market Reform in the United Kingdom," IMF Working Paper 94/152 (November 1994).

labor market performance of the United Kingdom and the Netherlands, on the one hand, and the rest of the EU, on the other, is even starker in the 1990s. Unemployment in both the United Kingdom and the Netherlands began to decline much earlier in the current economic upswing than in the 1980s, whereas the recent recovery in output has been virtually jobless in a number of other EU countries. A possible interpretation of these developments in the United Kingdom and the Netherlands is that the full impact of labor market reforms occurs only with considerable lags.¹⁵

The experience of the United Kingdom, the Netherlands, and the rest of the EU suggests that unless reforms to labor markets are comprehensive in nature, the current recovery in output is likely to have only a marginal impact in reducing unemployment. Moreover, even if such comprehensive reforms are undertaken currently, it will take a number of years for the reforms to have a favorable impact on EU labor markets.

How Strong Is the Japanese Recovery?

Following four years of below-trend growth, the performance of the Japanese economy in 1996 provided encouraging evidence that the recovery was becoming self-sustaining. Despite an apparent pause in the middle of last year—which was partly related to difficulties in adjusting statistics for the effects of the leap year—GDP growth reached 3½ percent in 1996 as a whole. Growth was supported by stimulative fiscal and monetary policies, but also reflected signs that the underlying structural imbalances that had impeded the recovery in previous years had begun to wane. Substantial progress with balance sheet and capital stock adjustments also helped foster a substantial pickup in business investment. Household consumption and residential investment strengthened considerably in response to a rebound in employment and labor income growth from the low levels of recent years, as well as a rise in confidence following the Kobe earthquake and terrorist attacks in 1995. By the latter half of 1996, the correction of the yen's overvaluation, which had peaked in mid-1995, also meant that the external sector was no longer acting as a drag on aggregate activity.

Nonetheless, considerable questions emerged late last year regarding the underlying strength of the recovery, and they have persisted in 1997, principally reflecting uncertainties about the magnitude and timing of the impact on aggregate demand of the substantial fiscal consolidation envisaged in the FY 1997 budget. These uncertainties have also fed on, and con-

tributed to, weaknesses in financial markets. While GDP growth surged in the first quarter, reaching 5¾ percent at an annual rate, this largely reflected anticipatory household demand ahead of the April consumption tax hike. This increase was more than reversed in the second quarter as private consumption and residential investment dropped sharply with the unwinding of the earlier surge in demand. The volatility of economic activity during the first half of the year has made it difficult to judge the underlying momentum of the recovery or to gauge the near-term impact of fiscal consolidation. Confidence remains weak, and stock prices have again softened in recent months. Moreover, there is concern that recent financial and economic difficulties in Southeast Asia could adversely affect economic prospects in Japan, although the magnitude of the effect on Japan's growth is unlikely to be large.

But there are also a number of factors that are positive for Japan's growth prospects. In particular, past exchange rate movements will spur external demand, improvements in labor market conditions are likely to support household demand, and continued easy monetary conditions should bolster private investment.¹⁶ Moreover, the sharp drop in public investment that already occurred in the latter half of 1996 and the first quarter of 1997 suggests that much of the impact of fiscal adjustment may already have been felt. However, in view of the sharp drop in activity in the second quarter, growth would still average only a little over 1 percent for 1997 as a whole—implying a widening of the output gap (Figure 17)—before rising to just over 2 percent in 1998.

Furthermore, concerns that difficulties in the Japanese banking sector may act as a significant drag on activity appear to have diminished. Record profits during the past two years have allowed most banks to make significant progress in writing off nonperforming loans and provisioning against future losses. Concerns regarding the health of the major banks, which intensified in late 1996, appear to have eased with the announcement of restructuring plans for two of the weakest banks. The government has also taken significant steps to restore confidence in the financial sector. Supervisors have closed or restructured a number of smaller institutions. Measures were introduced in 1996 to resolve insolvent housing loan corporations (the *jusen*), strengthen the supervisory and regulatory framework, and to recapitalize the deposit insurance system. An independent supervisory agency has also been established, which will begin operations in the first half of 1998.

¹⁵For a discussion of the lagged responses to policy changes, see S.G.B. Henry and Dennis Snower, eds., *Economic Policies and Unemployment Dynamics in Europe* (Washington: IMF, 1996).

¹⁶For a discussion of the IMF staff's estimates of monetary and financial conditions indices, see Gabrielle Lipworth and Guy Meredith, "Indicators of Monetary and Financial Conditions: A Reexamination," in *Japan—Selected Issues*, IMF Staff Country Report 96/114 (October 1996).

Taking all these factors into account, it seems reasonable to expect that Japan's economic recovery will resume at a moderate pace in the remainder of 1997 and proceed more steadily in 1998 than over the past one and one-half years.

Developing Countries

Are Economic Recoveries in Latin America and Sub-Saharan Africa Sustainable?

In the developing world, some of the clearest improvements in growth performance and prospects in recent years have occurred in the Western Hemisphere and sub-Saharan Africa. In the Western Hemisphere, growth picked up to 3½ percent last year following the slowdown associated with the Mexican crisis and is projected at 4–4½ percent in 1997–98, well above average growth in the 1980s and early 1990s. In sub-Saharan Africa, growth reached 4½ percent last year, its highest rate in two decades, having strengthened steadily since 1992; and it is projected to remain in the 4–5 percent range in 1997–98.

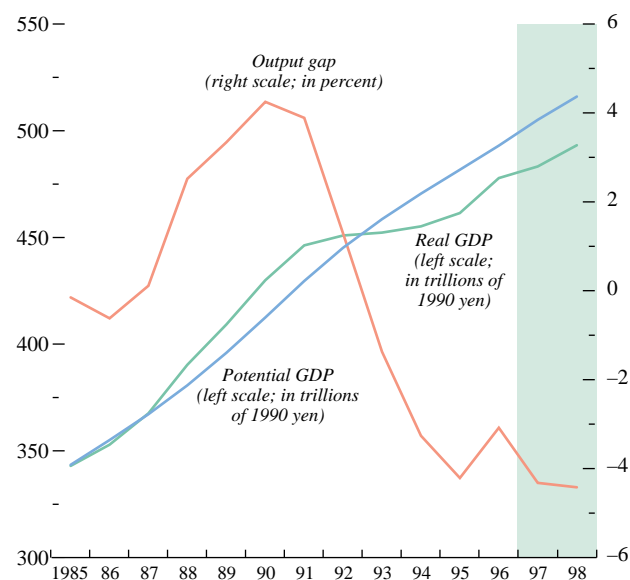
Over the past decade or so, countries in both regions have implemented more disciplined financial policies, adopted fiscal reforms aimed at reducing the size of the public sector, and introduced financial, exchange market, trade, and other structural reforms to increase private sector participation in the economy. In response, inflation has ebbed in both regions, private investment has picked up, and countries have rapidly regained access to international capital markets, although such access remains uneven and is markedly less for most countries in sub-Saharan Africa than in Latin America. While these improvements are encouraging, questions still lurk regarding their sustainability. Since 1985, Latin America has already witnessed two pronounced economic cycles. Is the current recovery the beginning of another? Is the stronger growth performance of countries in sub-Saharan Africa merely a result of more favorable weather and external conditions or a consequence of improved economic policies?

The current recovery in Latin America represents the third instance of improved growth performance following a downturn since the debt crisis of 1982.¹⁷ The 1996–97 recovery is similar to the first two years of the previous two recoveries—1984–85 and 1991–92—in that private domestic demand has fueled growth (Table 9). And, as in 1991–92, the recent upswing has resulted in a widening of the current account deficit, which has

¹⁷In Chile, which is excluded from the following discussion, growth has been sustained since the mid-1980s, and it is expected that the prudent macroeconomic policies and structural reforms that contributed to this performance will continue to deliver steady improvements in living standards, provided risks from overheating pressures are minimized.

Figure 17. Japan: Output Developments¹

After an encouraging performance in 1996, Japan's recovery seems likely to slow temporarily in 1997–98.



Sources: National authorities; and IMF staff estimates.

¹Shaded area indicates IMF staff projections.

Table 9. Selected Latin American Countries: Macroeconomic Indicators of Cyclical Change¹*(Annual average, in percent of GDP unless otherwise noted)*

	1983 Slowdown	1984–85 Recovery	1990 Slowdown	1991–92 Recovery	1995 Slowdown	1996–97 ² Recovery
Growth ³	-3.7	4.8	0.5	2.6	0.4	3.9
Contributions to growth						
Foreign balance	3.8	0.9	-1.1	-0.8	-0.6	-1.3
Domestic demand	-7.4	3.8	1.6	3.4	0.9	5.1
Public consumption	-0.1	0.4	0.9	-0.4	1.0	0.2
Private consumption	-2.1	2.3	1.0	2.4	1.2	2.9
Gross investment	-4.6	0.8	-0.5	0.7	-0.4	1.8
Government consumption	9.8	9.4	12.7	12.0	13.7	13.5
Private consumption	67.0	66.7	65.1	68.1	66.6	66.7
Private investment	13.9	14.2	17.2	16.3	16.6	17.0
Net private capital flows	-1.7	-0.4	1.4	3.3	1.7	4.7
Current account balance	-1.4	-0.2	-1.0	-1.6	-2.3	-3.1
Central government fiscal balance	-4.0	-3.2	-0.1	-0.1	-1.6	-1.7
Private saving	15.9	15.7	14.7	13.6	16.0	15.6
Total saving	19.0	20.0	20.0	18.0	17.6	17.6
Consumer prices (median) ³	111.1	136.8	2,314.7	99.4	20.9	10.5
Real effective exchange rate ³	-14.9	2.1	16.6	-0.3	-6.8	5.9
External debt	50.9	48.8	35.8	35.5	38.2	34.9

¹Comprises Argentina, Brazil, Colombia, Mexico, and Peru.²IMF staff estimates for 1997.³Annual percent change in real GDP.

been financed by a resurgence of capital inflows. In other ways, however, the current recovery is distinctive. Most important, during the current recovery inflation has been far lower than previously. While the success of Brazil's real plan and Argentina's currency board arrangement stand out as especially noteworthy achievements, inflation in almost all countries has fallen to exceptionally low levels by historical standards. In addition, although, as in the previous two recoveries, consumption has been a primary contributor to growth, in the current recovery, investment has also played a significant role in the expansion.

Recent economic success in Latin America reflects not only disciplined financial policies but also substantial progress since the early 1990s in reforming government pension plans, de-indexing wages, restructuring and privatizing state enterprises,¹⁸ and sustained trade reforms including progress in the reduction of nontariff barriers, and of the level and dispersion of import tariff rates.¹⁹ While this has created an environment more conducive to growth led by the private sector, a "second generation of reforms"—as discussed in Chapter I—is needed in most cases, to improve the quality of public expenditure, to create more transparent and equitably enforced regulatory

systems, and to improve governance in other aspects. This is in addition to the need to promote labor market flexibility and restructure banking sectors—making them less susceptible to systemic failures via stronger prudential regulation and more effective supervision. Although the low inflation, and higher investment rates in the current upswing are positive signs, the larger current account deficits, financed by record capital inflows, and the associated real exchange rate appreciations in some cases call for vigilance. If the second generation of reforms is aggressively implemented, then the improved economic fundamentals of the current recovery, combined with continued fiscal and monetary restraint, may not only help to maintain steady growth but even lead to faster growth.

In sub-Saharan Africa, two features of the recent improvement in economic performance stand out. First, the strengthening of growth has been increasingly broadly based across countries. While in 1992 only 17 of the 47 countries in the region recorded more than 3 percent growth, by 1995 the number had increased to 29, and it is expected to increase to 35 in 1997 (Table 10). Second, although a majority of countries during 1995–96 faced adverse trade shocks, domestic factors including improved macroeconomic policies and structural reforms—which were adopted in a large cross-section of countries—contributed to a significant share of the higher growth and lower inflation. Nevertheless, economic success remains unevenly distributed across countries. In Ethiopia, Ghana, Malawi, and Uganda significant progress has been made in increasing the role of the private sector and improving macroeconomic discipline. In many of the

¹⁸Some recent examples include the large privatization programs in Chile and Peru, privatization of railways and utilities in Argentina, divestiture of two major airlines, one of the world's largest copper mines and telecommunications in Mexico, and large-scale privatization under way in the telecommunications, mining, and electricity sectors in Brazil.

¹⁹In 1996, Brazil imposed some temporary restrictive measures.

Table 10. Sub-Saharan Africa: Recent Economic Developments and Their Distribution*(Annual percent change unless noted otherwise)*

	1990	1991	1992	1993	1994	1995	1996	1997
Average growth in real GDP	2.1	1.5	0.7	1.9	2.6	3.8	4.5	4.1
Number of countries with								
Negative growth	18	15	17	15	10	9	4	1
Positive growth	29	32	30	32	37	38	43	46
Less than 3 percent	8	14	13	12	11	9	9	11
Greater than 3 percent	21	18	17	20	26	29	34	35
Average change in terms of trade	2.4	-1.7	-2.5	-0.3	2.1	-1.8	-1.2	-1.3
Number of countries with								
Terms of trade deterioration	28	28	29	24	22	23	34	29
Terms of trade improvements	19	19	18	23	25	24	13	18
Average net private capital inflows (in percent of GDP)	-1.3	1.8	0.2	0.6	2.2	2.5	2.0	1.1
Number of countries with								
Negative net private capital inflows	22	12	18	18	12	20	11	18
Positive net private capital inflows	25	35	29	29	35	27	36	29
Average rate of inflation	16.8	27.6	37.7	37.6	46.4	41.1	31.8	18.7
Number of countries with								
Less than 10 percent	23	23	22	27	12	17	28	33
Greater than 10 percent	24	24	25	20	35	30	19	14

CFA franc countries, the 1994 devaluation and accompanying policies restored external competitiveness, and more recent fiscal reforms have further strengthened the recovery process. In South Africa, sustained reform and stabilization along the lines of the authorities' announced strategy will be needed to enhance growth prospects, while in Nigeria major structural reforms continue to be needed for the economy to begin approaching its productive potential.

Taking into account the substantial progress in economic liberalization, fiscal reforms, and the opening of African markets to world trade through trade and exchange reforms,²⁰ there is a good chance that growth will continue at around recent rates or even strengthen further in the medium term. However, critical to this assessment is the assumption that the reforms are continued and deepened. Despite the generally positive signs, the region's economies remain fragile and vulnerable to external shocks and continue to face policy challenges in improving resource allocation and fostering higher saving and investment rates, which lag well behind those in the more successful developing countries.

What Challenges Lie Ahead for the Developing Countries of the Middle East, North Africa, and Europe Region?

In a number of developing countries in the Middle East, north Africa, and Europe region, economic

growth has picked up since 1995, and positive growth of per capita income has been restored. These developments stem to a large extent from progress with policies of macroeconomic stabilization and structural reform, which put the countries in good stead to meet a number of economic challenges in the short and medium term.²¹

Many countries in the region are expected to maintain solid growth in real GDP in 1997. The strongest expansions are taking place in Egypt, the Islamic Republic of Iran, Jordan, Lebanon, Tunisia, Turkey, and the Republic of Yemen, with growth rates in the 5–7½ percent range projected for 1997. Except for Turkey, these countries have made significant progress in lowering inflation, strengthening external balances, and reducing debt burdens. Excluding Turkey, where inflation is expected to continue at around 80 percent, average inflation is projected to fall to below 9 percent in 1997, the lowest rate since the early 1980s. Inflation is projected at around 6 percent or below in the majority of countries with some—including Jordan, Morocco, and Tunisia—achieving rates close to or below 4 percent. Aggregate debt and debt-service ratios for the region are projected to continue to decline in 1997, including for the major debtors such as Egypt, Jordan, and Yemen; debt-relief and debt-rescheduling operations for these countries have

²⁰For more details on exchange reforms see October 1996 *World Economic Outlook*, pp. 70–71.

²¹See IMF, *Building on Progress: Reform and Growth in the Middle East and North Africa* (Washington, 1996); and Mohamed El-Erian, Sena Eken, Susan Fennell, and Jean-Pierre Chaffour, *Growth and Stability in the Middle East and North Africa* (Washington: IMF, 1996).

improved the investment climate and should strengthen growth prospects.

Tighter fiscal policies, more prudent monetary policies, and the successful implementation of structural reforms have provided the underpinning of these countries' improved macroeconomic performance, allowing many countries to take advantage of an international environment that has been favorable in many respects. Fiscal deficits in many countries in the region have declined substantially. Progress toward fiscal consolidation has been particularly strong in the oil exporting countries and has been achieved mainly through a sharp curtailment of expenditures.²² Algeria is projected to record a second consecutive fiscal surplus in 1997, and Egypt is on its way to fiscal balance. A wide range of structural reforms in the financial, public finance, and exchange and trade areas, and also privatization are under way in Egypt, Jordan, and Yemen. The oil producing countries of the Gulf Cooperation Council have continued their efforts to diversify their production base and encourage greater private sector participation in the economy, including in refining and petrochemicals.²³

Improvements in growth rates in the medium term are likely to require increases in the share of investment in output, improvements in capital efficiency, and relatedly a shift in the composition of investment toward the private sector. In addition, the region's investment financing would need to depend less on short-term capital flows and volatile oil revenues, and more on internally generated sources of financing as well as on foreign direct investment.²⁴ Further structural reforms—including deregulation, trade reform, and, more generally, reducing the role of the government in the economy—are also essential to improve medium-term growth prospects. The success of these reforms hinges to some extent on a strengthening of public institutions. Countries of the region would also need to foster outward-oriented policies if high growth rates are to be sustained. In this regard, the acceleration of structural reform will allow the region to capitalize on the opportunities offered by the current rapid expansion of international trade and capital flows, the EU's Mediterranean Initiative, and the Uruguay Round. In particular, there is significant potential for

expanding non-oil exports and attracting more direct investment.²⁵

What Are the Prospects for Growth in the Indian Subcontinent?

Following the reform program that India initiated in 1991–92, growth in real GDP recovered, and then accelerated, registering about 7 percent a year in the period 1994–96 (Figure 18). There has been some recent deceleration in economic activity, concentrated in industrial production and stemming from weakness in investment and exports. Nevertheless, with agricultural performance benefiting from a favorable monsoon, projected growth for 1997 remains at 6½ percent, well above the average of 5 percent achieved in the 1980s. Inflation is expected to remain moderate, while the external position should continue to be comfortable with a current account deficit of less than 2 percent of GDP and private capital inflows continuing to be strong.

Investment growth slowed over the past year partly because of political uncertainties, but, more important, because of the public sector's continuing absorption of a significant portion of financial savings to finance its deficit, and the consequent high real interest rates. Among the factors underlying the marked weakness of recent export performance are more sluggish partner country demand, including in the Asia region, lower international diamond prices, and increased nontariff barriers in the European Union on Indian textile products. But it also reflects the dwindling expansionary impulse of the trade liberalization and exchange rate adjustment of the early 1990s. Deepening infrastructure problems, such as capacity constraints in roadways and ports, have also adversely affected both investment and export growth.

To sustain and improve its growth performance of the recent past and to reach its full potential, India will need not only to reduce the government budget deficit, but also to carry out a more comprehensive and deep-rooted second wave of reform measures. While significant progress in reforms has been achieved since 1991–92, such as in trade and exchange liberalization, reduction of tax rates, and industrial de-licensing, a wide range of reforms remain to be implemented.

Achieving higher growth in India over the medium term will depend on mutually reinforcing fiscal measures and structural reforms. On the fiscal front, the recent tax cuts should be complemented with measures to expand the tax base, cut subsidies, and increase ef-

²²For a discussion of developments in the oil exporting countries, see Cyrus Sassanpour, *Policy Challenges in the Gulf Cooperation Council Countries* (Washington: IMF, 1996).

²³The relationship between fiscal policy and growth in the Middle East and north Africa region is examined in more detail in Sena Eken, Thomas Helbling, and Adnan Mazarei, "Fiscal Policy and Growth in the Middle East and North Africa Region," IMF Working Paper (forthcoming).

²⁴The investment and saving performances of the region, including developments in total factor productivity are analyzed in Amer Bisat, Mohamed El-Erian, and Thomas Helbling, "Growth, Investment and Savings in the Arab World," IMF Working Paper (forthcoming); and Mohamed El-Erian, "The Middle East's Investment Challenge," *Middle East Policy*, Vol. 5, No. 2, pp. 194–99.

²⁵The relationship between globalization and growth prospects in the region is analyzed in Patricia Alonso-Gamo, Annalisa Fedelino, and Sebastian Paris Horvitz, "Globalization and Growth Prospects in Arab Countries," IMF Working Paper (forthcoming); and Said El-Naggar, ed., *The Uruguay Round and the Arab Countries* (Washington: IMF, 1996).

efficiency in the central and state government-run public enterprises, including through increased privatization efforts. Deeper trade reforms, including the dismantling of remaining quantitative restrictions and a lowering of average tariff rates to global levels, are needed to ensure strong medium term export performance. In the context of increasingly open capital markets, greater exchange rate flexibility may be needed as a component of a balanced response to potential surges in private capital flows. The move toward capital account convertibility envisaged by the authorities would offer substantial efficiency gains but should be phased in alongside further substantial progress in fiscal consolidation and banking and financial sector reform.

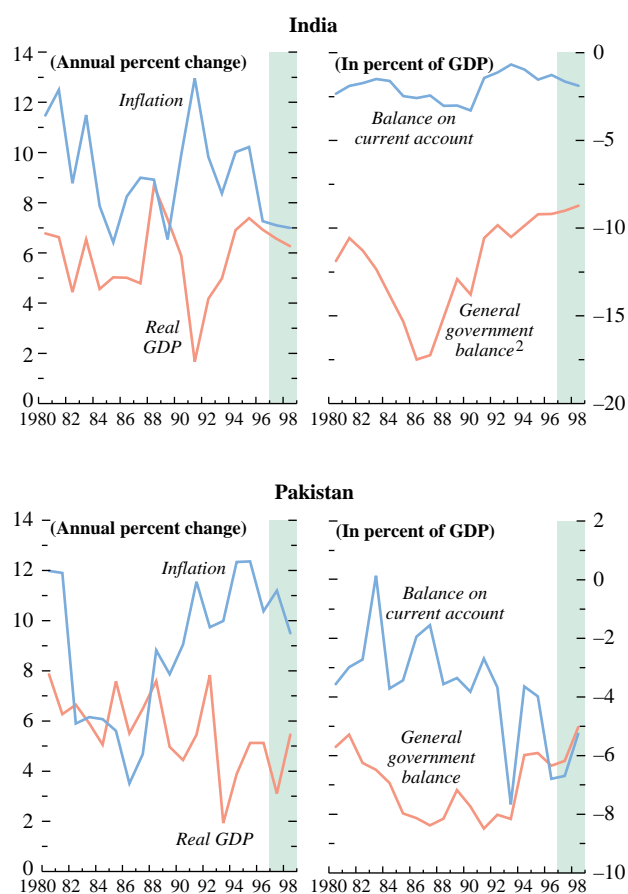
Turning to Pakistan, real GDP, after expanding at a brisk pace of about 6 percent a year in the 1980s, decelerated quite sharply in the early 1990s due to a combination of policy weaknesses and natural disasters, which caused a severe reduction in cotton production, the most important cash crop and export of the economy (see Figure 18). Despite a slowdown in imports resulting from the sharp decline in output growth in 1993, balance of payments difficulties emerged with the current account deficit rising to over 7 percent of GDP.

The government of Pakistan embarked on a program of macroeconomic adjustment and structural reform in 1993 to restore financial stability and economic growth in the economy. However, progress in implementing these policies during 1994 and 1995 was limited, particularly in the fiscal area where budget tightening measures were not sustained, administrative difficulties were encountered in tax collection, and further tax exemptions and concessions were granted. Because adjustment and reform efforts were not adequately sustained, the economy's balance of payments situation remained fragile, undermining private sector confidence.

Growth temporarily picked up in 1995 and early 1996. However, Pakistan's macroeconomic performance continued to be hindered by large financial imbalances. Reflecting the loose stance of fiscal policy, the balance of payments situation deteriorated during 1996. The trade deficit widened, private capital inflows weakened, and pressures on official reserves intensified. Facing widening macroeconomic imbalances and a threat of a foreign exchange crisis in the latter half of 1996, the authorities adopted a wide-ranging policy package to strengthen macroeconomic policies and implement structural reforms. The structural components of the policy package were strengthened substantially in the first half of 1997 in such areas as tariff reform, tax reform, and financial sector restructuring. These efforts hold promise of a recovery of GDP growth to the 5–6 percent range, as well as of a more stable macroeconomic environment. This prospect is contingent, however, upon the sustained

Figure 18. India and Pakistan: Macroeconomic Indicators¹

In India, growth is expected to remain strong although fiscal imbalances persist. In Pakistan, prospects for improved growth depend on the success of the reform program.



¹Shaded areas indicate IMF staff projections.

²Includes central government public enterprises.

implementation of stabilization and structural policies. Improving Pakistan's public finances remains the key to overcoming recurrent financial difficulties.

In Bangladesh, a reform program launched in the late 1980s helped restrain inflation, bolster exports and restore a viable external position. Although economic growth rose to nearly 5 percent during the first half of the 1990s, poverty remained pervasive. Inadequate progress in removing deep-seated structural rigidities in the economy, including a large public sector and a weak and undercapitalized banking system, made it difficult to attain a more rapid rate of growth and poverty reduction.

The economic expansion was threatened by a reemergence of financial imbalances in the mid-1990s. While growth exceeded 5 percent in 1995–96, this was due partly to a weather-related rebound in agricultural production. Industrial activity and investment growth were adversely affected by stalled reforms and market uncertainty in the run-up to two rounds of parliamentary elections. As aid and private capital inflows were also depressed, balance of payments pressures resurfaced and the earlier buildup of reserves was partly reversed.

Progress with reforms in Bangladesh has been slow, and government borrowing from the central bank, which was a principal cause of the financial imbalances in 1995–96, has continued to exert pressure on reserves. Strengthening public saving, including by taking long-overdue measures to eliminate the quasi-fiscal deficit, will be central to restoring external stability. To foster higher investment and growth, stabilization policies will need to be complemented by reforms to privatize ailing public enterprises, restore the soundness of the banking system, and liberalize trade.

In Sri Lanka, the macroeconomic situation has improved since mid-1996, with the end of the drought and the power shortages. Growth, which had slowed to under 4 percent in 1996, is expected to recover to 6 percent in 1997. With the improvement in the food supply, inflation subsided to single digits by mid-1997. The external position remains manageable with the current account deficit expected to decline slightly to below 5 percent of GDP in 1997.

Persistently large fiscal deficits are at the heart of many of Sri Lanka's economic problems, including the lack of durable inflation control and relatively modest growth. After two consecutive years of fiscal deficits in excess of 10 percent of GDP, the deficit narrowed slightly to 9½ percent in 1996. Nonetheless, the budget remains structurally weak, as evidenced by the widening of the deficit on current operations and the lack of revenue buoyancy. The 1997 budget, which aims to reduce the deficit by 2 percentage points of GDP, is a significant start to the necessary medium-term fiscal consolidation but further fiscal adjustment is necessary. To address the long-standing structural impediments to growth, a number of measures are needed: reforms to improve the performance of the

state-owned commercial banks; a new wave of privatization to strengthen the role of the private sector in the economy; and further liberalization of external trade to facilitate the diversification of the export and production base.

Transition Countries

What Caused the Recent Crises in Bulgaria and Romania?

Bulgaria and Romania suffered macroeconomic crises at the end of 1996 and beginning of 1997 involving bursts of inflation and, in Bulgaria, significant declines in output that substantially reversed previous gains. Underlying both crises was insufficient progress with structural reform that gave rise to quasi-fiscal deficits and excessive money growth, as the Central Bank of Bulgaria extended credits to insolvent banks facing runs, and the Central Bank of Romania extended credits to insolvent banks and loss-making agricultural and industrial enterprises. These situations are thus quite unlike the recent problems in the Czech Republic and other countries relatively advanced in the transition, where crises resulted from a combination of buoyant domestic spending and restrictive monetary policies that led to overly appreciated real exchange rates and widened current account deficits. Unlike their more successful neighbors, Bulgaria and Romania had not completed the first stage of the transition by stabilizing inflation and providing the macroeconomic foundations for sustained growth; nor had they undertaken adequate structural reforms to establish the microeconomic foundations of growth. Their most recent problems illustrate the fragility of progress in the early stages of transition.

Although Bulgaria began the transition in a relatively unfavorable position compared with other countries in central and eastern Europe—that is, with high external debt, an extremely centralized economy, and high dependence on rapidly collapsing export markets in the Baltics, Russia, and other countries of the former Soviet Union—the recent crisis was mainly due to delays in enterprise reform, accommodation of bad loans in the banking system, and weak monetary and fiscal discipline. Thus the crisis was triggered by a collapse of confidence in the banking system following the public recognition that many banks were insolvent. Attempts to tighten fiscal and monetary policy in 1996 were undermined by large withdrawals of foreign exchange deposits, reflecting doubts about Bulgaria's ability to service its large external debt, and by a weakening of the economy. As the revenue-to-GDP ratio declined and sources of deficit financing dried up, discretionary expenditure was cut drastically, but accelerating inflation and ensuing high nominal interest rates pushed up the interest bill and contributed to

a doubling of the overall budget deficit to 13 percent of GDP. The economic crisis culminated in February 1997 when monthly inflation reached 243 percent.

The crisis in Romania resulted mainly from monetization of a fiscal deficit that grew from 2 percent of GDP in 1994 to 5¾ percent of GDP in 1996 and reflected significant increases in agricultural subsidies, wages and pensions, credits given to clear interenterprise arrears, and tolerance of tax arrears as a means of supporting ailing state-owned enterprises. Rapid growth in consumption and appreciation of the exchange rate resulted in a sharp deterioration of the balance of payments, with the current account deficit growing from 1¾ percent of GDP in 1994 to 6½ percent of GDP in 1996. Although output grew in Romania in the years preceding the crisis, it was driven in large measure by unsustainable direct and indirect subsidies to industry.

Bulgaria and Romania are now faced with the task of implementing reform programs that will allow them to catch up with other countries in central and eastern Europe. The necessary measures include the need to free up remaining administered prices, liberalize foreign trade, privatize state-owned enterprises, strengthen the collection of fiscal revenues, and develop regulations and prudential oversight of the banking sector. In both countries, agreements on stabilization and reform programs have led to a resumption of official support from the IMF and World Bank.

Have Russia and Ukraine Turned the Corner Toward Growth?

The resumption of growth in two major countries in transition, Russia and Ukraine, has been long awaited. Both countries suffered a massive and protracted fall in output from 1991 to 1996, with real GDP officially estimated to have dropped by around 40 percent in Russia and 60 percent in Ukraine. The decline appears to have ended in Russia but not yet in Ukraine. According to the most recent Russian official national accounts data, real GDP was about ¼ of 1 percent lower in the first seven months of 1997 than in the same period a year earlier, with an increase in industrial output of 1¼ percent being overshadowed by declines in agricultural and construction activities. In Ukraine, the official data show a 7 percent decline in real GDP in January–July 1997 compared with the same period in 1996.

Notwithstanding the difficulties in tracking the precise course of economic activity, there is little doubt that the rebound in growth in Russia and Ukraine has been slow to materialize compared with the central and eastern European and Baltic transition countries.²⁶

²⁶See “Problems in Measuring Output in Transition Countries,” Box 5, May 1997 *World Economic Outlook*, pp. 34–35.

Part of the explanation can be found in delays in stabilization. The experience of these other transition economies shows that there has tended to be a lag of around two years between stabilization taking hold and the resumption of growth. In Russia and Ukraine, macroeconomic stabilization began in earnest in the middle of 1995, and inflation fell to moderate levels only in 1996. With 12-month inflation rates in both countries currently at around 15 percent and their currencies having achieved reasonable stability in exchange markets, the macroeconomic conditions for growth have been established. But structural weaknesses in a number of areas have continued to hamper growth in both countries.

Weakness of the banking sectors has thus led to a markedly diminished role for financial intermediation, hindering the banks’ role in financing sustainable economic growth. At the same time, owing to the relatively underdeveloped state of domestic bond and equity markets, Russian and Ukrainian enterprises have had limited access to alternative sources of financing. At the end of 1996, banking sector claims on the private sector in Russia and Ukraine were less than 10 percent of GDP, compared with about 40 percent of GDP in central and eastern European countries and over 80 percent in the advanced economies. The low share of long-term credits in total lending to the private sector—less than 10 percent—and substantial spreads of 20 percentage points and more between lending and deposit rates are other signs of weak intermediation. Significant declines in treasury bill rates in recent months have improved prospects that banks will shift lending toward enterprises and that loan rates will fall. Additional measures to improve the capital market infrastructure and establish a sound banking system are also needed.

Another area of remaining structural weakness is the former state enterprises, where progress with restructuring has been limited. Dispersed and insider-dominated share ownership has contributed to weak corporate governance, which in turn has reduced the incentives to restructure. It is estimated that three-fourths of formerly state-owned enterprises in Russia still need radical restructuring, that around half of them are currently making losses, and that at least one-fourth of them should be put through the bankruptcy process; the situation in Ukraine appears to be even worse.²⁷ Continuing unusual variability in the sectoral pattern of production growth in both countries is another indication that restructuring is far from complete.²⁸ Similarly,

²⁷See Joseph Blasi, Maya Kroumova, and Douglas Kruse, *Kremlin Capitalism: The Privatization of the Russian Economy* (Ithaca, New York: Cornell University Press, 1997).

²⁸The standard deviation of changes in output in nine industrial sectors in 1996 was equal to around 9 percentage points in Russia and around 14 percentage points in Ukraine, compared with 6 percentage points in Poland and 3 percentage points in the United States.

with management and incentives little changed, output and productivity in the former state farms remain in secular decline.

More generally, a market environment in which private sector activity can thrive is not yet fully established in either country. Elements of the old government-dominated system are still in place, particularly in Ukraine, as government regulation and intervention in the economy remain widespread, nurturing administrative malpractices and perpetuating distortions. The structure of government expenditures is still tilted toward unproductive expenditures, and government revenues are difficult to mobilize because of an inefficient, nontransparent, and onerous tax system. At the same time, the institutional framework for the new market system is far from complete: an effective legal and judicial system that defines and protects property rights, enforces contracts, and ensures the maintenance of law, order, and personal security is still

largely missing. Further progress with structural reform is needed in all these areas. Accelerated integration into the world economy, which would be supported by accession to membership in the WTO, will help such reform by increasing exposure to world prices and foreign competition.

Structural weaknesses in the regulatory, judicial, and tax systems inhibit investment, thereby further contributing to a slow resumption of growth. According to official estimates, gross fixed capital formation in Russia in 1996 was only one-fourth of what it was in 1990 in real terms, and capital formation in Ukraine only one-fifth of the 1990 levels; indications are that overall investment remained subdued in the first half of 1997. At the same time, foreign direct investment, while picking up in the first half of 1997, remains relatively low in both countries, and as a result, only limited progress has been made in the replacement of inefficient and obsolete capital and building new capacity.