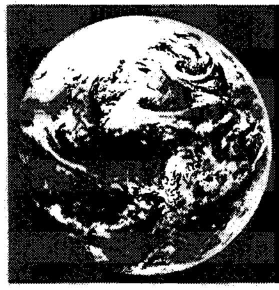


II

World Economic Situation and Short-Term Prospects

World output growth is expected to increase further, to about 4½ percent, in 1997 and to remain at this rate in 1998, projections that are slightly higher than those in the October 1996 *World Economic Outlook*. Relatively solid growth is expected in the United States and the United Kingdom, although in both countries there is a risk of inflationary pressures emerging. In Canada, where there is considerable economic slack, the expansion is expected to gain momentum. In Japan, recovery is expected to continue at a moderate pace. Declines in interest rates over the past two years and the return of exchange rates to more competitive levels are expected to support recovery in Germany, France, and elsewhere in continental Europe, although continuing fiscal consolidation and weaknesses in consumer and business confidence pose downside risks. Growth in the newly industrialized economies of Asia should also pick up slightly in 1998, as exports recover from the recent slowdown.

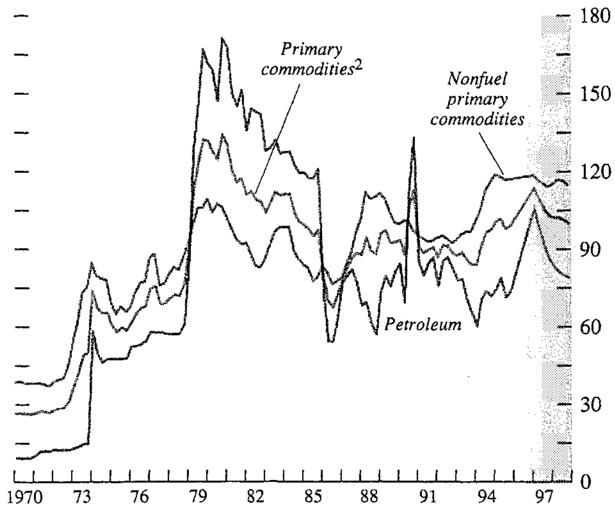
Activity is projected to strengthen among the developing countries of the Western Hemisphere, as the recovery from the 1995 Mexican crisis continues, while growth in Africa should remain close to its improved rate in 1996, reflecting further progress with stabilization and reform. Sustained growth at about 8 percent is expected in the developing countries of Asia, while recovery is likely to weaken slightly in the Middle East and Europe region, where conditions remain mixed. For the countries in transition, the growth outlook for 1997 is somewhat weaker than perceived last October, but recovery is still expected to broaden as an increasing number of countries reap the benefits of sustained stabilization and reform efforts.

Inflation remained subdued during 1996 in the advanced economies and declined further in the developing and transition countries, despite a sharp increase in oil prices. The IMF's index of commodity prices rose by about 5 percent in U.S. dollar terms in 1996, with an increase of about 20 percent in the price of crude petroleum partly offset by a 1 percent decline in the prices of nonfuel primary commodities (Chart 4).[2]

[2]Measured in SDRs, the IMF's index of commodity prices rose by nearly 10 percent in 1996, reflecting a 24 percent increase in crude petroleum and a 3 percent increase in nonfuel primary commodities. The smaller increases in terms of U.S. dollars reflect the appreciation of the U.S. currency against most other major currencies during 1996.

Chart 4. Commodity Price Indices[1]
(In U.S. dollars; 1990 = 100)

Petroleum prices increased during 1996 but are expected to be lower in 1997.

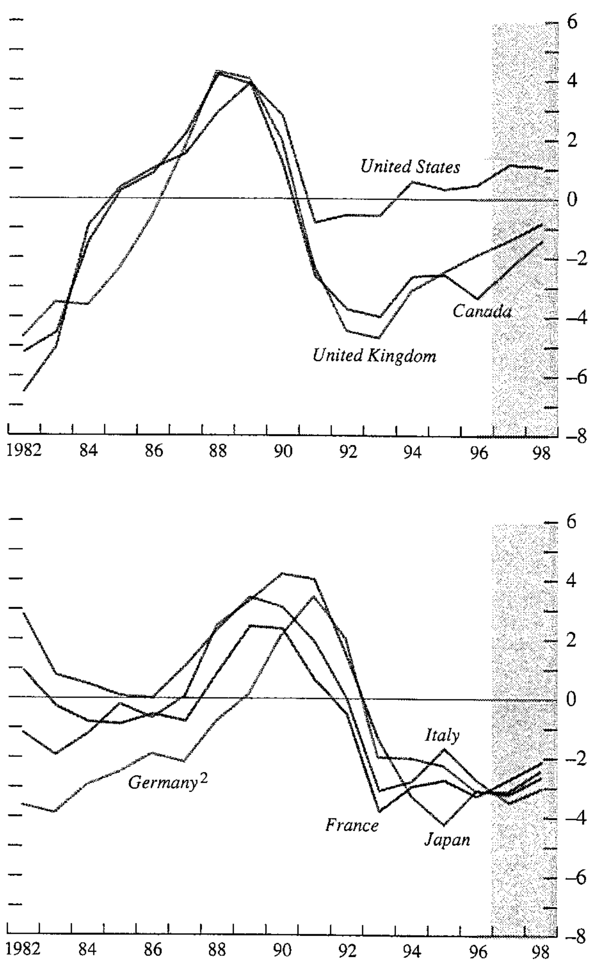


[1]Shaded area indicates IMF staff projections.
[2]The weights are 57.7 percent for the index of nonfuel primary commodities and 42.3 percent for the index of petroleum prices.

For petroleum prices, the low levels of stocks in the aftermath of the unusually harsh 1995–96 winter season in the Northern Hemisphere exacerbated the impact of increased demand for heating oil, particularly in the second half of 1996 (Box 3). After peaking in mid-January 1997, petroleum prices fell by about 23 percent by the end of February owing to stronger world oil production and improved inventory levels, and remained near this level through the end of March. With no other upward pressures evident, petroleum prices by the end of 1997 are expected to be about 20 percent lower than at the end of 1996.

Chart 5. Major Industrial Countries: Output Gaps[1]
(Actual less potential, as a percent of potential)

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



[1]Shaded areas indicate IMF staff projections. The gap estimates are subject to a significant margin of uncertainty. For a discussion of the approach to calculating potential output, see *World Economic Outlook*, October 1993, p. 101.

[2]Data through 1991 apply to west Germany only.

Economic Activity, Inflation, and Policy Stances in Advanced Economies

Following the 1995 slowdown in most major industrial countries, a more uneven pattern of economic growth developed in 1996 (Chart 5). In the United States, hesitant growth during 1995 gave way to more solid expansion in 1996, in part reflecting the response to lower interest rates. In Japan, the economic recovery gained momentum in late 1995 and early 1996 and while erratic maintained a moderate underlying pace. In Canada, expansion picked up in the second half of 1996 after 18 months of weak growth; markedly lower interest rates and improved confidence are helping to spur the recovery. In the United Kingdom, growth during 1996 was significantly stronger than in the preceding year, raising concerns about the buildup of inflationary pressures. In contrast, 1996 brought renewed sluggishness in economic activity for continental Europe. In a number of countries, including Germany and France, weak consumer and business confidence persisted, industrial production stagnated, and unemployment continued to increase to new postwar records. By year-end, however, with lower interest rates and the return of exchange rates to more competitive levels, conditions for a pickup appeared to be in place. In other advanced economies, including Korea, Singapore, and Hong Kong, growth in 1996 slowed from above-trend rates, reflecting a weakening in exports and, in some cases, a tightening of monetary conditions.

Growth in the advanced economies is expected to firm to almost 3 percent in 1997, a projection that has changed little from the October 1996 *World Economic Outlook,* and to remain at this rate in 1998 (Table 2). Although growth is expected to improve in 1997 in Europe, its projected pace of 2½ percent will be insufficient to make any significant dent in the high level of unemployment.

Safeguarding price stability is critically important for ensuring continued economic expansion and requires careful monitoring of underlying price pressures. To illustrate the considerations involved, Table 3—introduced in the October 1996 *World Economic*

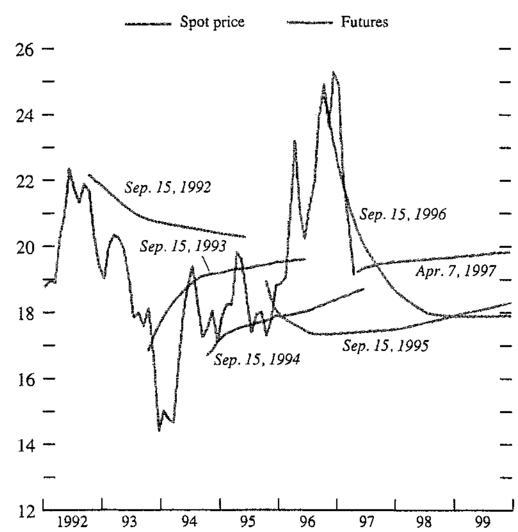
Box 3. Rising Petroleum Prices in 1996

After remaining fairly steady at about $17 a barrel during most of 1994–95, the price of petroleum rose to about $21 a barrel by April 1996, subsequently receded, but climbed higher by year-end.[1] Between 1995 and 1996, petroleum prices increased on average by about 20 percent. The spot price peaked in the second week of January 1997 at about $25 a barrel and declined by about $6 a barrel by the end of February reflecting the less severe winter weather—as compared with a year earlier—in Europe and North America, rising global oil production, particularly the resumption of oil export shipments by Iraq, and the strengthening of the U.S dollar.

The upward trend in petroleum prices in 1996 can be explained by the interaction between low inventories of crude oil and petroleum products and weather-related demand for heating oil. Inventories of crude petroleum and petroleum products are usually run down by the end of the Northern Hemisphere's winter season, with replenishment beginning in May and June before the summer maintenance period in the North Sea and well in advance of the next winter season. However, following the relatively severe 1995/96 winter, early stock replenishment was more limited than usual, and there was little additional accumulation until late October. As a result, stocks were lower at the beginning of the 1996/97 winter season than at the beginning of the 1995/96 winter season.

The low level of stocks was partly attributable to the reluctance to accumulate sizable inventories given the continued expectation of lower prices in the not too distant future. During most of 1995 and throughout 1996, the prices for distant deliveries of crude oil were at substantial discount to prices for near deliveries, reflecting expectations of increased supplies, mainly from Iraq but also from other sources. In September 1996, for example, futures prices for West Texas crude for September 1997 delivery were about $3.50 a barrel (about 15 percent) below prices for December 1996 contracts *(see chart)*. This price pattern created little incentive to increase private stocks above the levels required to meet immediate consumption demand. Thus, each time unexpected adverse weather increased demand for heating oil, there was little supply buffer, and prices rose sharply. The Organization of Petroleum Exporting Countries (OPEC) appears to have had little to do with the rise in petroleum prices in 1996 and early 1997. In fact, trade journals have reported that a number of countries have been producing in excess of their OPEC quotas, with Venezuela and Nigeria exceeding the quotas regularly and by substantial margins.[2]

West Texas Oil Prices: Spot and Futures Contracts[1]
(In U.S. dollars a barrel)



[1]Spot prices are monthly averages.

Agreement was reached in December between Iraq and the United Nations on the implementation of an oil-for-food sales plan, which allows Iraqi oil exports of up to $1 billion in each 90-day period. World oil production is expected to be stronger—through continued exports from Iraq, and higher exports from the North Sea and several other sources—which should restore inventories to more normal levels, thereby loosening the supply constraint that helped to drive prices upward in 1996. Prices quoted on futures markets indicate that average 1997 prices will be about 5 percent lower than average 1996 prices, and prices at the end of the year will be about 20 percent lower than at the end of 1996. In fact, nearly all of the correction in oil prices reflected in recent futures contracts seemed to have occurred by mid-February, earlier than had been anticipated by the markets.

[1]The average petroleum price referred to is the simple mean of prices for U.K. Brent, Dubai, and West Texas crude petroleum.

[2]Crude oil production by OPEC members in the fourth quarter of 1996 is reported in trade journals to have been 26.3 million barrels a day (mbd) compared with 25.9 mbd in the third quarter. December crude oil production by these countries is estimated at 26.6 mbd, including 0.85 mbd in Iraq. These levels of production compare with the total OPEC quotas of 25.033 mbd. See, for example, International Energy Agency, *Oil Market Report*, January 14, 1997.

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

	Real GDP				Consumer Prices				Unemployment			
	1995	1996	1997	1998	1995	1996	1997	1998	1995	1996	1997	1998
Advanced economies	**2.5**	**2.5**	**2.9**	**2.9**	**2.6**	**2.4**	**2.5**	**2.5**	**7.3**	**7.3**	**7.2**	**7.0**
Major industrial countries	2.0	2.2	2.6	2.6	2.3	2.2	2.3	2.3	6.9	6.9	7.0	6.7
United States[1]	2.0	2.4	3.0	2.2	2.8	2.9	2.9	3.0	5.6	5.4	5.5	5.5
Japan	1.4	3.6	2.2	2.9	–0.1	0.1	1.3	1.2	3.1	3.3	3.1	3.0
Germany	1.9	1.4	2.3	3.0	1.8	1.5	1.8	2.0	9.4	10.3	11.3	10.6
France	2.2	1.3	2.4	3.0	1.8	2.0	1.6	1.8	11.6	12.4	12.8	12.3
Italy	3.0	0.7	1.0	2.4	5.4	3.9	2.4	2.0	12.0	12.1	12.3	12.0
United Kingdom[2]	2.5	2.1	3.3	2.8	2.8	2.9	2.6	2.5	8.2	7.5	6.2	6.0
Canada	2.3	1.5	3.5	3.4	2.2	1.7	1.7	1.8	9.5	9.7	9.4	8.8
Other advanced economies	4.2	3.7	3.8	4.1	3.7	3.3	3.1	3.0	8.5	8.4	8.2	7.9
Spain	2.8	2.2	2.8	3.4	4.7	3.5	2.5	2.3	22.9	22.1	21.4	20.7
Netherlands	2.1	2.7	3.0	2.9	2.0	2.1	2.7	2.5	8.3	7.6	7.1	6.3
Belgium	1.9	1.4	2.3	2.2	1.5	2.1	2.0	2.0	12.9	12.6	12.8	12.6
Sweden	3.6	1.1	2.0	2.5	2.5	0.5	2.3	2.2	7.7	8.1	7.2	6.7
Austria	1.8	1.1	1.7	2.8	2.2	1.9	1.9	1.9	4.6	4.7	4.8	4.8
Denmark	2.7	2.4	2.7	2.5	2.1	2.1	2.5	2.7	10.3	8.8	8.2	8.1
Finland	4.5	3.2	4.4	3.4	1.0	0.6	1.3	1.6	17.2	16.3	15.1	14.0
Greece	2.0	2.6	3.0	3.1	9.3	8.5	6.9	6.0	10.0	9.8	9.6	9.3
Portugal	2.3	3.2	3.3	3.5	4.1	3.1	2.5	2.3	7.2	7.3	7.4	7.5
Ireland	10.3	7.0	6.3	5.6	2.5	1.6	2.2	2.1	13.4	12.4	11.6	11.0
Luxembourg	3.5	3.7	3.7	3.5	1.9	1.8	2.0	2.0	2.8	2.8	2.8	2.8
Switzerland	0.1	–0.7	0.7	2.3	1.8	0.8	1.0	1.5	4.2	4.7	5.5	5.5
Norway	3.3	4.8	4.2	3.2	2.5	1.3	2.5	2.5	4.9	4.8	4.0	3.8
Israel	7.1	4.4	4.8	4.8	10.0	11.3	7.9	6.6	6.3	6.7	6.8	6.5
Iceland	2.1	5.5	3.0	2.4	1.7	2.3	2.8	2.5	5.0	4.3	4.1	4.0
Korea	8.9	7.1	5.6	6.3	4.5	5.0	4.4	4.1	2.0	2.1	2.2	2.2
Australia[3]	3.2	4.0	3.2	3.7	2.7	2.7	2.1	2.8	8.5	8.6	8.4	8.0
Taiwan Province of China	6.0	5.6	6.0	6.3	3.7	3.1	3.4	3.3	1.8	2.6	2.5	2.4
Hong Kong	4.8	4.5	5.0	5.0	9.0	6.0	7.1	6.5	3.2	2.9	2.9	2.8
Singapore	8.8	7.0	6.6	6.1	1.7	1.4	1.8	2.0	2.7	3.0	3.0	3.0
New Zealand[3]	3.4	2.7	3.7	3.0	2.4	2.4	1.9	1.6	6.3	6.2	6.0	5.9
Memorandum												
European Union	2.5	1.6	2.4	2.9	3.0	2.5	2.2	2.1	11.2	11.3	11.3	10.8

[1]The projections for unemployment have been adjusted to reflect the new survey techniques adopted by the U.S. Bureau of Labor Statistics in January 1994.
[2]Consumer prices are based on the retail price index excluding mortgage interest.
[3]Consumer prices excluding interest rate components; for Australia also excluding other volatile items.

Outlook, and updated to reflect recent changes—seeks to answer a number of questions about various signs of inflationary pressure in each of the major industrial countries. In general, policymakers' credible commitment to reasonable price stability has played an important role in taming inflation and will remain essential to keeping inflation down. In the United States and the United Kingdom, where resource use is high, inflation remains subdued, although some recent evidence suggests a risk of price pressures in both countries. Relatively large output gaps arising from delayed or weak recoveries in Canada, France, Germany, Italy, and Japan indicate that there is little risk of a resurgence of inflation as growth firms in the year ahead.

Similarly, in a number of other advanced economies where signs of recovery have recently emerged, including Austria, Belgium, Finland, and Sweden, considerable slack can also be expected to dampen inflationary pressures. Moderating economic growth in 1996 in Australia and New Zealand has allayed earlier concerns about the possibility of overheating. The highest inflation rates in the advanced economies are in Greece, Hong Kong, and Israel, each of which is expected to see inflation of 7–8 percent over the next year. Overall, therefore, inflation remains subdued in most of the advanced economies and, taking into account recent and projected movements in primary commodity prices, including recent declines in petroleum prices, is expected to remain at about 2½ percent through 1998.

The overall growth and inflation projections mask considerable differences in the pace and phase of, and in the risks to, economic expansion among the advanced economies. Growth in 1997 is expected to

Table 3. Major Industrial Countries: Questions About Inflationary Pressures[1]
(*Italics indicate a change since the October 1996* World Economic Outlook)

	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	Slightly above	No
2. Does the IMF forecast that inflation will pick up in 1997?	Only slightly	No	*Only slightly and in part due to increases in administered prices*	No	Yes, but increase mainly reflecting higher consumption taxes	No (excluding mortgage interest)	Only slightly
3. Do private forecasters expect inflation to pick up in 1997? (*Consensus Forecasts*, Consensus Economics, Inc.)	Only slightly	No	Only slightly	No	Yes	Only slightly (headline rate)	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	*Becoming so*	Yes
8. Do yield curves or changes in market interest rates suggest a rise in inflation expectations?	No[2]	No	No	No	No[2]	No	No
9. Is exchange rate weakness stimulating inflation?	No	*Only slightly*	*Only slightly*	No	*Yes, but prospective inflation still low*	No	No
10. Do external accounts show signs of overheating?	No	No	No	No	No	No	*Possibly*
11. Have equity prices risen rapidly?	*Somewhat*	*Yes*	*Yes*	*Yes*	No	Yes, through 1996	Yes
12. Have real estate prices recently been rising rapidly?	No	No	No	No	No	Recovering after long stagnation	No

[1]This 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]Yield curve has steepened but this appears unlikely to reflect increased inflation expectations.

edge somewhat above potential in the United States and the United Kingdom, two countries that are into their fifth or sixth year of economic expansion. Although inflation is expected to remain relatively subdued in both countries, the high level of resource use implies a growing risk of overheating.

In the *United States*, the economy continued to operate near capacity during 1996, with further improvements in business and consumer confidence. The unemployment rate fell to 5¼ percent in midyear and subsequently remained close to that level, below most estimates of the natural rate. Despite high resource use, the core rate of inflation has remained subdued at just above 2½ percent;[3] there has, however, been some acceleration of wages. Following a 3 percent rate of expansion in 1997, growth is expected to moderate to

[3]Some recent studies have drawn attention to the possibility that inflation is overestimated by official price data (Box 4).

Box 4. United States: Sources and Implications of Bias in the Consumer Price Index

Changes in the consumer price index (CPI) provide the most commonly used measure of inflation in all countries. In a recent study, the U.S. Advisory Commission to Study the Consumer Price Index estimated that the U.S. CPI overstated inflation by 1.1 percentage points in 1996, and by slightly more in each of the previous twenty years.[1] Thus, whereas the official 1996 rate of inflation was 2.9 percent, the true rate of inflation may have been in the neighborhood of 1.8 percent. This upward bias arises because the CPI methodology does not adequately capture shifts in consumer purchases when relative prices move, or the effects of changes in quality, or the introduction of new products, or the increasing number of discount stores. While some experts have disputed that the upward bias is as large as suggested by the Commission, there is a growing consensus that there may be significant bias.

Upward bias in the official inflation rate has important implications. First, real wage growth may have been significantly higher over the past two decades than suggested by official data, which indicate that they have hardly grown at all.[2] Second, in the area of fiscal policy, upward bias has considerable budgetary cost: expenditures indexed to the CPI rise more than needed to offset inflation; and tax brackets are overadjusted by the CPI, reducing tax revenues. Recent estimates indicate that if the current inflation bias continues for the next ten years, the federal government deficit will increase on this account alone by $140 billion by the end of the period, and more than $650 billion will be added to the U.S. national debt.

The Commission's report identified and quantified three sources of bias, all of which arise because of limitations in the methodology of how the CPI is calculated (*see table*).

Sources of Bias in the U.S. Consumer Price Index, 1996

Sources of Bias	Percentage Points
Quality change/new product bias	0.6
Substitution bias	0.4
Outlet substitution bias	0.1
Total	**1.1**
(Plausible range)	(0.8–1.6)

(1) *Quality change and new product bias*, the largest source of bias, arises because the CPI does not adequately take into account improvements in the quality of goods and services and the introduction of new products. If changes in quality are not taken into account, changes in the CPI will not show true inflation, because they will partly reflect changes in the characteristics of products. New products need to be incorporated into the CPI on a timely basis so that the early declines in price that are a normal part of the product life cycle are captured.

(2) *Substitution bias* occurs because the CPI assumes that consumers purchase a constant mix (in terms of quantities) of various goods and services despite changes in relative prices. In actuality, if the price of one good rises relative to that of another good, consumers will tend to sub-

[1] *Toward a More Accurate Measure of the Cost of Living*, Final Report to the Senate Finance Committee from the Advisory Commission to Study the Consumer Price Index, December 4, 1996. The report notes that the 1.1 percentage point estimate of bias falls within a plausible range of 0.8 to 1.6 percentage points.

[2] Preliminary evidence suggests that the GDP deflator also suffers from upward bias implying that real GDP growth and productivity may have been understated over the last two decades. The magnitude of this bias, however, remains to be fully documented.

about the rate of potential in 1998, and inflation to remain close to 3 percent. A pickup in inflation and the need for a stronger tightening of monetary policy than is assumed remain a risk to the forecast. The federal budget deficit declined to 1½ percent in fiscal year 1996, the lowest ratio to GDP since 1974, reflecting expenditure restraint as well as the strong cyclical position of the economy (Table 4). The Federal Reserve left the target federal funds rate unchanged at 5¼ percent between February 1996 and late March 1997, but then increased it by 25 basis points to restrain persistently strong demand and avert the risk of inflationary pressure. In late January 1997, for the first time, the U.S. Treasury issued inflation-indexed securities, auctioning just over $7 billion of such securities with a ten-year maturity, at a real yield of 3½ percent. The differential with respect to the yield on nonindexed bonds of comparable maturity provides a rough indication of the market's inflation expectations over the medium term.[4] At the time of the auction, this differential was about 3¼ percent.

Growth in the *United Kingdom,* having moderated during 1995, strengthened to rates close to or above potential during 1996 as private consumption rebounded. By early 1997, unemployment had fallen to 6¼ percent, one of the lowest rates in Europe, although in the current cyclical upswing unemployment has fallen significantly more than employment has risen, partly owing to changes in the unemployment benefit system. The rate of inflation remained above its 2½ percent target throughout 1996, rising above 3 percent temporarily in the final quarter. Increasing tightness in the labor market (reflected in an acceleration of labor earnings to 5 percent annual growth in early 1997), a significant pickup in house prices, and

[4] See October 1996, *World Economic Outlook*, pp. 118–19.

stitute away from the relatively higher priced good. Because the weights of goods in the CPI are adjusted infrequently (revisions occur about once every ten years), substitution is not taken into account, creating an upward bias.

(3) *Outlet substitution bias* occurs because the CPI does not adequately take into account the extent to which new discount-type stores have offered lower prices and enticed consumers away from the more traditional outlets that tend to be more fully represented in the CPI basket.

To eliminate the various biases, the Commission recommends replacing the method used in calculating the CPI with one that more accurately takes into account changing spending patterns.[3] Other changes recommended include adopting new procedures for annual updates of weights and revisions to historical data; changing the price data and methods of collection; and establishing a committee of outside experts to review and advise on statistical issues.

The Commission's conclusions have been subject to some criticism. There is widespread agreement among economists that an upward bias in the CPI exists, but its magnitude remains controversial. The largest uncertainties surround the magnitudes of quality and new product bias. Measuring quality improvements is particularly difficult because direct quantitative evidence is scarce and no new substantive information on this issue was provided in the report. Some critics have noted that the report does not take into account the fact that for some goods and services quality has deteriorated.

Although the debate about upward bias in the CPI has been most active in the United States, the findings of the Commission's study are relevant more generally, as many countries use methodologies having much in common with that used in the United States. Analyses of the Canadian CPI suggest that there may be an upward bias in the range of ½–1 percentage point, somewhat lower than in the United States, reflecting in part the more frequent updating in Canada of the weights of the goods and services in the CPI market basket.[4] A study on the United Kingdom's retail price index (RPI) suggests a plausible range of bias of about 0.35–0.8 percentage point, although further work is under way to assess whether the bias may be larger.[5] More generally, the magnitude of bias in other countries depends on, among other factors, the frequency with which the CPI weights and items sampled are updated; the extent to which new and improved products are brought to market; the formula used in estimation; and the extent to which quality adjustments are made. For example, countries such as Norway, Sweden, and the United Kingdom, where weights are updated annually, are likely to be less susceptible to substitution bias. Although most industrial countries—including the United States—make some attempt to allow for quality changes, they are not successful in eliminating this form of bias entirely. In most of the developing and transition countries, however, no quality adjustments are made, suggesting that this form of bias may be important, particularly when newly opened markets increase the variety and quality of goods and services available to the consumer.

[3]This would entail switching from the currently used base-weighted price index to a chain-superlative formula. By taking into account both current and previous purchasing patterns, the latter method would substantially eliminate substitution bias.

[4]See, for example, A. Crawford, "Measurement Bias in the Canadian CPI," Technical Report No. 64 (Ottawa: Bank of Canada, 1993). This study suggests that the bias is not more than 0.5 percentage point.

[5]Alastair Cunningham, "The Measurement Bias in Price Indices: An Application to the U.K.'s RPI," Bank of England Working Paper No. 47 (March 1996).

rapid monetary expansion may be viewed as early warning signals that inflationary pressures are building. The 1997 growth projection has been revised up to 3¼ percent, reflecting the renewed strength in private consumption, and an expected pickup in investment spending. The threat posed to the United Kingdom's inflation target by the growing momentum in the economy prompted the authorities in October 1996 to raise the minimum lending rate by 25 basis points to 6 percent. The appreciation of sterling since August should also have a dampening effect on demand and price pressures. Fiscal slippages during 1995–96, accounted for mainly by revenue shortfalls, slowed the pace of fiscal consolidation, and the budget presented in November tightened fiscal policy only slightly further in the near term. Thus, during 1996 the planned path of deficit reduction toward medium-term balance was put back a year. The general government deficit for 1997 is projected to be close to 3 percent.

The pace of economic expansion in *Australia* moderated over the course of 1996 as consumption spending slowed. An improvement in the outlook for inflation provided room for the authorities to lower interest rates in the latter part of 1996, which should help sustain growth through 1997. In *New Zealand,* economic expansion slowed to about 2¾ percent in 1996, the slowest growth in four years but a welcome development as it reduced the risk of overheating. Economic activity is expected to strengthen in 1997 owing to a pickup in consumption, reflecting recent and planned future tax cuts.

In contrast to the countries that are in advanced stages of their current expansions, in *Japan* recovery did not get under way in earnest until late 1995. Since then growth has fluctuated, around a moderate underlying pace. Domestic demand growth has remained modest, with increases in business fixed investment largely offset by small declines in private consumption

Table 4. Major Industrial Countries: General Government Fiscal Balances and Debt[1]
(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	–3.0	–2.3	–2.1	–1.5	–1.4
Output gap	—	0.7	–0.2	–1.7	–1.3	–1.4	–1.4	–1.0	–0.7	–0.1	0.3
Structural balance	–2.8	–3.1	–3.5	–3.3	–2.7	–2.6	–2.2	–1.6	–1.6	–1.4	–1.6
United States											
Actual balance	–2.6	–3.3	–4.4	–3.6	–2.3	–2.0	–1.4	–1.5	–1.3	–1.1	–1.1
Output gap	–0.4	–0.8	–0.5	–0.5	0.6	0.4	0.5	1.2	1.1	0.9	0.7
Structural balance	–2.4	–3.1	–4.1	–3.4	–2.5	–2.1	–1.6	–1.9	–1.7	–1.5	–1.3
Net debt	35.4	46.7	50.0	52.1	52.9	53.9	53.8	53.3	52.8	51.5	50.0
Gross debt	49.4	62.1	64.6	66.4	66.0	66.2	67.0	66.5	65.8	64.1	62.3
Japan											
Actual balance	–1.1	2.9	1.5	–1.6	–2.3	–3.7	–4.6	–2.9	–2.7	–2.2	–3.1
Output gap	0.3	4.1	1.5	–1.4	–3.3	–4.2	–3.1	–3.2	–2.6	–1.1	—
Structural balance	–1.2	1.5	0.9	–1.1	–1.1	–2.0	–3.3	–1.7	–1.6	–1.8	–3.1
Net debt	20.9	4.8	4.2	5.2	8.0	11.8	16.0	18.5	20.6	23.9	28.1
Gross debt	66.5	66.7	70.0	75.1	82.4	90.1	94.9	98.8	101.2	106.4	112.7
Memorandum											
Actual balance excluding social security	–4.0	–0.7	–2.0	–4.8	–5.4	–6.5	–7.3	–5.5	–4.9	–5.4	–5.8
Structural balance excluding social security	–4.1	–2.0	–2.5	–4.3	–4.3	–5.1	–6.3	–4.5	–4.1	–5.0	–5.7
Germany[2]											
Actual balance	–2.1	–3.3	–2.8	–3.5	–2.4	–3.5	–3.8	–3.3	–2.9	–1.8	–1.3
Output gap	–1.3	3.4	2.0	–2.0	–2.0	–2.2	–3.1	–3.1	–2.4	–0.7	—
Structural balance	–1.5	–5.2	–3.8	–2.3	–1.2	–2.2	–1.8	–1.1	–1.2	–1.3	–1.3
Net debt	21.0	21.4	27.7	35.4	40.7	49.1	51.5	53.0	53.5	52.9	51.4
Gross debt	40.1	41.1	44.1	48.2	50.4	58.1	60.3	61.5	61.6	60.2	58.2
France											
Actual balance	–1.9	–2.0	–4.0	–5.8	–5.8	–5.0	–4.1	–3.3	–3.4	–2.7	–2.0
Output gap	0.6	0.6	–0.5	–3.8	–3.0	–2.7	–3.3	–2.7	–2.1	–0.9	0.3
Structural balance	–2.2	–2.4	–3.5	–3.3	–3.7	–3.2	–1.9	–1.4	–1.8	–2.0	–2.1
Net debt[3]	22.0	27.1	30.2	34.4	40.2	43.5	46.9	48.4	49.5	50.6	50.2
Gross debt	29.6	35.8	39.7	45.7	48.6	52.9	56.3	57.8	58.9	60.0	59.6
Italy[4]											
Actual balance	–10.9	–10.2	–9.5	–9.6	–9.0	–7.1	–6.8	–3.3	–4.1	–3.6	–2.9
Output gap	2.6	1.9	—	–3.1	–2.8	–1.7	–2.7	–3.5	–3.0	–1.5	–0.2
Structural balance	–12.0	–11.2	–9.6	–8.1	–7.6	–6.2	–5.4	–1.7	–2.7	–2.9	–2.8
Net debt	73.4	96.3	103.0	111.8	117.3	116.8	116.4	115.0	113.0	108.9	102.0
Gross debt	79.0	101.4	108.5	119.3	125.5	124.9	123.0	121.5	119.3	115.0	107.8
United Kingdom											
Actual balance	–2.0	–2.5	–6.3	–7.8	–6.8	–5.6	–4.4	–3.1	–2.1	–0.4	0.1
Output gap	–0.6	–2.3	–4.5	–4.7	–3.1	–2.5	–1.9	–1.4	–0.8	–0.7	—
Structural balance	–1.3	–2.7	–3.8	–4.3	–3.9	–3.6	–2.9	–2.1	–1.5	0.2	0.3
Net debt	40.3	26.7	28.1	32.5	37.7	40.9	43.9	45.7	43.1	41.3	37.2
Gross debt	48.0	33.6	34.8	40.4	46.0	47.3	49.3	49.4	49.6	47.8	43.7
Canada											
Actual balance	–4.5	–6.6	–7.4	–7.3	–5.3	–4.1	–1.8	–0.3	0.3	1.4	2.1
Output gap	0.1	–2.6	–3.7	–4.0	–2.6	–2.6	–3.3	–2.3	–1.4	–0.1	0.3
Structural balance	–4.4	–4.9	–4.8	–4.6	–3.6	–2.7	—	0.9	1.0	1.4	1.9
Net debt	30.1	49.7	56.9	61.9	64.7	67.5	68.7	66.3	62.9	55.3	47.1
Gross debt	60.2	79.4	86.9	92.5	94.6	98.3	99.9	96.5	91.7	81.5	70.9

Note: The budget projections are based on information available through March 1997. The specific assumptions for each country are set out in Box 2. See also notes to Chart 3.

[1]The 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.

[2]Data 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.

[3]Figure for 1980–90 is average of 1983–90.

[4]Data from 1996 onward reflect a new accounting methodology.

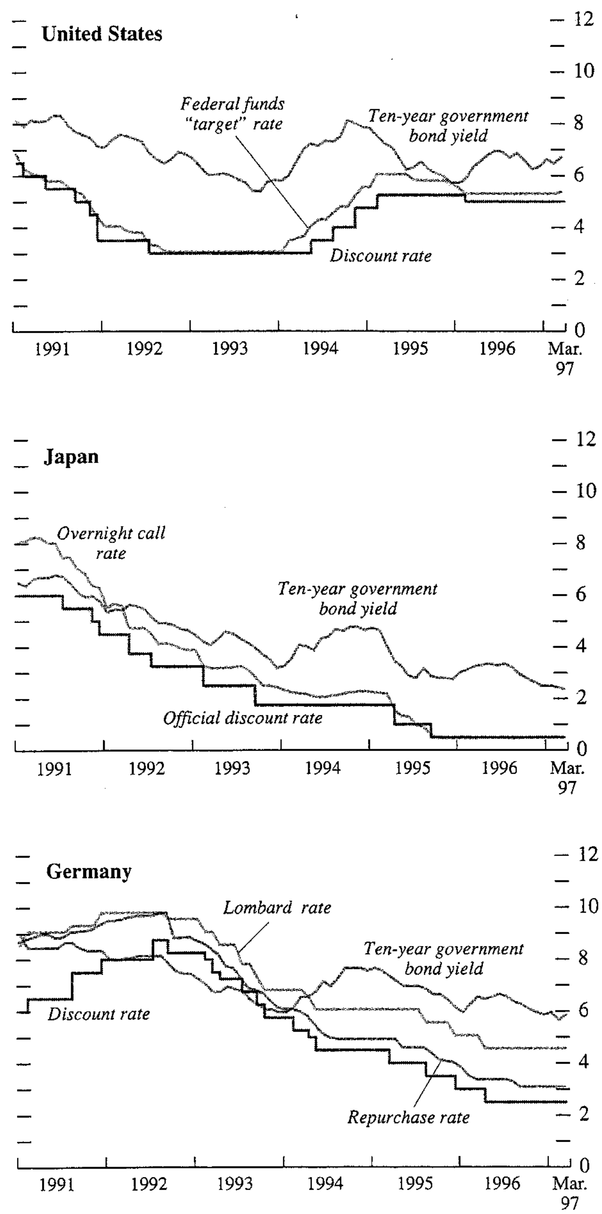
and the initial effects of an unwinding of the earlier surge in public investment. With the official discount rate at ½ of 1 percent since September 1995, monetary policy has been set so as to provide important stimulus to economic recovery (Chart 6). With fiscal policy also supporting economic activity, the general government deficit (excluding social security) reached 7¼ percent of GDP in 1996, of which 6¼ percentage points were structural. The structural deficit is expected to decline to about 4½ percent of GDP in 1997 as a result of further reductions in public investment expenditures, the unwinding of temporary cuts in income taxes, and a rise in the consumption tax. The recovery in labor earnings and rising net exports are expected to sustain growth, outweighing the effects of the withdrawal of fiscal stimulus. The 1997 growth projection for Japan has been revised down slightly to 2¼ percent partly to reflect the possible adverse effects of recent stock market weakness and lower confidence. The inflation rate is expected to rise slightly in 1997 albeit largely due to the increase in the consumption tax.

In *Canada,* following a reasonably strong upswing in 1993–94, the economy slowed considerably in 1995. A revival of activity emerged in the second half of 1996, but growth for the year amounted to only 1½ percent. Domestic demand, particularly increases in residential construction and investment in machinery and equipment, has fueled the recent pickup. Unemployment has remained in the 9½–10 percent range for most of the period since late 1994; and core inflation eased further to about 1½ percent last year, within the lower half of the official target range of 1 to 3 percent. In this context of low inflation, a large output gap, and upward pressure on the Canadian dollar, the Bank of Canada lowered short-term interest rates by close to 3 percentage points during 1996, thereby maintaining an accommodative monetary policy stance. This easing of monetary conditions, the return of confidence, and continued progress in reducing the fiscal deficit helped lower long-term interest rates. The strength of fundamentals in Canada bodes well for continuing recovery in 1997–98, with inflation remaining within the target range.

In contrast with the sustained growth in countries such as the United States and the United Kingdom, the continuing moderate upturn in Japan, and the promising recovery in Canada, growth in continental Europe has been more modest and prospects remain uncertain. Nevertheless, a number of improvements that have occurred in the economic environment are expected to contribute to a strengthening of activity in 1997. The mix of economic policies has shifted since 1995 in a direction that is more conducive to sustainable growth in the medium term. A high degree of price stability and continued efforts at fiscal consolidation have allowed a more accommodative stance of monetary policy, and monetary conditions, broadly defined to in-

Chart 6. Three Major Industrial Countries: Policy-Related Interest Rates and Ten-Year Government Bond Yields[1]
(In percent a year)

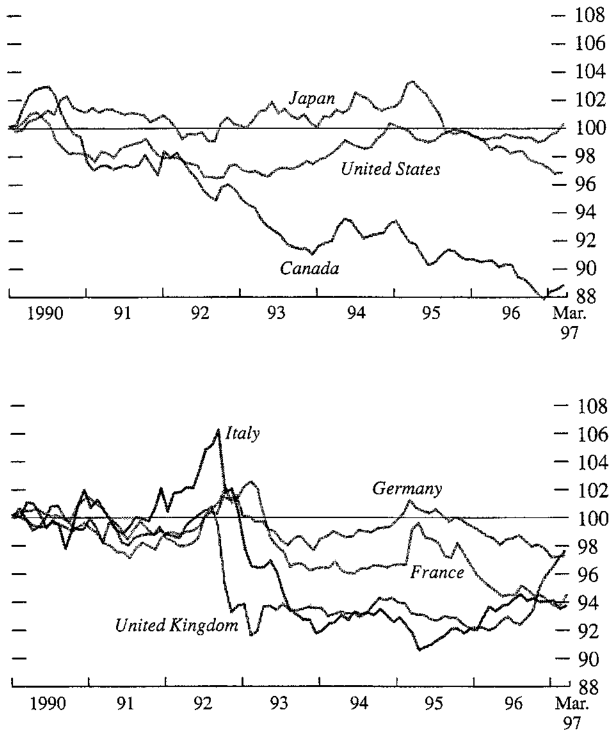
Policy-related interest rates in Japan and Germany remain low.



[1]The 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.

Chart 7. Major Industrial Countries: Monetary Conditions Indices[1]

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



[1]For 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.

clude the effects of exchange rate changes, have eased considerably since early 1995, particularly in France (Chart 7). Short-term interest rates in Germany were cut by 75 basis points during 1996, following larger reductions in each of the three preceding years, and a number of other European countries lowered their rates in tandem. Commitment to fiscal consolidation has also contributed to declines in long-term interest rates, and exchange rates vis-à-vis key non-ERM currencies have returned to more competitive levels from their positions of early 1995, providing stimulus to net exports and the opportunity to take advantage of solid world demand.

With this favorable climate, there would seem to be some upside potential to the 1997 European growth projection of 2½ percent, but this conjecture is balanced by a number of considerations working in the opposite direction. A convincing revival of domestic demand remains to be seen particularly in Germany, France, and Italy (Chart 8). Record levels of unemployment have eroded consumer confidence and weakened consumer spending (Chart 9). Large margins of slack may mean that sluggishness in business investment will continue for some time to come. Moreover, further efforts to achieve fiscal consolidation and meet the 3 percent Maastricht reference value for budget deficits are likely to have a dampening effect on domestic demand (Table 5).[5] At the same time, however, failure to reach the deficit target could heighten uncertainty about EMU and further undermine business and consumer confidence. In addition to macroeconomic factors, structural rigidities in European labor markets have also been contributing to the lack of dynamism, creating a vicious circle of prolonged underutilization of resources, erosion of human capital, and rising levels of already high structural unemployment. Structural unemployment, which will not decline through economic recovery alone, probably accounts for close to three-quarters of the 11¼ percent unemployment rate in Europe.

Indicators of economic activity in *Germany* remain mixed. Real GDP rebounded quite strongly in the second and third quarters of 1996 but growth slowed to a virtual halt in the fourth quarter. The export sector has been the main source of strength, and business confidence has rebounded; but domestic demand growth has remained modest, consumer confidence has yet to recover, and unemployment rose to a new seasonally adjusted peak of 11¼ percent in January before falling slightly in February. Inflation remains subdued, at about 1½ percent, with wage settlements in 1996 gen-

[5]The reductions in fiscal deficits in 1997 shown in Tables 4 and 5 exaggerate the projected fiscal adjustment in a number of cases, particularly France and Italy, because they include accounting measures with no impact on underlying fiscal positions and one-off measures whose reversal is expected to increase deficits subsequently.

erally below 2 percent, and settlements thus far in 1997 of about 1 percent.

In contrast with the easing of monetary conditions referred to above, the stance of fiscal policy in Germany is being tightened in 1997, correcting the slippages that occurred in 1995 and making up for the lack of progress in 1996. From a general government deficit of about 4 percent of GDP in 1996, the fiscal program for 1997 aims to reduce the budget deficit to below 3 percent of GDP to meet the Maastricht criteria, although fully achieving this objective may be difficult without additional policy action. With monetary conditions supportive of moderate recovery, growth of 2¼ percent is projected for 1997, with continuing strong expansion of exports helping to revive investment in machinery and equipment. Consumption is expected to pick up later in the year. Reflecting the considerable output gap, inflation is projected to remain subdued. Weaker-than-expected investment and consumption could, however, delay prospects for recovery.

In *France,* economic activity in 1996 as a whole remained sluggish, with real GDP increasing by about 1¼ percent. Despite weak income growth and very low consumer confidence, consumer spending as well as net exports contributed positively to growth. Investment, however, remained flat, and destocking continued to be a drag on growth. Unemployment reached a new peak of 12¾ percent in early 1997. Inflation remained firmly under control. The fiscal deficit was held to the government's 1996 target of 4 percent of GDP, following the adoption of a supplementary budget in November. Fiscal plans for 1997 entail keeping central government spending unchanged in nominal terms and strict limits on social security expenditure; but additional measures appear necessary to bring the deficit below 3 percent of GDP on a durable basis. Since the Deutsche Bundesbank last lowered short-term interest rates in August, the Bank of France has reduced its operating rates by between 15 and 25 basis points; while the franc has remained stable against the deutsche mark, it has depreciated against the dollar and in effective terms.

Growth in 1997 is expected to strengthen to almost 2½ percent, as the underlying expansion of private consumption is maintained and exports continue to expand. Unemployment is expected to exceed 13 percent by midyear, and inflationary pressures are likely to remain negligible. Though growth could be stronger if exchange rates remain near their levels in early 1997, there is at least an equal risk that rising unemployment could undermine consumption and that sluggishness in European growth could hinder the expansion of exports.

In *Italy,* activity stagnated in 1996, reflecting in part the strengthening of the lira since mid-1995 and the weakness of key export markets in Europe. Industrial production declined during the year, and unemploy-

Chart 8. Selected European Countries: Real Total Domestic Demand

(Percent change from four quarters earlier)

A convincing revival of domestic demand remains to be seen in continental Europe.

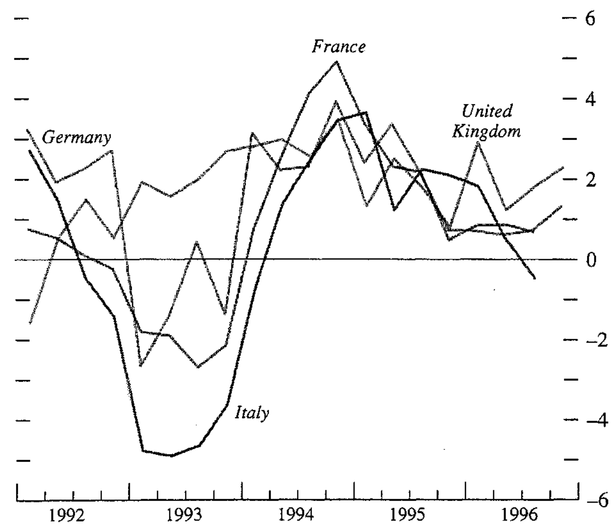
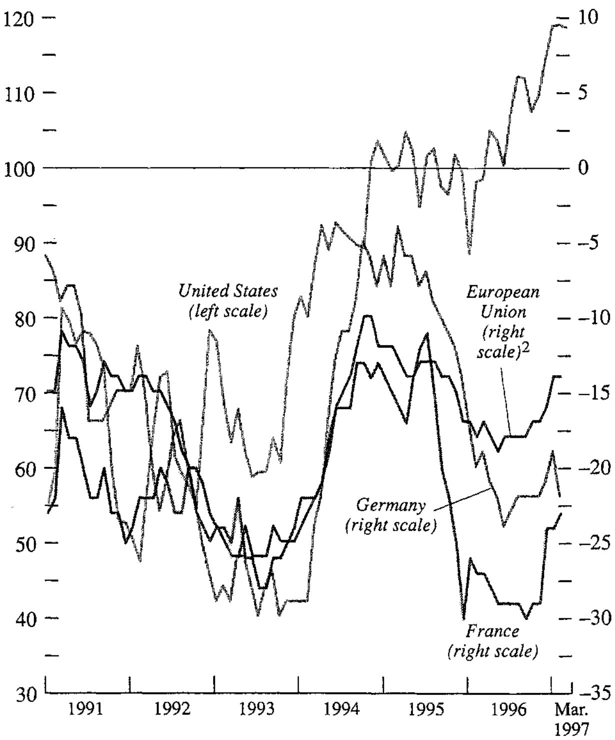


Chart 9. European Union and the United States: Indicators of Consumer Confidence[1]

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



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

[1]Indicators are not comparable across countries.

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

ment was relatively stable at about 12 percent. Inflation has been the main bright spot of recent performance, falling from 6 percent in November 1995 (on a 12-month basis) to 2¼ percent in March 1997. Modest growth of 1 percent is expected in 1997. Apart from the direct effects of fiscal tightening, growth remains dampened by the lagged effects of the lira's appreciation and depressed private sector demand. Inflation is expected to remain subdued and in line with the official target for the year of 2½ percent.

The substantial headway made in reducing Italy's fiscal imbalances in 1992–95 stalled in 1996, owing to inadequate expenditure control as well as weak growth. Despite the corrective measures taken at midyear, the general government deficit, at 6¾ percent of GDP (inclusive of all accounting revisions), exceeded the official target by a considerable margin. For 1997, the government's objective of early EMU participation will require a comparatively large fiscal correction, for which additional measures were recently taken, along with the announcement of a forthcoming review of pension and welfare spending. The additional package should serve to reduce the deficit to close to the Maastricht reference value in 1997. However, the considerable reliance in 1997 on one-off measures would—in the absence of additional measures—lead to a rebound of the deficit in subsequent years. Hence it is important that the forthcoming review of social transfers leads to structural cost-saving measures to ensure the sustainability of adjustment in 1998 and the medium term. Increased market confidence in the authorities' commitment to reduce the budget deficit and bring down inflation has contributed to a marked reduction in long-term interest rates over the past two years. The performance of the lira in the ERM, which it rejoined in November 1996, and continued subdued inflation allowed a reduction of 75 basis points in official interest rates in late January 1997, following a similar reduction in October 1996.

Evidence of economic recovery is apparent in a number of the smaller economies of Europe. In *Sweden,* economic activity picked up around the middle of last year, primarily fueled by the external sector and investment spending. Monetary policy was eased significantly during 1996 with cuts in the repurchase rate. Growth is expected to strengthen further in 1997. A pickup in exports has also contributed to tentative recoveries in Austria, Finland, and Spain. In *Austria,* the external sector and business fixed investment are expected to support stronger growth during 1997 and 1998. Further fiscal consolidation, however, aimed at reducing the fiscal deficit by about 1 percent of GDP in 1997 may keep economic activity somewhat subdued. In *Finland,* the strengthening of exports during 1996 has contributed to a resumption of growth. Continued buoyancy of consumption and investment is also supporting growth, which is expected to exceed

Table 5. European Union: Convergence Indicators for 1995, 1996, and 1997
(In percent)

	Consumer Price Inflation			General Government Balance/GDP				Gross Government Debt/GDP[3]			Long-Term Interest Rates[4]
	1995	1996	1997	1995	1996	1997[1]	1997[2]	1995	1996	1997	March 1997
Germany[5]	1.8	1.5	1.8	–3.5	–3.8	–3.3	–2.9	58.1	60.3	61.5	5.8
France	1.8	2.0	1.6	–5.0	–4.1	–3.3	–3.0	52.9	56.3	57.8	5.7
Italy	5.4	3.9	2.4	–7.1	–6.8	–3.3	–3.0	124.9	123.0	121.5	7.6
United Kingdom[6]	2.8	2.9	2.6	–5.6	–4.4	–3.1	. . .	47.3	49.3	49.4	7.5
Spain	4.7	3.5	2.5	–6.6	–4.4	–3.2	3.0	65.3	69.5	69.0	7.1
Netherlands	2.0	2.1	2.7	–4.0	–2.3	–2.2	. . .	79.7	78.8	76.1	5.7
Belgium	1.5	2.1	2.0	–4.1	–3.4	–2.9	–2.9	133.5	130.0	127.1	5.9
Sweden	2.5	0.5	2.3	–7.9	–2.5	–0.8	–2.6	78.2	78.6	76.6	7.1
Austria	2.2	1.9	1.9	–5.3	–3.9	–2.5	–3.0	69.3	69.8	68.1	5.7
Denmark[7]	2.1	2.1	2.5	–1.9	–1.6	–0.1	0.2	72.2	69.9	67.3	6.5
Finland	1.0	0.6	1.3	–5.2	–2.6	–1.9	–1.4	58.5	58.0	58.7	6.1
Greece[8]	9.3	8.5	6.9	–9.2	–7.6	–5.1	–4.2	111.8	110.7	107.7	10.3
Portugal	4.1	3.1	2.5	–4.9	–4.0	–2.9	–2.9	71.7	70.8	69.2	6.9
Ireland	2.5	1.6	2.2	–2.4	–1.0	–1.6	–1.5	84.8	76.4	72.3	6.3
Luxembourg	1.9	1.8	2.0	0.4	–0.1	–0.1	. . .	5.4	5.9	5.7	6.1
All EU[9]	3.0	2.5	2.2	–5.2	–4.4	–3.1		72.1	73.2	73.0	6.6
Reference value[10]	**2.9**	**2.4**	**3.1**	**–3.0**	**–3.0**	**–3.0**		**60.0**	**60.0**	**60.0**	**7.9**

Sources: National sources; and IMF staff projections.

Note: The table shows the convergence indicators mentioned in the Maastricht Treaty, except for the exchange rate. The three relevant convergence criteria are (1) consumer price inflation must not exceed that of the three best-performing countries by more than 1½ percentage points; (2) interest rates on long-term government securities must not be more than 2 percentage points higher than those in the same three member states; and (3) the financial position must be sustainable. In particular, the general government deficit should be at or below the reference value of 3 percent of GDP. If not, it should have declined substantially and continuously and reached a level close to the reference value, or the excess over the reference value should be temporary and exceptional. The gross debt of general government should be at or below 60 percent of GDP or, if not, the debt ratio should be sufficiently diminishing and approaching the 60 percent value at a satisfactory pace. The exchange rate criterion is that the currency must have been held within the normal fluctuation margins of the ERM for two years without a realignment at the initiative of the member state in question.

[1]Based on information available up to the end of March 1997.

[2]Official targets or intentions. The IMF staff's fiscal projections shown in the preceding column are in some cases based on different growth, inflation, or interest rate assumptions from those used by national authorities and do not take into account further consolidation measures that are planned by EU governments in accordance with their convergence programs but which have not yet been announced. See Box 2 for the IMF staff's fiscal assumptions.

[3]Debt data refer to end of year. They relate to general government but may not be consistent with the definition agreed at Maastricht.

[4]Ten-year government bond yield or nearest maturity.

[5]While some other EU countries have adopted supplementary fiscal actions for 1997 (e.g., France and Italy), the German authorities have not yet announced additional measures to achieve the Maastricht fiscal deficit criterion.

[6]Retail price index excluding mortgage interest.

[7]Government deposits with the central bank, government holdings of nongovernment bonds, and government debt related to public enterprises amounted to some 20 percent of GDP in 1995.

[8]Long-term interest rate is 12-month treasury bill rate.

[9]Average weighted by GDP shares, based on the purchasing power parity (PPP) valuation of country GDPs for consumer price index, general government balances, and debt.

[10]The Treaty is not specific as to what methodology should be used to calculate reference values for inflation and the interest rate beyond noting that they should be based on the three lowest-inflation countries. For illustrative purposes, a simple average for the three countries is used in calculating the reference values.

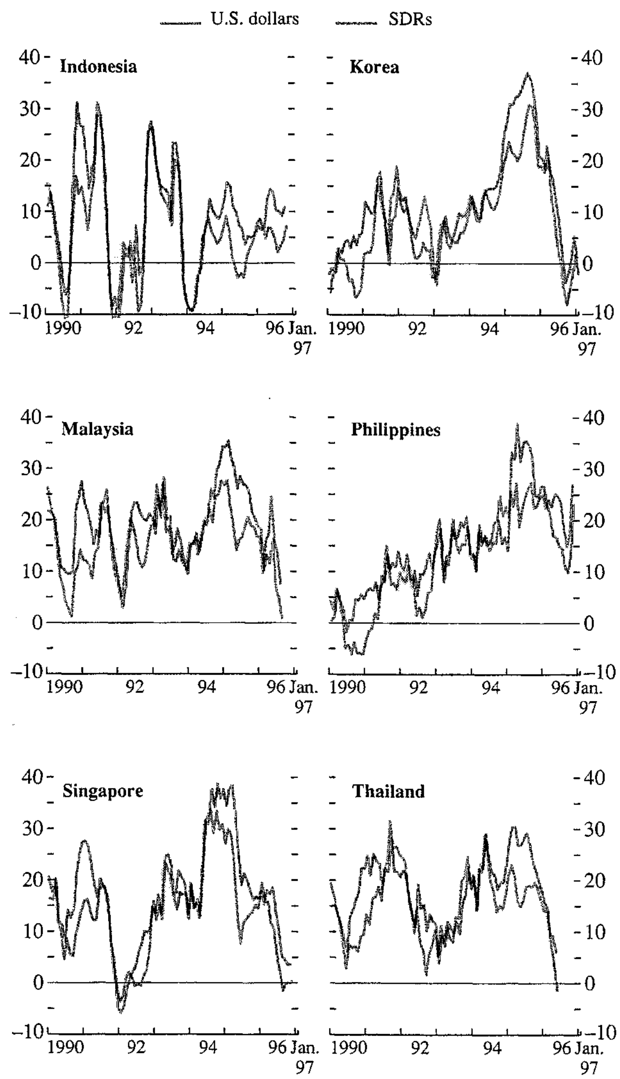
4 percent in 1997. In *Spain,* exports and equipment investment are the driving forces behind the emerging recovery. Employment growth has been stronger than in previous economic cycles, but unemployment of over 22 percent remains Spain's greatest economic challenge.

Elsewhere in continental Europe, revivals of domestic demand are contributing to recoveries from the 1995 slowdown. Activity strengthened in early 1996 in *Denmark,* with notable increases in construction and in private consumption, and also in the *Netherlands,* reflecting gains in employment and more buoyant consumer spending. Growth of exports coupled with continued buoyancy in domestic demand is expected to sustain relatively solid growth in both countries in the year ahead. In *Portugal* also, growth picked up in 1996 as both consumption and investment improved. Activity is expected to firm over the next year as investment strengthens further. Similarly in *Belgium,* a recovery in business fixed investment is expected to support stronger growth. In *Greece,* despite consolidation plans to reduce the structural fiscal

Chart 10. Selected Asian Countries: Growth in Export Revenues[1]

(Percent change from 12 months earlier; three-month moving averages)

Exports in U.S. dollar terms from a number of Asian countries slowed markedly during 1995–96; in a number of countries, the slowdown was less pronounced in SDR terms.



[1]Trade in goods and services.

deficit substantially in 1997, economic growth is expected to pick up, led by investment. In contrast, domestic demand in *Switzerland* remains weak, and real GDP in 1996 contracted by ¾ of 1 percent. With monetary policy now having been eased substantially, real GDP is projected to expand, but by less than 1 percent in 1997, supported mainly by the partial reversal of the earlier excessive appreciation of the Swiss franc.

Robust economic recoveries in Ireland, Norway, and Israel have slowed, or are expected to slow, to a more sustainable pace. Growth in *Ireland* moderated to 7 percent in 1996 after peaking at over 10 percent in 1995, and inflation has also decelerated. The strong and broadly based economic upswing in *Norway* continued, with real GDP accelerating to 5 percent growth in 1996. Although the expansion is expected to moderate somewhat in 1997, the marked tightening of the labor market in the current upswing and the recent easing of monetary policy, motivated by exchange rate considerations, indicate a risk of rising inflation. In *Israel,* six years of rapid economic growth with widening budget deficits culminated in a sharp increase in the current account deficit during 1995–96, with inflation near 10 percent. The projected tightening of fiscal policy, if successfully implemented, should allow growth to continue at a more sustainable pace, the external imbalance to narrow, and inflation to moderate.

In several of the advanced economies of Asia, growth slowed during 1996, and growth projections for 1997 have been revised downward somewhat. The slowdown, which represented a mild cyclical correction following the above-trend growth rates of 1994–95, resulted partly from appropriate policy tightening intended to diminish the risk of overheating. At the same time, exports slowed owing to losses in the external competitiveness of currencies tied to the appreciating U.S. dollar, weaker import demand from other advanced economies and from within the region, and the general deceleration in world industrial activity, which was particularly pronounced in the global electronics market. The slowdown in the growth of export revenues in U.S. dollar terms was particularly marked, reflecting the appreciation of the U.S. dollar; in SDR terms, the slowing of export revenues was less pronounced (Chart 10). A recovery in exports is expected in 1997, as global demand firms. In *Hong Kong,* growth in private consumption and continuing rapid growth in China are expected to support somewhat stronger growth in 1997. In *Singapore,* improvements in the external sector are expected to offset a moderation in both public consumption and private investment—which made considerable contributions to GDP growth last year—resulting in growth of about 6½ percent in the year ahead. In *Taiwan Province of China,* a recovery in domestic demand should support activity in 1997. In *Korea,* the slowdown in growth to 7 percent has reduced the risk of overheating. The short-term outlook for growth appears favorable, although labor unrest and uncertainties associated with the recent Hanbo bankruptcy imply some downside risk.

Economic Situation and Prospects in Developing Countries

In the developing countries, growth in output firmed to 6½ percent in 1996, marking the fifth consecutive year of expansion of around 6 percent, and the median inflation rate slowed to about 7 percent, the lowest rate in nearly a quarter century (Table 6). Sustained growth close to 6½ percent, with further declines in inflation, is expected in the period ahead.

Among the developing countries of the *Western Hemisphere,* growth picked up to 3½ percent in 1996—a somewhat better performance than projected last October—and inflation declined further. Growth in the region is expected to reach almost 4½ percent in 1997 as recoveries in several countries gain momentum, and inflation is projected to moderate further. In Mexico, the economic recovery in 1996 exceeded most expectations, with real GDP increasing by 5 percent. Strong export performance and a pickup in domestic investment—reflecting improved confidence and lower interest rates—are expected to sustain recovery this year. Tight fiscal and monetary policies should help to lower inflation to below 20 percent. Economic recovery also gathered strength in Argentina, with GDP increasing by about 4½ percent in 1996 after a comparable decline in output in the preceding year; inflation was virtually zero. With a pickup in growth in the second half of the year, Brazil's economy expanded by 3 percent in 1996, and inflation declined to about 11 percent, its lowest rate in many years. Reflecting the success of the real plan, a further strengthening of growth and decline in inflation are expected in the year ahead. In Chile, high real interest rates and weaker exports associated with the fall in world copper prices reduced growth to 7 percent in 1996, and a further slowdown is projected for the year ahead. Nevertheless, Chile's growth rate in 1997, at about 5¾ percent, will again be one of the highest in the region. Although the adjustment measures taken in early 1996 in Venezuela contributed to a 1 percent decline in output, they succeeded in improving financial stability: the exchange rate stabilized, and inflation began to decline in the second half of the year. Economic activity is expected to rebound this year, supported by higher oil prices and buoyant foreign direct investment in the newly privatized oil and mining sectors.

With an increasing number of countries in *Africa* making significant progress with macroeconomic stabilization and structural reform efforts, the upturn in economic growth that began in 1994–95 broadened further in 1996. In fact, the 5 percent expansion seen in 1996 was Africa's best growth performance in two decades, and reflected strong activity in the primary products sector—agriculture, in particular, with a number of countries recovering from earlier adverse weather—and in some cases, manufacturing. Growth is expected to average about 4¾ percent in 1997. In South Africa, the government's commitment to fiscal responsibility and structural reform is gaining increasing credibility, but efforts to stabilize the economy and remaining uncertainties are likely to constrain the pace of growth in the near term. In Morocco, the rate of expansion is expected to slow, mainly because of weaker performance in the agricultural sector. In many other countries in Africa, however, growth prospects are quite encouraging, with further declines expected in inflation. Adjustment efforts in Kenya have continued in many areas, including fiscal consolidation, but a weakening of growth is likely in 1997 reflecting the impact of a drought and a slowing of structural reform. Robust growth in Uganda continues to be fueled partly by capital inflows, and by investment in manufacturing and construction, all of which reflect increased confidence. In Ethiopia, growth surged to almost 8 percent in 1996, owing to strong performance of the agricultural sector, and inflation declined to about 1 percent. Tight monetary policy and further strong output growth should keep inflation at a similar level in 1997. Rapid growth driven by agricultural production and exports continued in Malawi during 1996, while inflation declined substantially. After the 1995 drought, output growth picked up in Zambia, largely owing to recoveries in agricultural and copper production, and is projected to strengthen further in 1997. Some limited progress was made during 1996 to restore economic stability in Nigeria, but inflation, while easing, remained high. A recovery in output and a further fall in inflation are expected in 1997.

Following the 1994 devaluation of the CFA franc and the implementation of associated structural adjustment programs, growth in the countries of the CFA franc zone registered a turnaround in 1995. During 1996, economic activity gathered strength, resulting in growth rates of about 5 percent. Output growth is projected to remain relatively strong in 1997, and inflation to remain low or to decline further. In Senegal, the rebound in agricultural production and continued expansion in the output of the industrial and construction sectors contributed to growth of 5 percent in 1996. In Côte d'Ivoire, robust growth in 1996 was largely driven by expansion of exports, especially cocoa and petroleum, which partly reflected improved competitiveness. Inflation continued to abate despite further price liberalization measures.

Among the developing countries of *Asia,* growth in 1996 moderated to 8¼ percent. This aggregate outcome, however, masks diverse developments across the region. The weakening of export growth, noted

Table 6. 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**	**6.6**	**21.3**	**13.1**	**9.7**
Median	**4.1**	**4.3**	**4.7**	**10.0**	**7.0**	**5.4**
Africa	**2.9**	**5.0**	**4.7**	**32.1**	**24.8**	**12.0**
Algeria	3.9	4.0	5.0	21.9	15.1	7.0
Cameroon	3.3	5.0	5.1	26.9	6.4	3.5
Côte d'Ivoire	7.0	6.5	6.0	14.3	6.6	3.0
Ghana	4.5	5.0	5.0	59.5	45.6	21.5
Kenya	4.9	4.2	3.8	1.7	9.0	8.0
Morocco	–7.6	10.3	3.0	6.1	3.0	3.5
Nigeria	2.5	2.1	4.7	70.0	29.3	14.1
South Africa	3.4	3.1	2.2	8.6	7.4	10.2
Sudan	4.5	4.0	4.0	57.0	85.0	55.0
Tanzania	3.8	4.5	5.0	34.0	25.7	15.0
Tunisia	2.5	7.5	7.0	6.3	5.0	4.5
Uganda	9.8	7.0	7.0	7.4	5.0	5.0
SAF/ESAF countries[1]	4.9	6.0	5.5	22.0	15.7	7.4
CFA countries	4.6	5.2	5.7	15.3	6.0	3.2
Asia	**8.9**	**8.2**	**8.3**	**11.8**	**6.6**	**6.2**
Bangladesh	4.9	5.0	5.0	6.3	3.5	3.3
China	10.5	9.7	9.5	14.8	6.0	6.0
India	7.4	6.9	6.6	10.2	7.0	8.0
Indonesia	8.2	7.8	8.0	9.4	7.9	7.3
Malaysia	9.5	8.4	8.0	3.4	3.5	3.8
Pakistan	4.4	6.0	5.0	12.1	10.3	11.0
Philippines	4.8	5.5	6.3	8.1	8.4	6.5
Thailand	8.7	6.7	6.8	5.8	5.8	4.5
Vietnam	9.5	9.5	9.5	12.8	6.0	7.0
Middle East and Europe	**3.8**	**4.5**	**3.9**	**33.8**	**24.5**	**21.0**
Egypt	3.2	4.3	5.0	9.4	7.2	6.2
Iran, Islamic Republic of	3.1	4.2	3.8	49.4	23.0	15.7
Jordan	6.9	5.2	6.5	2.4	6.5	4.0
Kuwait	1.6	1.6	0.8	0.7	0.9	1.2
Saudi Arabia	0.0	2.5	2.0	5.0	1.0	1.0
Turkey	7.5	6.4	3.9	93.6	82.3	75.0
Western Hemisphere	**1.3**	**3.5**	**4.4**	**36.0**	**20.4**	**12.9**
Argentina	–4.6	4.4	5.0	3.4	0.1	1.1
Brazil[2]	4.2	3.0	4.5	. . .	11.1	8.0
Chile	8.5	7.2	5.8	8.2	7.4	6.0
Colombia	5.4	3.0	3.4	20.9	20.8	18.0
Dominican Republic	4.8	7.3	5.0	12.5	5.4	5.0
Ecuador	2.3	1.8	3.0	23.0	24.4	30.4
Guatemala	4.9	3.1	4.0	8.4	10.6	9.5
Mexico	–6.2	5.1	4.5	35.0	34.1	17.3
Peru	7.0	2.8	5.0	11.2	11.5	9.9
Uruguay	–2.4	4.8	4.5	42.3	28.3	19.3
Venezuela	3.4	–1.2	3.9	59.9	99.9	46.6

[1]African 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. From December 1995 to December 1996, the inflation rate was 9.3 percent.

earlier in the context of the advanced Asian economies, was also visible in a number of the fast-growing developing countries of the region. In some countries, such as Indonesia, Malaysia, and Thailand, the impact of the export slowdown on output coincided with the effects of tighter domestic financial policies aimed at reducing the risk of overheating. The decline in export growth affected activity in Thailand more than in other East Asian countries, although real GDP still grew by nearly 7 percent in 1996, with the current account deficit remaining large. In contrast, in Indonesia, the export slowdown was limited and partially offset by continued buoyancy of domestic demand, in part reflecting large capital inflows. As a consequence, growth remained close to 8 percent. In Malaysia, slower export growth, combined with a tighter monetary policy, helped contain overheating pressures. While labor markets in Malaysia are tight and rates of expansion in private credit, real estate sales, and investment demand have remained high, pressures on capacity should be eased by the tightening of fiscal policy announced in the 1997 budget. The economic recovery that began in 1994 continued in the Philippines, with a further strengthening of output. Deregulation and liberalization are helping by producing supply-side benefits and growth is projected to strengthen slightly further in 1997 as investment and exports pick up.

In China, after three years of double-digit inflation, a soft landing was successfully achieved in 1996. While inflation declined to 6 percent, GDP growth was well maintained at about 9½ percent. The outlook for 1997 remains favorable, with growth roughly unchanged and inflation remaining in the single digits. In India, strong agricultural output partly offset a slowdown in the industrial sector so that real GDP growth slowed only moderately to about 7 percent in 1996, while inflation declined to 7 percent. In Pakistan, after economic activity started to pick up in early 1996, the fiscal position worsened and a balance of payments crisis ensued later in the year as the trade deficit widened and capital inflows slowed. The adjustment required is expected to lead to slower growth in 1997 but will help improve the medium-term outlook.

Solid performance continues in the Asian developing countries undergoing transition from central planning to market-based systems. Cautious fiscal and monetary policies in Vietnam succeeded in lowering inflation in 1996, while solid growth was maintained. Continued robust growth is expected in the year ahead, with only a slight increase in inflation. The economic recovery under way in Cambodia continued in 1996, although growth slowed somewhat reflecting the adverse impact of recent floods on rice output, and further progress was made in reducing inflation. In the Lao People's Democratic Republic, growth remained buoyant owing to strong construction and services activity, which offset a slump in export-based manufacturing.

For almost a decade, the performance of many economies in the *Middle East and Europe* region has been disappointing. While the region has been periodically beset by political tensions and fluctuating oil revenues, inadequate economic policies also help explain the weak economic conditions. In recent years, however, a number of countries have implemented reform programs, albeit with varying degrees of commitment and subsequent success. Reflecting the continued progress toward macroeconomic stabilization and deregulation of the economy in the past few years, growth in Egypt increased to about 4 percent in 1996 and inflation was contained at about 7 percent. Prudent monetary and fiscal policies in Jordan have been supporting robust growth, which is expected to continue in the year ahead. Gradual fiscal consolidation has been the centerpiece of Saudi Arabia's reform efforts during the past decade. Improved fiscal and external positions, buoyed by higher oil export revenues, contributed to increased private sector confidence and a pickup in economic activity in 1996. In contrast, overheating pressures continued in Turkey last year. Inflation accelerated to around 80 percent, the fiscal deficit climbed to over 9 percent of GDP, and interest rates reached over 120 percent.

Developments and Prospects in Transition Countries

For the countries in transition, considered as a group, the contraction in economic activity seems to have bottomed out in 1996 after six years of deep decline. Also last year, inflation fell to 40 percent on an annual average basis, its lowest rate since the transition began, and to lower levels on a 12-month basis by the end of the year (Table 7 and Chart 11). Output is expected to expand by 3 percent in 1997—with all but five countries registering growth of 2 percent or higher—and inflation to slow further. It should be emphasized that output data for these countries may underestimate actual growth because they may not take full account of various forms of economic activity, particularly the output of new enterprises and activity in the informal service sector (Box 5).

The *countries more advanced in the transition process* have generally continued to make progress in macroeconomic stabilization and structural reform.[6] By the end of 1996, inflation had declined to 20 percent or less in each of these countries, and to 10 percent or below in the Czech Republic, the Slovak Republic, Croatia, and Slovenia. Output growth, although still quite strong, moderated somewhat in the Czech Republic, Estonia, Poland, and the Slovak Republic, mainly reflecting weaker exports to the EU. Nevertheless, overheating remains a risk in both the Czech Republic and the Slovak Republic, where relatively high wage increases are helping to fuel domestic demand. Despite a slowdown in growth in Hungary in 1996, tight fiscal and monetary policies have estab-

[6]See Chapter V, Table 21, for lists of countries considered to be more and less advanced in transition.

Table 7. Countries in Transition: Real GDP and Consumer Prices
(Annual percent change)

	Real GDP			Consumer Prices[1]		
	1995	1996	1997	1995	1996	1997
Countries in transition	**–0.8**	**0.1**	**3.0**	**119**	**40**	**31**
Median	**1.5**	**2.7**	**4.0**	**46**	**24**	**16**
Central and eastern Europe	1.6	1.6	3.0	68	36	38
Excluding Belarus and Ukraine	5.0	3.4	3.3	24	30	41
Albania	8.9	8.2	2.0	8	13	20
Belarus	–10.2	2.0	0.0	709	52	30
Bulgaria	2.6	–9.0	–4.8	62	123	769
Croatia	1.5	5.0	5.5	2	3	4
Czech Republic	4.8	4.2	4.5	9	9	8
Estonia	3.2	3.1	4.4	29	23	17
Hungary	1.5	1.0	2.0	28	24	18
Latvia	0.4	2.5	4.0	25	19	12
Lithuania	3.1	3.5	4.5	39	25	12
Macedonia, former Yugoslav Rep. of	–1.4	1.1	5.0	16	2	2
Moldova	–3.0	–8.0	3.0	30	24	11
Poland	6.5	5.5	5.5	28	20	16
Romania	7.1	4.1	–1.5	32	39	109
Slovak Republic	6.8	7.0	6.0	10	6	6
Slovenia	3.9	3.5	4.0	13	10	8
Ukraine	–12.0	–10.0	2.7	376	80	25
Russia	–4.0	–2.8	3.0	190	48	14
Transcaucasus and central Asia	–3.9	1.6	2.8	260	70	52
Armenia	6.9	6.6	5.5	177	19	8
Azerbaijan	–11.0	1.3	5.2	412	20	9
Georgia	2.4	10.5	10.0	163	40	12
Kazakstan	–8.9	1.0	2.0	176	39	21
Kyrgyz Republic	1.3	5.6	6.9	53	30	27
Mongolia	6.3	3.0	5.0	57	50	39
Tajikistan	–12.5	–7.0	–5.3	610	443	32
Turkmenistan	–8.2	–3.0	1.7	1,005	992	153
Uzbekistan	–0.9	1.6	2.0	305	54	87

[1]Average annual percent changes in consumer prices can differ significantly from during-the-year changes. See Chart 11 for monthly data for selected countries in transition.

lished important conditions for robust and sustainable growth; indeed signs of a pickup in activity emerged in the second half of 1996. Progress with structural reforms continues in these countries, although often at a slower pace than previously, reflecting the relatively difficult tasks now being addressed, including enterprise restructuring, the rehabilitation and rebuilding of infrastructure, and the establishment of robust financial and legal institutions.

For a number of *countries less advanced in transition,* efforts at macroeconomic stabilization were rewarded in 1996 with sustained and sharp declines in inflation and, except for Russia and Ukraine, significantly improved growth performance. Inflation fell markedly in 1996 in Armenia, Azerbaijan, Georgia, Kazakstan, Russia, and Ukraine and remained broadly stable in the Kyrgyz Republic and Moldova owing in part to the increased stability of nominal exchange rates. Positive growth emerged in 1996 in Azerbaijan, Kazakstan, and the former Yugoslav Republic of Macedonia, while Armenia and the Kyrgyz Republic recorded growth above 5 percent and Georgia above 10 percent. The recent economic performance of Russia and Ukraine has been mixed. Both countries made substantial progress in bringing down inflation during 1996—with end-of-year annual inflation declining to 22 percent in Russia and to 39 percent in Ukraine. However, both countries have yet to record positive growth in output since the start of the transition. The government's fiscal position in Russia remains fragile, with revenue collection particularly weak, but recent indicators suggest that the long-awaited recovery of output may materialize in 1997. In particular, private investment is expected to begin to pick up in response to reforms and progress with macroeconomic stabilization. In Ukraine, progress has been made with privatizing large- and medium-scale enterprises in the last two years, but the pace has slowed down in early 1997, and regulatory uncertainty continues to impede market activity.

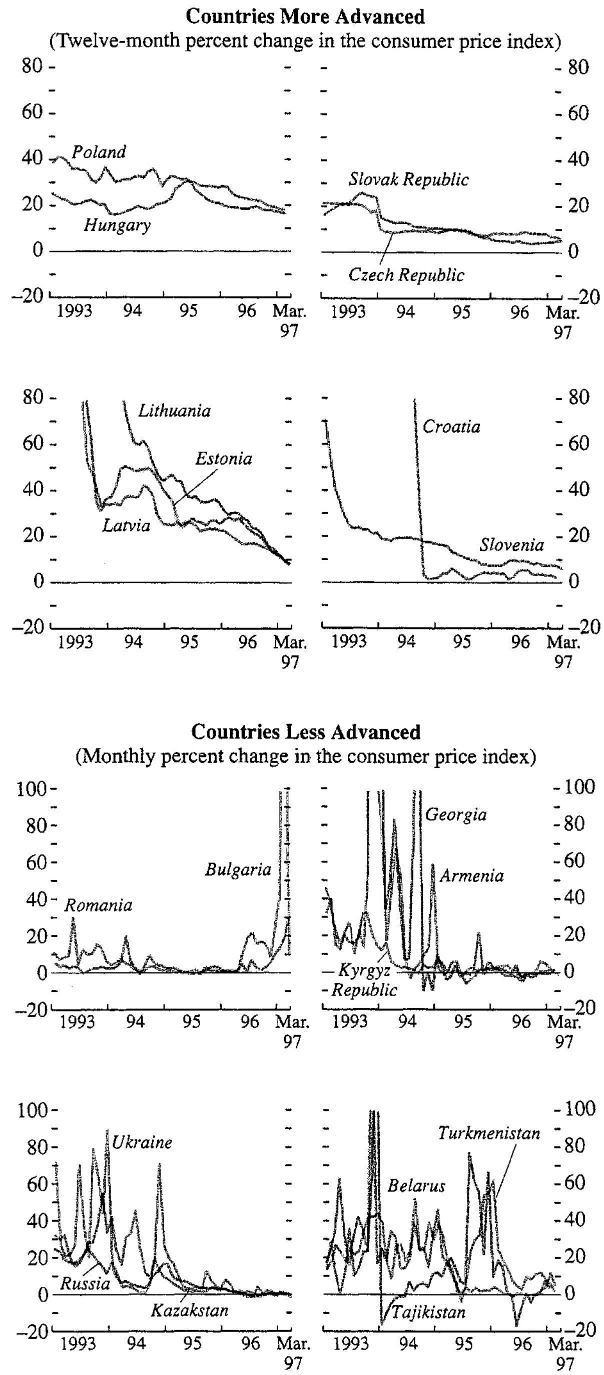
In other countries less advanced in transition, including Albania, Bulgaria, Romania, and Uzbekistan, macroeconomic stabilization has slipped, and there have been significant increases in inflation in recent months. The situation has been particularly difficult in Bulgaria, where the banking system came under severe pressure in late 1996. In early 1997, the Bulgarian and Romanian governments both adopted far-reaching stabilization and reform programs. Inflation in Bulgaria has since declined sharply and the exchange rate has stabilized. Albania was confronted in early 1997 with a financial crisis caused by the collapse of "pyramid" investment schemes. The crisis led to civil strife and the breakdown of law and order in the country. Uzbekistan has taken steps backward in the reform process, notably by reimposing restrictions on current account convertibility. Civil unrest has continued in Tajikistan, while already limited structural reform efforts have been partly reversed in Belarus. In Turkmenistan, the inflation rate has remained the highest among all the countries in transition.

Financial and Foreign Exchange Markets

Developments in the foreign exchange and financial markets of the advanced economies since the October 1996 *World Economic Outlook* have reflected changing perceptions of the near-term growth prospects for individual countries, of the outlook for continued low global inflation, and of progress with fiscal consolidation and toward monetary union in Europe. Short-term interest rates have in most cases either remained broadly unchanged or declined, the most notable exceptions being the United Kingdom and the United States, where they were raised slightly in October 1996 and March 1997, respectively. Long-term interest rates continued on a downward trend until early December in the United States and Canada and until mid-February in most other countries, with the higher-yielding bond markets in Europe recording the largest overall declines. Renewed concerns about inflation risks in the United States combined with signs of stronger activity in Europe and some increase in EMU-related uncertainty prompted significant increases in long-term rates in most countries except Japan in late February and March. Movements in exchange rates, for the most part, have maintained the trends prevailing since mid-1995, with the U.S. dollar appreciating further against most other major currencies, although a marked acceleration in the appreciation of the pound sterling in late 1996 and early 1997 was a notable new development. The exchange rate mechanism (ERM) of the European Monetary System was generally free of significant tensions, with the Finnish markka joining the ERM in October and the Italian lira reentering in November. The environment of low inflation, stable or falling interest rates, and

Chart 11. Selected Transition Countries: Inflation

In countries more advanced in transition, inflation has come down steadily. In those less advanced in transition, inflation has been reduced in the countries that have maintained tight financial policies.



Box 5. Problems in Measuring Output in Transition Countries

Real output in the transition economies declined sharply in the initial phase of the transformation. Output is officially reported to have fallen cumulatively by more than one-half in the early years in a number of countries of the former Soviet Union. While by 1996 output growth had resumed in most transition countries, official reports show another year of decline in five countries of the former Soviet Union, including Russia and Ukraine. There are indications, however, that the actual size and consequences of the decline in output have been less severe than the official numbers suggest. Official measures of output are likely to overstate the decline for a number of reasons, including a tendency to exaggerate output before the transition began; methodological problems in constructing real output indicators; and incomplete coverage and underreporting of certain economic activities. Moreover, it is difficult to assess the welfare effects of output changes following such a shift in economic regime, and the decline in output is likely to overstate significantly the deterioration of living standards during the transition.

The statistical authorities in the transition economies, while gradually beginning to compile GDP statistics on the basis of the 1993 *System of National Accounts*, encountered numerous methodological problems in the derivation of real output indicators. The difficulties were compounded by the effects of high inflation and persisting distortions in relative prices, as measuring the changes in real output involves valuation issues such as the choice of the appropriate weighting scheme to aggregate sectoral physical output indicators and the computation of the share of intermediate consumption in gross output; these issues have often not been adequately addressed. With statistical systems having improved substantially and inflation having fallen to more moderate levels, the methods to derive measures of aggregate real output have become more sound; however, the flawed estimates for the initial years of the transformation still await revision in many cases.

The traditional statistical methodology, based on exhaustive reporting of production by state-owned and mainly large-scale enterprises, was not well equipped to deal with privatization and the rapid increase in new, and for the most part small, private enterprises. As a result, many enterprises and activities are still not covered or are reported inadequately. Households involved in small-scale private activities, such as retail trade and agriculture, and private firms that would not be included in business registers, do not report at all. In addition, a large number of enterprises that are covered by the reporting system seem to underreport their activities, often to avoid taxes. To the extent that new forms of economic activity in particular are poorly measured, the reported data also tend to overestimate the share of the declining sectors inherited from central planning relative to the new and expanding private sectors. Statistical authorities in the transition countries have long recognized that incomplete coverage and underreporting are major issues and have started to make upward adjustments to the output data provided through the traditional reporting channels and to prepare estimates of the magnitude of unreported activity. For instance, a recent statement by the Russian State Statistical Committee indicated that in 1996 only about 85 percent of industrial output and around 45 percent of trade activity was actually reported to the statistical authorities.

A consensus is emerging that the cumulative output decline in the early years of the transition has been overesti-

moderate or improving growth prospects in most countries laid the basis for further large gains in major industrial country equity markets, with the notable exception of Japan, in the period until early March before a partial correction occurred that appeared to be prompted mainly by concerns about rising interest rates, particularly in the United States.

Since early September, monetary authorities in most industrial countries have either held *short-term* interest rates steady or lowered them. The most notable exceptions are the United Kingdom, where official rates were raised by 25 basis points in October to help counter the inflation risks associated with a consumer-led upswing in activity, and the United States, where the Federal Reserve raised the target federal funds rate by 25 basis points in late March in response to the persisting strength of demand and increasing risk of rising inflation (Chart 12). Short-term rates have remained unchanged in Japan (since September 1995) and Germany (since August 1996). The Bank of France made four modest cuts in official rates, amounting to 15–25 basis points, in the closing months of 1996 and early 1997, and as a result French and German short-term rates had converged by late February compared with a differential of over 100 basis points in favor of French rates a year earlier.

Elsewhere in Europe, the Bank of Italy's discount rate was cut on two occasions, in October and January, by a cumulative 150 basis points as inflation in Italy fell below 3 percent, activity remained weak, and plans were announced for a substantial fiscal tightening in 1997. Fiscal consolidation and favorable inflation developments also provided scope for official rate cuts in Portugal, Spain, and Sweden, where short-term rates have fallen by 90–150 basis points since early September, while the Norwegian central bank cut the overnight lending rate by 125 basis points between November and January in an effort to curb upward pressures on the exchange rate. Conversely, in the Netherlands, the central bank raised the special advances rate by a cumulative 40 basis points on two occasions in late February and early March. Outside mated. A recent detailed revision of Russia's national accounts found that the cumulative decline in real GDP was about 35 percent during 1990–94, compared with an initial estimate of around 47 percent.[1] The revision reflects both methodological corrections (including correction of the underlying data for 1991) and more accurate estimates of value added, as well as improvements in the coverage of trade and other services. Similarly, the cumulative output decline in Kazakstan during 1990–94 was recently revised from 51 percent to around 35 percent. Reassessments for other countries, especially countries of the former Soviet Union, while not yet available, are likely to result in comparable revisions for this period.

Despite significant improvements in methodology and coverage, the authorities may still be conservative in their estimates of underreporting. For Russia, the IMF staff estimates that after taking proper account of increasing tax avoidance the output decline in 1996 was 2.8 percent rather than the officially reported 6 percent. In a number of other cases, for instance Azerbaijan and the Kyrgyz Republic in 1995, the IMF staff has also made upward adjustments to the official output data. Without proper adjustment for problems of incomplete coverage and underreporting, the output recovery in countries where growth has resumed is similarly underestimated. The real GDP data for the transition countries reported in the *World Economic Outlook* reflect the IMF staff's current best estimates.

There is clearly a need to continue to improve the quality of the national accounts estimates in the transition countries by strengthening the standard survey processes, combining information from separate sources, such as household budget surveys, and developing methods for estimating activities that are difficult to measure.[2] At the same time, it should be recognized that not only will implementing these improvements take time, but also the increasing share of activities that go untaxed and unrecorded reflects underlying problems. Such activities are a response to inefficient tax collection practices, high tax burdens and nontransparent tax laws, poor implementation of laws and regulations, and general macroeconomic instability.[3] Experience in a number of central and eastern European countries shows that the role of activities outside the normal fiscal and regulatory framework diminishes as progress with the transformation process continues, including through the redefinition of the role of and limits on government intervention in the economy. However, tax evasion can be a serious problem even in advanced economies and will be difficult to curtail completely.

[1]See State Statistics Committee of the Russian Federation and the World Bank, Russian Federation: Report on the National Accounts (Washington: The World Bank, October 1995); this revision confirms the argument and computations in Evgeny Gavrilenkov and Vincent Koen, "How Large Was the Output Collapse in Russia? Alternative Estimates and Welfare Implications," *Staff Studies for the World Economic Outlook* (IMF, September 1995), pp. 106–19.

[2]See Adriaan M. Bloem, Paul Cotterell, and Terry Gigantes, "National Accounts in Transition Countries: Distortions and Biases," IMF Working Paper 96/130 (November 1996).

[3]See Daniel Kaufman and Aleksander Kaliberda, "Integrating the Unofficial Economy into the Dynamics of Post-Socialist Economies: A Framework of Analysis and Evidence," World Bank Policy Research Working Paper No. 1691 (Washington: World Bank, December 1996).

Europe, Canadian short-term rates fell by a further 100 basis points in October and early November as the Bank of Canada cut official rates to offset the tightening of monetary conditions associated with the rise of the Canadian dollar. The Australian and New Zealand central banks have also permitted short-term rates to fall since early September by about 100 and 200 basis points, respectively, in response to slower growth and an improved outlook for inflation.

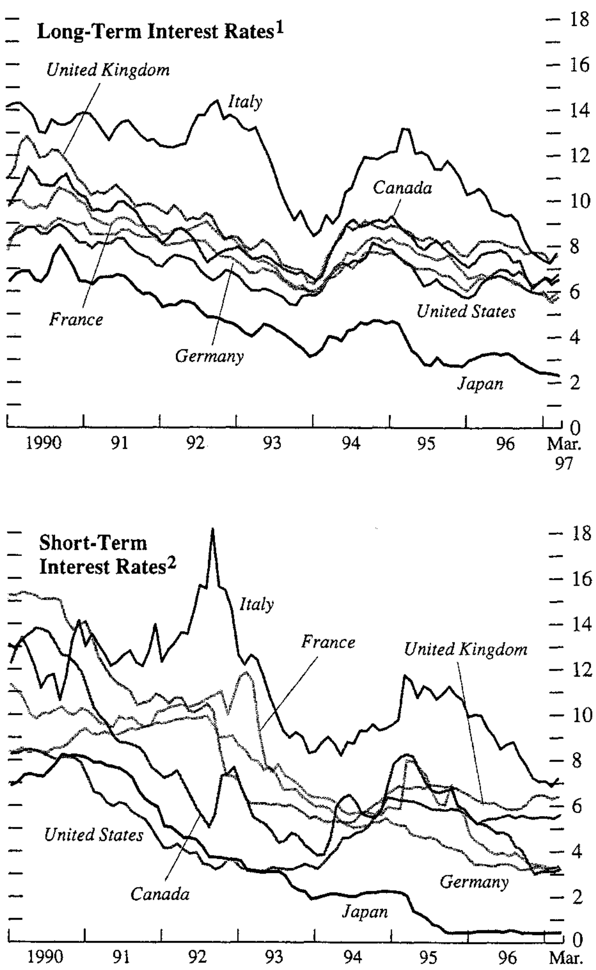
Following the divergent movements in long-term interest rates in the previous six months, bond yields fell virtually across the board in major industrial countries in the period from early September until early December. Yields fell by 60–90 basis points in many countries and by 150–200 basis points in a few cases, reflecting reduced concerns about global inflation, as price pressures remained subdued or eased further in many countries, and as the moderation of growth in the United States in the third quarter became clearer in the data. In addition, bond yield spreads continued to narrow in Europe in response to further convergence in inflation performance and progress on fiscal consolidation, which also contributed to positive market assessments of prospects for EMU. Additional factors contributing to the yield declines were cuts in official interest rates in several countries and expectations that the highly accommodative monetary stance in Japan would be maintained for longer than perceived earlier given the hesitant progress of the recovery. The largest declines were recorded in Italy, Portugal, and Spain on lower inflation and intensified efforts to meet the criteria for EMU participation. Long-term interest rates also fell by 100–150 basis points in several other higher-yielding bond markets, notably Australia, Canada, and Sweden.

Between early December and early April, long-term rates rebounded by about 90 basis points in the United States as the renewed strength of activity in the fourth quarter became more apparent to markets and as data became available indicating continued growth above potential in the first three months of 1997. Rates in Canada rose by a similar amount, reflecting the upturn

Chart 12. Major Industrial Countries: Nominal Interest Rates

(In percent a year)

In most countries, short-term interest rates have remained steady or declined, and long-term rates have continued on a downward trend.



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

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

[2]Three-month maturities.

in the Canadian economy as well as the spillover effects of higher U.S. rates. In Europe, bond yields mostly continued to move downwards until mid-February before turning up partly in response to the rise in U.S. rates but also owing to signs of stronger activity in continental Europe and some market reassessment of the probabilities of early participation by certain countries in EMU. In contrast, long-term rates continued to decline in Japan, reaching historic lows around 2.1 percent in early April. By that time, long-term rates in the United States had returned to their early September levels, but in most other countries they remained lower, particularly in Canada and in the higher yielding European markets. As a result of these movements, the premium of U.S. over German and French yields has widened to close to a full percentage point after having been negative in most of 1995 and early 1996. This change in differentials is a particularly welcome development, reflecting the lower underlying inflation rates in continental Europe, the relative cyclical positions of the U.S. and key continental economies, and the correction of the overly strong exchange rate of the deutsche mark in terms of the U.S. dollar.

In *foreign exchange markets,* the U.S. dollar strengthened further against most other major currencies since last September but weakened against the pound sterling and barely changed in value against the Canadian dollar (Chart 13). By early April, the dollar was about 15 percent higher than in early September in terms of the Japanese yen, the deutsche mark, and the French franc, and more than 20 percent higher against the Swiss franc. On the other hand, it was about 3 percent weaker against sterling. Reflecting these partly offsetting movements, the dollar was about 10 percent higher in nominal effective terms than in early September 1996 and about 19 percent above its trough of April 1995. The yen weakened by a further 9 percent in nominal effective terms between early September 1996 and early April 1997, taking the cumulative depreciation since April 1995 to 30 percent. During the fourth quarter of 1996 the pound sterling rose against all other major currencies, strengthening by 10 percent against the deutsche mark and in nominal effective terms, before weakening slightly in January but strengthening again in February. The Italian lira has weakened in effective terms by about 2 percent, while the Canadian dollar has strengthened by about 3 percent.

These exchange rate movements are partly attributable to the continued disparities in relative cyclical positions among the major economies, which have been reflected in interest rate differentials given the subdued inflation environment in these countries. Thus the appreciation of the U.S. dollar has been supported by the continued relatively strong performance of the U.S. economy and by associated interest differentials in favor of dollar-denominated assets. Interest differentials favoring sterling-denominated assets and expectations that higher interest rates may be needed in the United Kingdom to avoid higher inflation also contributed to the rise of sterling. In contrast, the yen has continued to weaken as concerns over the robustness of the Japanese economic recovery have contributed to expectations that domestic interest rates will remain low for some time. Similarly, low interest rates in Switzerland and weak domestic growth prospects have contributed to the marked depreciation of the Swiss franc.

These currency realignments have for the most part been helpful responses to relative demand pressures in the major economies given their different cyclical positions, redistributing demand among countries in ways that are generally conducive to sustainable growth, and seemingly not taking exchange rates to levels that would be clearly out of line with medium-term requirements for balance of payments sustainability. In the case of the dollar, recent movements have more than reversed the sharp depreciation that took it to its low point in April 1995 and by early April 1997 had taken the real exchange value of the dollar to its highest level since 1989. Similarly, by early April, the real effective value of the yen had returned to its level prior to the large run-up beginning in 1993, while the deutsche mark returned to the level prevailing in late 1994, and sterling had reversed most of the losses following its withdrawal from the ERM in mid-1992. Following their meeting in early February, finance ministers of the seven major industrial countries released a statement noting that the earlier misalignments in exchange markets had been corrected and that there was agreement to monitor exchange market developments and to cooperate as appropriate. Subsequently, the exchange rates of the major currencies generally traded within fairly narrow ranges in February and March.

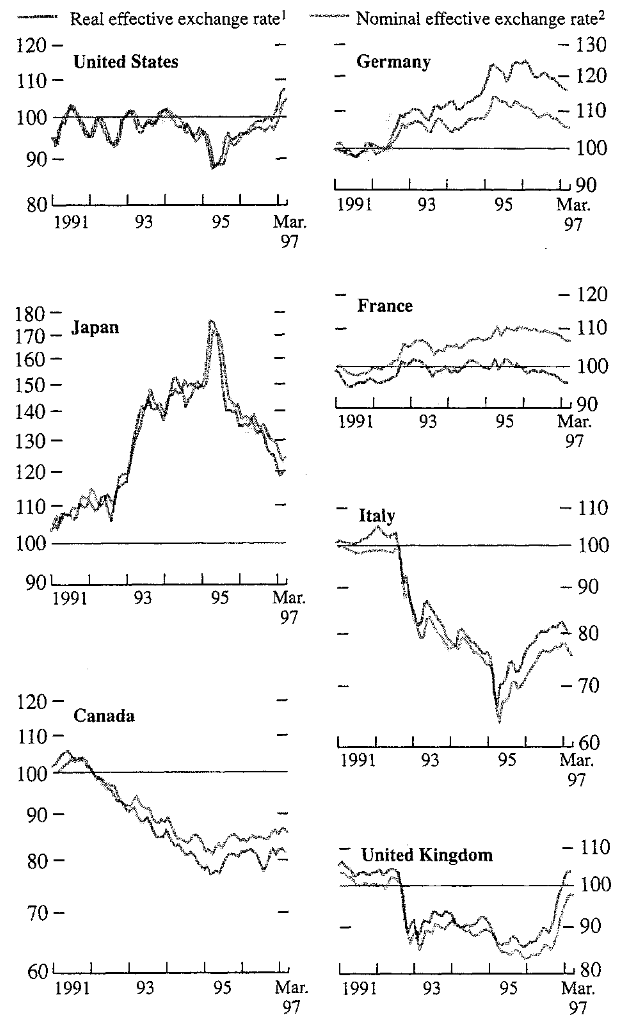
Stock market prices rose strongly in most industrial countries in the period between early September and early March, extending the gains recorded earlier in 1996. By mid-March, equity prices in the United States, Canada, and several major European markets were about 30–45 percent higher than at the end of 1995. Subsequently, in late March and early April, most major markets underwent downward corrections on the order of 10 percent in the United States and Canada and somewhat less in Europe in response to the rise in bond yields.

Prior to the subsequent correction, the rise in the U.S. stock market to new peaks in late 1996 and early 1997 had prompted official expressions of concern. The total value of the U.S. equity market is estimated to have reached nearly 140 percent of GDP in early 1997, which is well above the levels seen in the past three decades. The rise in equity prices in recent years is clearly related to the strong growth of corporate earnings (profits), which rose from about 8 percent of

Chart 13. Major Industrial Countries: Effective Exchange Rates

(1990 = 100; logarithmic scale)

As the dollar has risen to levels not seen earlier in the 1990s, the yen has declined to the levels of early 1993.

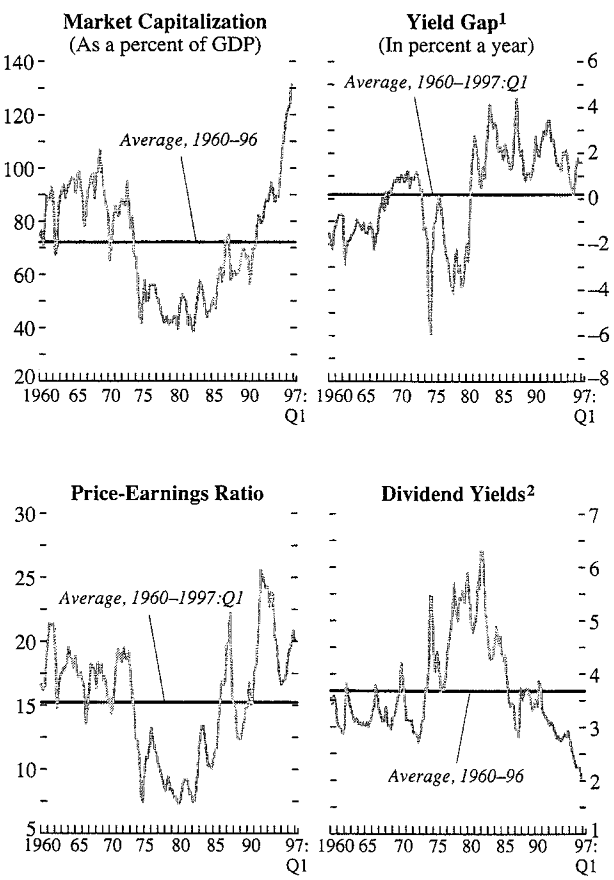


[1]Defined in terms of relative normalized unit labor costs in manufacturing, as estimated by the IMF's Competitiveness Indicators System, using 1989–91 trade weights.

[2]Constructed using 1989–91 trade weights.

Chart 14. United States: Stock Market Indicators

With the strong increase in U.S. equity prices in recent years, market capitalization has reached a high; price-earnings ratios have increased; and dividend yields have declined to low levels; but the yield gap vis-à-vis bonds has remained below recent peaks.



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

[1]The equity yield gap is defined as the difference between the yield on ten-year government bonds and the inverse of the price-earnings ratio of S&P's 500 price index.

[2]Dividend yields are calculated as a ratio of gross dividends to share prices.

GDP in 1990–91 to 11 percent in 1996. The rise in price-earnings ratios has therefore been less dramatic than the rise in equity prices; but price-earnings ratios nevertheless have risen to levels well above the averages of the past three decades (Chart 14). There has been a corresponding decline in dividend yields to levels well below recent historical averages. The decline in equity yields and rise in price-earnings ratios may be attributed partly to declines in yields on alternative assets, owing in particular to declines in interest rates and inflation. Thus the yield gap between bonds and equities, though becoming wider (in favor of bonds) than the average since 1960, has remained significantly lower than peaks reached in recent years, for example, immediately prior to the 1987 market drop. The rise in the U.S. equity market in recent years may therefore be attributed in large part to strong fundamentals—strong earnings growth and lower interest rates, in particular. But this indicates that the market would be vulnerable both to increases in interest rates and to downward revisions of expectations of future profit growth, and both of these factors seemed to underlie the partial correction of prices that subsequently occurred in late March and early April.

Equity markets in Canada and Europe mostly lagged behind the U.S. market prior to 1996, and their more recent upswing appears to reflect improved growth prospects in many countries combined with lower bond yields. The main exception to this trend has been Japan, where equity prices fell 13 percent in the period between early September and early April on concerns about the outlook for growth and corporate profitability, combined with concerns about weaknesses in bank balance sheets and uncertainties about the pace and extent of financial deregulation. Concerns about corporate indebtedness and its effects on the financial sector also contributed to a further fall in equity prices in Korea, where growth has slowed and exports have weakened.

Against a background of continued strong capital flows to emerging markets, *foreign exchange markets in developing countries* remained relatively stable in the second half of 1996, with occasional periods of turbulence in particular countries generally not having significant spillover effects on other markets.[7] After several months of relative stability, the Mexican peso weakened by about 6 percent in October as a result of uncertainty concerning the announcement of the economic policy program for 1997 and investor concerns linked to the privatization of public enterprises, among other factors. However, the peso quickly stabilized after the central bank tightened monetary policy and

[7]Capital inflows to emerging market countries and related issues including policy options in managing these flows have been discussed extensively in previous issues of the *World Economic Outlook*. For example, see Annex IV, October 1996 *World Economic Outlook*.

agreement was reached with business and labor leaders on policy targets for 1997; financial markets in Mexico have since rebounded. In mid-January, the Chilean central bank widened the exchange rate band and revalued the peso, in terms of its reference exchange rate, by about 4 percent against the U.S. dollar. In Brazil, the real continued to depreciate gradually within its band, while reserve accumulation slowed in response to lower interest rates and measures taken in early 1996 to dampen capital inflows. The trading band for the real against the U.S. dollar was depreciated by about 7 percent in February 1997. In Venezuela, higher oil prices and an improved capital account contributed to a $6 billion rise in reserves in 1996, and the bolívar stabilized following exchange rate unification and the adoption of an IMF-supported program in April. In Colombia, reserves rose strongly toward the end of 1996 as the authorities sought to contain upward pressure on the peso.

Strong capital inflows contributed to further substantial reserve accumulation in several Asian countries in 1996. Most countries maintained broadly stable exchange rates against the U.S. dollar, which entailed appreciation in real effective terms given inflation differentials and the rise of the dollar especially against the Japanese yen. In China, reserves rose by a further $30 billion following comparably large increases in the previous two years. In Indonesia, the authorities have continued gradually to lower the intervention band for the rupiah in terms of the dollar and have also allowed somewhat greater flexibility by widening this band on three occasions during 1996. In Malaysia, the authorities allowed the ringgit to rise moderately in nominal effective terms in early 1997 in response to continued strong capital inflows. Thailand encountered downward pressures on its currency in 1996 and early 1997, partly reflecting concerns about its current account deficit. Although the Thai baht depreciated only slightly against the U.S. dollar, the authorities intervened substantially to support the currency on three occasions—in July, December, and January–February. In late October, the Pakistan rupee was devalued by 8½ percent as part of a package of measures to address widening macroeconomic imbalances and a sharp fall in foreign exchange reserves.

Among other emerging market economies, the South African rand came under renewed downward pressure in October on concerns about higher inflation and disappointment with progress toward the macroeconomic plan announced earlier in the year; the pressure was resisted by a hike in interest rates. The rand depreciated by about 28 percent in 1996 but rebounded somewhat in early 1997. In Turkey, the lira maintained its path of steady but rapid depreciation broadly in line with inflation. In central and eastern Europe, with the exceptions of Bulgaria and Romania, all countries saw their currencies appreciate in real terms. The Czech koruna appreciated even in nominal effective terms, reflecting a tightening of domestic monetary conditions intended to dampen inflationary pressures and contain a widening in the current account deficit.

In contrast to the performance of industrial country markets, there was a variety of equity price movements in emerging market countries in the second half of 1996. Price gains overall were modest, with the International Finance Corporation (IFC) composite index rising only 7½ percent in 1996 as a whole (Chart 15). However, the flat overall picture disguises sharp movements in some individual countries. In China, prices rose between two- and threefold prior to a partial correction in December prompted by official expression of concern about illegal speculation, which was accompanied by a tightening of regulations. In contrast, stock market prices fell sharply in Thailand as growth slowed in response to earlier monetary tightening and the rapid downturn in exports. Improved investor confidence following the successful implementation of stabilization measures saw equity prices roughly double in U.S. dollar terms in Hungary, Russia, and Venezuela in 1996. In most other emerging market countries, price gains in dollar terms were modest, with price falls recorded in the second half of the year in Chile, the Czech Republic, and South Africa. Following the subdued overall performance in 1996, equity markets in most developing countries recorded significant gains in early 1997 with the IFC composite index rising 10 percent in the period through early April.

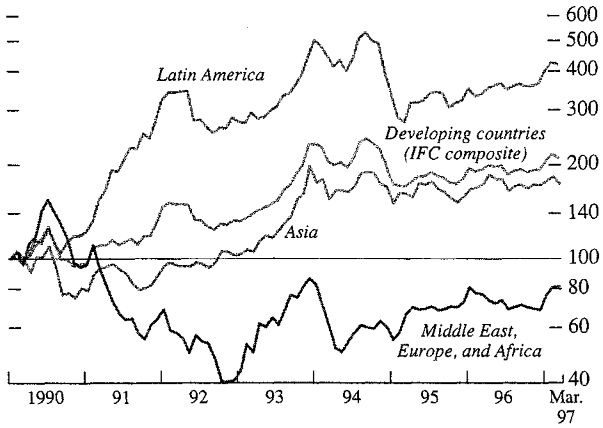
External Payments, Financing, and Debt

The expansion of world trade slowed markedly in 1996 following the exceptionally rapid growth of the two preceding years (Chart 16). Some decline in trade growth both absolutely and relative to output growth was projected in the October 1996 *World Economic Outlook*. But the decline that occurred last year exceeded expectations, taking the elasticity of trade with respect to output to its lowest level since the mid-1980s. This elasticity nevertheless remained higher than the averages of both the 1970s and the 1980s. Even though the growth of world output increased in 1996, sluggish demand for imports in some of the advanced economies—arising in some cases from efforts to reduce excessive inventories—and moderating growth in a number of Asian countries appear to have contributed to the disproportionate slowing of trade.[8]

[8]The IMF staff's estimate that the expansion of world merchandise trade slowed to 5½ percent in 1996 may be compared with the World Trade Organization's (WTO) estimate that it slowed to about 4 percent. The discrepancy between these estimates is largely attributable to differences in underlying data sources, with the IMF using balance of payments trade data and the WTO using customs statistics.

Chart 15. Emerging Market Countries: Equity Prices
(In U.S. dollars; logarithmic scale; January 1990 = 100)

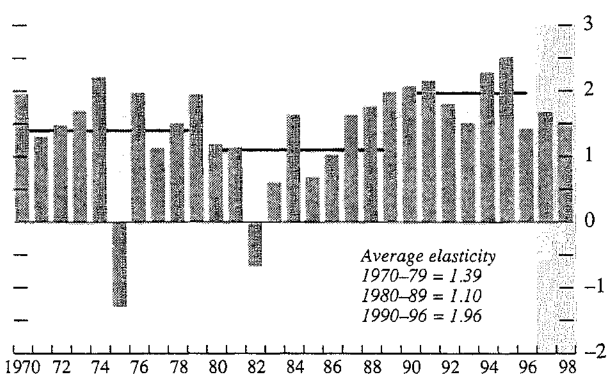
Stock markets have been more stable for most of this year compared with the turbulence in 1995.



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

Chart 16. Elasticity of World Trade with Respect to World Output[1]

The elasticity of world trade with respect to world output declined markedly in 1996 but remained higher than the averages for the 1970s and 1980s.



[1]The growth in world trade (which refers to goods and services) is calculated as the average of annual percent changes for world exports and imports. The elasticity is calculated as the annual percent change in world trade divided by the annual percent change in world GDP. Shaded area indicates IMF staff projections.

Within the overall slowdown, Japan, Germany, and France experienced small declines in their shares of world exports, while the other major industrial countries and the emerging market economies maintained or increased their shares (Table 8). Progress with multilateral trade negotiations continued with the first Ministerial Conference of the World Trade Organization concluding an agreement in December to liberalize global trade in information technology products.

Current account imbalances in the major industrial countries have in most cases remained moderate, and smaller than those seen in a number of countries in the mid-1980s. The recent pattern of imbalances reflects the improved alignment of exchange rates among the major currencies that has emerged in recent years, although relative cyclical developments have also had important effects (Table 9). In Japan, the appreciation of the yen in the period up to early 1995, in combination with continuing structural changes, helped to reduce the current account surplus to 1½ percent of GDP in 1996; a modest widening to 1¾ percent of GDP is projected for this year. In the United States, the current account deficit widened slightly in 1996 as the domestic economy grew relatively strongly, and the recent appreciation of the dollar is expected to outweigh the effect of a prospective pickup in growth in other advanced economies, resulting in a further slight increase in the deficit this year. Current accounts reached virtual balance in 1996 in Canada and the United Kingdom, but in the latter case a moderate deficit is expected to emerge this year reflecting strong growth of domestic demand and the recent appreciation of sterling. Pickups in exports in 1996 slightly reduced the current account deficit in Germany and modestly increased the surplus in France, and these trends are expected to continue in 1997. Italy's current account surplus widened further to 3½ percent of GDP in 1996 as the slowdown in domestic demand resulted in weaker imports; a slightly larger surplus is expected this year.

Among other advanced economies, current account deficits in New Zealand and Australia are expected to remain broadly unchanged in 1997. In Korea, the sharp drop in export prices and appreciation of the won against the yen resulted in a widening of the current account deficit to almost 5 percent of GDP last year, even though export volumes grew strongly. Slower import growth is expected to contribute to a narrowing of the deficit in 1997.

Among the developing countries of Asia, changes in current account positions in 1996 reflected a variety of factors. In Malaysia, the current account deficit narrowed to 6 percent of GDP as a tightening of monetary policy reduced import demand, more than offsetting a slowdown in exports. Current account deficits remained roughly unchanged both in Indonesia, at about 3½ percent of GDP, with a slowdown

Table 8. Selected Economies: World Export Market Shares
(In percent of world exports of goods and services)

	1970–79	1980–89	1990–94	1995	1996	Projections 1997	1998
United States	12.4	12.2	13.1	12.6	12.8	13.2	13.2
Japan	6.3	7.9	8.1	7.9	7.2	6.8	6.7
Germany	10.3	9.7	10.3	9.8	9.4	8.8	8.7
France	7.0	6.6	6.4	5.9	5.7	5.4	5.4
Italy	4.4	4.4	4.9	4.8	5.0	4.8	4.7
United Kingdom	6.0	5.6	5.3	5.0	5.1	5.2	5.1
Canada	4.0	3.7	3.4	3.4	3.4	3.5	3.5
Hong Kong	1.0	1.6	3.0	3.4	3.4	3.6	3.8
Korea	0.7	1.5	1.9	2.4	2.4	2.5	2.6
Singapore	0.7	1.3	1.9	2.4	2.4	2.5	2.5
Taiwan Province of China	0.7	1.5	1.9	2.0	2.0	2.2	2.2
China	0.7	1.1	1.7	2.4	2.4	2.6	2.7
Indonesia	0.6	0.8	0.8	0.9	0.9	1.0	1.0
Malaysia	0.5	0.7	1.0	1.3	1.3	1.4	1.5
Thailand	0.3	0.4	0.9	1.1	1.1	1.1	1.2
Argentina	0.5	0.4	0.3	0.4	0.4	0.4	0.4
Brazil	0.9	1.0	0.8	0.8	0.8	0.8	0.9
Mexico	0.6	1.0	1.0	1.1	1.2	1.3	1.4
Czech Republic	0.5	0.4	0.3	0.5	0.4	0.5	0.5
Poland	0.9	0.5	0.4	0.5	0.5	0.6	0.6
Russia	2.5	2.7	1.5	1.5	1.5	1.6	1.5

in non-oil export receipts offset by stronger oil exports and low growth in imports, and in Thailand, at about 8 percent of GDP, with a decline in imports offset by higher foreign interest payments on short-term bank liabilities. Indonesia's deficit could widen further in 1997. In China, the current account remained in approximate balance in 1996, moving from small surplus to small deficit owing to a narrowing of the trade surplus and further increases in outward profit remittances.

With recovery taking hold in a number of Latin American countries, current account deficits expanded in 1996 reflecting faster growth of imports, particularly capital goods. Mexico's current account deficit increased slightly in 1996 to ½ of 1 percent of GDP and is projected to widen to 1¼ percent of GDP in 1997. In Argentina, the current account deficit is also expected to increase modestly in 1997, and in Brazil to narrow slightly. Mostly owing to significant declines in the prices of copper and other commodities, Chile's current account shifted from near balance in 1995 to a deficit of 4 percent of GDP in 1996. In Venezuela, higher oil prices in 1996 boosted exports, resulting in an increase in the current account surplus, despite higher imports.

Declines in various commodity prices resulted in a widening of current account deficits in a number of African countries in 1996. A slight deterioration is projected for the region in 1997. The overall picture masks significant diversity among countries. Current account deficits are expected to widen in Ethiopia and Zambia, owing to further deteriorations in terms of trade, but to improve or remain broadly unchanged in several other countries, including a number in the CFA franc zone, and Kenya and Tanzania. In contrast, higher oil prices in 1996 eliminated current account deficits in Nigeria and Algeria.

Also aided by higher oil prices, Saudi Arabia's oil export revenues grew by 17 percent in 1996, enabling the current account to return to approximate balance after deficits of close to 15 percent of GDP in 1992 and 1993, which were progressively brought down to just over 5½ percent by 1995. Jordan's current account deficit as a proportion of GDP fell by about 1 percentage point to 3 percent in 1996, as a rise in workers' remittances more than offset the increase in the trade deficit brought about by higher imports of food and transport equipment.

Current account balances deteriorated in 1996 in many countries in transition. In the Czech and Slovak Republics deficits widened to about 8 percent of GDP, as imports surged and capital inflows contributed to real exchange rate appreciations. Tight financial policies in Hungary helped narrow the current account deficit.

Net private capital flows to developing countries reached a record high of about $200 billion in 1996, with flows to China alone reaching about $40 billion (Table 10). This level of net capital inflows reflects relatively low interest rates in industrial countries, the continued development of capital markets, particularly bond and equity markets, in many emerging market

Table 9. Selected Economies: Current Account Positions
(In percent of GDP)

	1993	1994	1995	1996	1997
Advanced economies					
United States	–1.5	–2.1	–2.0	–2.2	–2.3
Japan	3.1	2.8	2.2	1.4	1.8
Germany	–0.7	–1.0	–0.9	–0.7	–0.5
France	0.7	0.5	1.1	1.3	1.6
Italy	1.1	1.5	2.5	3.5	3.7
United Kingdom	–1.7	–0.4	–0.5	—	–0.9
Canada	–4.0	–3.0	–1.4	–0.2	—
Australia	–3.4	–5.0	–5.3	–3.7	–3.6
Austria	–0.4	–0.9	–2.0	–1.8	–1.6
Finland	–1.3	1.3	4.3	3.4	3.4
Greece	–0.4	0.2	–1.5	–1.4	–2.0
Hong Kong	7.4	2.0	–2.0	1.3	1.1
Ireland	3.9	2.7	2.4	1.1	1.3
Israel	–1.7	–3.1	–4.5	–5.2	–3.8
Korea	0.1	–1.2	–2.0	–4.9	–4.1
New Zealand	–1.2	–3.0	–4.3	–5.5	–5.8
Norway	3.0	2.4	3.1	7.2	8.5
Singapore	7.2	15.9	17.7	15.7	15.8
Spain	–1.1	–1.4	0.2	0.5	0.6
Sweden	–2.0	0.4	2.1	2.5	4.3
Switzerland	8.4	6.9	6.9	6.6	6.2
Taiwan Province of China	3.0	2.6	1.9	2.7	2.4
Developing countries					
Algeria	1.6	–5.3	–5.3	0.4	–0.4
Argentina	–3.1	–3.6	–1.4	–2.1	–2.7
Brazil	–0.1	–0.3	–2.5	–3.3	–3.1
Cameroon	–5.2	–4.2	–0.4	–2.4	–2.4
Chile	–4.6	–1.2	0.2	–4.1	–3.5
China	–2.7	0.6	0.2	–0.1	–0.7
Côte d'Ivoire	–11.0	–1.0	–4.7	–4.9	–4.9
Egypt	4.7	0.4	1.2	–0.6	–1.9
India	–0.7	–0.8	–1.5	–1.7	–2.0
Indonesia	–1.5	–1.7	–3.4	–3.6	–3.9
Malaysia	–4.8	–6.3	–8.5	–6.0	–4.8
Mexico	–5.8	–7.0	–0.3	–0.5	–1.2
Nigeria	–2.9	–3.2	–1.7	5.0	11.9
Pakistan	–7.7	–3.7	–3.7	–6.9	–5.9
Philippines	–5.5	–4.6	–4.4	–4.3	–4.3
Saudi Arabia	–14.6	–8.7	–5.5	–0.2	2.0
South Africa	1.6	–0.3	–2.1	–1.6	–1.1
Thailand	–5.9	–5.6	–8.1	–8.2	–7.4
Turkey	–3.5	2.0	–1.4	–3.8	–3.4
Uganda	–1.5	–2.2	–1.8	–1.6	–1.8
Countries in transition					
Czech Republic	2.2	–0.1	–3.0	–7.9	–8.2
Hungary	–9.0	–9.5	–5.6	–3.8	–3.7
Poland[1]	–0.1	2.3	3.3	–0.8	–2.2
Russia	1.4	3.8	1.2	1.7	0.6

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

countries, and the progress made by many of them with privatization and other structural reforms.

Within private capital flows, the trend away from bank loans toward foreign direct investment and portfolio investment has continued, particularly in Latin America and Asia. Over the past five years, these last two types of inflows ranged between 2 percent and 4 percent of developing country GDP, compared with less than 1 percent in years prior to 1990. Bond issues have also been on the rise, including in some transition countries. In Russia, for example, the recent issuance of Eurobonds amounting to $1 billion represented the largest ever debut issue by a sovereign government. The cost of capital to emerging market countries has also declined since early 1995. Spreads on Brady bonds in Latin America have narrowed considerably in

Table 10. Developing Countries: Capital Flows[1]
(Annual average, in billions of U.S. dollars)

	1983–88	1989–95	1991	1992	1993	1994	1995	1996
Developing countries								
Net private capital flows[2]	15.1	107.6	136.1	127.4	141.2	118.3	151.2	200.7
Net direct investment	10.4	41.8	26.7	34.3	50.2	69.5	72.5	90.7
Net portfolio investment	3.4	44.0	36.1	53.0	89.3	83.6	16.9	44.6
Other net investments	1.3	22.1	73.2	41.6	2.3	–35.0	61.7	64.9
Net official flows	29.0	21.4	20.8	14.3	23.3	20.4	31.0	–3.8
Change in reserves[3]	8.4	–42.7	–49.7	–45.7	–40.0	–42.2	–60.7	–82.3
Africa								
Net private capital flows[2]	3.5	7.2	5.5	5.7	4.7	12.7	13.6	9.0
Net direct investment	1.1	2.3	2.4	1.9	1.2	3.4	2.3	5.1
Net portfolio investment	–0.9	–0.2	–1.6	–0.7	0.9	0.4	1.9	0.7
Other net investments	3.3	5.1	4.7	4.5	2.5	8.8	9.4	3.2
Net official flows	5.0	6.0	5.9	8.6	6.2	5.5	4.0	6.4
Change in reserves[3]	0.2	–2.3	–3.2	2.4	–1.0	–5.8	–2.2	–4.4
Asia								
Net private capital flows[2]	11.9	43.6	32.4	21.8	52.7	63.2	89.2	94.7
Net direct investment	3.6	25.0	12.1	17.7	34.0	43.6	49.5	54.8
Net portfolio investment	1.2	5.2	0.5	1.8	11.7	10.0	10.2	9.2
Other net investments	7.1	13.6	19.8	3.7	7.6	9.2	29.4	30.1
Net official flows	7.6	8.4	10.6	10.7	10.1	6.2	5.6	7.2
Change in reserves[3]	–2.2	–23.8	–26.7	–15.1	–25.3	–47.4	–28.3	–43.2
Middle East and Europe								
Net private capital flows[2]	1.8	23.9	73.2	44.5	22.0	–2.4	12.6	19.4
Net direct investment	1.1	1.3	1.4	1.9	1.5	0.9	0.8	0.8
Net portfolio investment	4.2	13.5	22.6	21.2	15.6	12.2	12.2	7.6
Other net investments	–3.4	9.0	49.2	21.3	4.9	–15.6	–0.5	10.9
Net official flows	6.7	1.4	1.1	–3.0	5.9	10.3	–1.3	–5.8
Change in reserves[3]	9.9	–4.4	–4.3	–11.7	6.1	–0.1	–6.5	–13.9
Western Hemisphere								
Net private capital flows[2]	–2.0	33.0	24.9	55.5	61.7	44.9	35.7	77.7
Net direct investment	4.7	13.2	10.9	12.9	13.4	21.5	19.9	29.9
Net portfolio investment	–1.1	25.4	14.5	30.6	61.1	60.8	–7.5	27.1
Other net investments	–5.7	–5.6	–0.5	12.0	–12.8	–37.5	23.3	20.7
Net official flows	9.7	5.7	3.2	–2.0	1.1	–1.7	22.7	–11.6
Change in reserves[3]	0.5	–12.2	–15.5	–21.3	–19.9	11.2	–23.6	–20.8

[1]Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing.
[2]Because of data limitations other net investment may include some official flows.
[3]A minus sign indicates an increase.

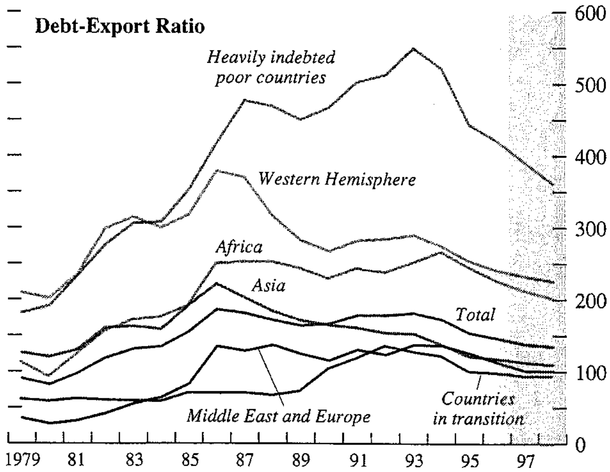
the aftermath of the Mexico crisis, reflecting restored confidence in adjustment programs. Elsewhere, spreads have declined by less, but recently dropped below 100 basis points for Poland and the Philippines. While in many cases reflecting improvements in economic conditions and policies in recipient countries, the narrowing of spreads has been such as to suggest that in some cases, expected returns may be overestimated, and risks underestimated.

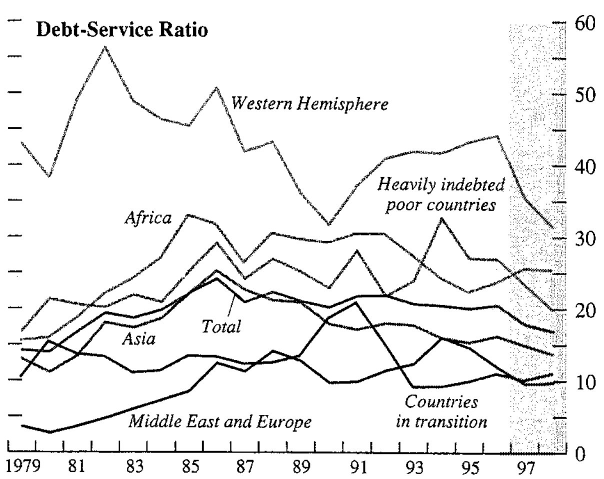
Net private capital flows to developing countries are likely to maintain and perhaps exceed their recent levels in the period ahead. Demand for infrastructure finance is expected to increase with economic growth, particularly in Asia. However, capital flows remain vulnerable to increases in interest rates and equity market developments in major industrial countries and to contagion effects from adverse developments in some emerging market countries. While the aggregate flows as a whole seem sustainable under current market conditions, some countries may be adversely affected by changes in financial market sentiment. In particular, countries where there is insufficient fiscal consolidation, and therefore excessive reliance on short-term interest rates to restrain domestic demand (and overheating pressures), may be more vulnerable to changes in financial market sentiment. The IMF staff's assessment of the outlook for capital flows assumes continued progress with the implementation of reforms and stabilization policies in developing countries.

The solid and steady economic expansion in the developing countries as a group and the gains in stabilization and reform in the countries in transition resulted in a further easing of the overall burden of

Chart 17. Developing Countries and Countries in Transition: External Debt and Debt Service[1]
(In percent of exports of goods and services)

The burden of external debt eased further in 1996.





[1]Debt service refers to actual payments of interest on total debt plus actual amortization payments on long-term debt. The projections (shaded areas) incorporate the impact of exceptional financing items.

external debt in 1996 for the fifth consecutive year (Chart 17). The ratio of debt to GDP is projected to decline to 29 percent in 1997, and the ratio of debt to export earnings to 139 percent—the lowest level since 1984.[9] Many poor countries, particularly in sub-Saharan Africa, continue to suffer heavy external debt burdens. For some of these countries, traditional debt-relief mechanisms are unlikely to make debt burdens sustainable in the medium term even with continued policies of adjustment and reform. To ensure that all heavily indebted poor countries (HIPCs) that pursue appropriate policies can attain debt sustainability, the World Bank and the Fund approved and are in the process of implementing the "HIPC Initiative," which involves concerted action by all creditors of qualifying countries to reduce their total debt to sustainable levels.

Since the October 1996 *World Economic Outlook,* a number of countries have completed debt and debt-service agreements with official and commercial creditors. Under the aegis of the Paris Club, flow reschedulings on Naples terms involving a 67 percent reduction in the net present value (NPV) of debt were agreed with Mozambique in November 1996; with Niger in December 1996; with Ethiopia and Tanzania in January 1997; and with Guinea in February involving a 50 percent NPV reduction of all arrears. Agreement was also reached in October 1996 with Benin on a stock-of-debt operation with a 67 percent NPV reduction of all eligible debt. Other countries have made progress in completing debt and debt-service agreements with commercial banks. Agreement was reached with Côte d'Ivoire on highly concessional terms for $5.4 billion of debt in November 1996, and with Vietnam for a $900 million repayment package—which will clear arrears accumulated since the late 1970s—in January 1997.

[9]In addition, the ratio of debt service to export earnings is projected to decline from 23 percent in 1996 to 20 percent in 1997—also the lowest level since the early 1980s.