CHAPTER I ECONOMIC PROSPECTS AND POLICY ISSUES

Following a series of adverse shocks in the first half of 2003, there are now increasing signs of a renewed recovery, and the balance of risks—in April, tilted well to the downside—has improved significantly. But with the pace and robustness of the recovery still unclear, and inflationary pressures low, monetary policies should remain accommodative for the time being; fiscal policies increasingly need to focus on medium-term consolidation, especially given coming demographic pressures. The widening global imbalances, and continuing dependence of global growth on the United States, underscore the need for an acceleration of structural reforms in many countries, along with measures to rein in the U.S. budget deficit over the medium term and, in some cases, a gradual move to greater exchange rate flexibility.

When the last *World Economic Outlook* was published in April 2003, the IMF staff expected—provided the war in Iraq was short and contained—that the global recovery would resume in the second half of the year, with global growth picking up to about 4 percent in 2004 (Table 1.1 and Figure 1.1). In the event, with major hostilities in Iraq indeed ending quickly, forward-looking indicators generally turned up, with equity markets strengthening markedly, accompanied by some pickup in business and consumer confidence, particularly in the United States (Figure 1.2). Concurrent data initially remained weak, with industrial production and trade growth slowing markedly in the second quarter (Figure 1.2), reflecting continued geopolitical uncertainties, the continued aftereffects of the bursting of the equity price bubble, and—particularly in Asia—the impact of Severe Acute Respiratory Syndrome (SARS). Most recently, however, there have been growing signs of a pickup in activity—including investment—particularly in the United States, Japan, and some emerging market countries, notably in Asia. With inflationary pressures very subdued, macroeconomic policies have been eased further across the globe. Interest rates have been reduced in Europe and the United States, as well as in a number of other industrial and emerging market countries; and fiscal policy has been further relaxed in the United States and a number of Asian countries. That said, the degree of macroeconomic stimulus among the major industrial countries continues to vary widely, with significant stimulus in the pipeline in the United States and the United Kingdom and relatively little in the euro area and Japan (Figure 1.3).

In mature financial markets, the combination of ample liquidity, monetary easing, and the expectation that low policy interest rates will be maintained for longer than earlier thought drove long-run interest rates down to 40-year lows by mid-June. Since that time, long-run interest rates have rebounded, most sharply in the United States (Figure 1.4), apparently reflecting growing expectations of recovery, higher inflationary expectations, and the continuing strong supply of government paper.[1] Even so, the recent rebound has had only a limited effect on equity markets, which have retained their substantial gains since March, and on corporate spreads, which have benefited from actual and anticipated progress in corpo-

[1]See the September 2003 *Global Financial Stability Report* for a detailed discussion of financial market developments.

Table 1.1. Overview of the *World Economic Outlook* Projections

(Annual percent change unless otherwise noted)

			Current Projections		Difference from April 2003 Projections[1]	
	2001	2002	2003	2004	2003	2004
World output	**2.4**	**3.0**	**3.2**	**4.1**	**—**	**—**
Advanced economies	1.0	1.8	1.8	2.9	–0.1	—
United States	0.3	2.4	2.6	3.9	0.4	0.3
Euro area	1.5	0.9	0.5	1.9	–0.6	–0.4
Germany	0.8	0.2	—	1.5	–0.5	–0.4
France	2.1	1.2	0.5	2.0	–0.7	–0.4
Italy	1.8	0.4	0.4	1.7	–0.7	–0.6
Japan	0.4	0.2	2.0	1.4	1.2	0.4
United Kingdom	2.1	1.9	1.7	2.4	–0.3	–0.1
Canada	1.9	3.3	1.9	3.0	–0.9	–0.2
Other advanced economies	1.6	2.7	1.7	3.0	–0.8	–0.2
Newly industrialized Asian economies	0.8	4.8	2.3	4.2	–1.8	–0.3
Developing countries	4.1	4.6	5.0	5.6	—	–0.2
Africa	3.7	3.1	3.7	4.8	–0.2	–0.4
Sub-Sahara	3.5	3.0	3.1	5.0	–0.7	–0.4
Developing Asia	5.8	6.4	6.4	6.5	0.1	—
China	7.5	8.0	7.5	7.5	—	—
India	4.2	4.7	5.6	5.9	0.5	—
ASEAN-4[2]	2.9	4.3	4.1	4.4	0.2	0.1
Middle East and Turkey[3]	2.0	4.8	5.1	4.6	—	–0.3
Western Hemisphere	0.7	–0.1	1.1	3.6	–0.4	–0.6
Brazil	1.4	1.5	1.5	3.0	–1.3	–0.5
Countries in transition	5.1	4.2	4.9	4.7	0.9	0.6
Central and eastern Europe	3.1	3.0	3.4	4.1	—	–0.2
Commonwealth of Independent States and Mongolia	6.4	4.9	5.8	5.0	1.4	1.0
Russia	5.0	4.3	6.0	5.0	2.0	1.5
Excluding Russia	9.2	5.9	5.4	5.0	0.1	0.1
Memorandum						
World growth based on market exchange rates	1.3	1.9	2.3	3.2	0.1	—
World trade volume (goods and services)	**0.1**	**3.2**	**2.9**	**5.5**	**–1.8**	**–0.7**
Imports						
Advanced economies	–1.0	2.2	2.8	4.8	–1.9	–1.1
Developing countries	1.6	6.0	5.1	7.8	0.4	–0.2
Countries in transition	11.9	6.3	6.6	8.1	0.5	5.0
Exports						
Advanced economies	–0.8	2.2	1.6	5.2	–2.2	–0.6
Developing countries	2.7	6.5	4.3	6.9	0.6	–0.7
Countries in transition	6.0	6.3	5.8	5.6	–0.1	2.9
Commodity prices (U.S. dollars)						
Oil[4]	–14.0	2.8	14.2	–10.5	–10.0	8.8
Nonfuel (average based on world commodity export weights)	–4.0	0.6	5.0	2.4	. . .	. . .
Consumer prices						
Advanced economies	2.2	1.5	1.8	1.3	–0.1	–0.4
Developing countries	5.8	5.3	5.9	4.9	0.1	–0.2
Countries in transition	16.2	11.1	9.7	9.1	0.3	1.7
Six-month London interbank offered rate (LIBOR, percent)						
On U.S. dollar deposits	3.7	1.9	1.3	2.0	–0.4	–1.5
On euro deposits	4.2	3.3	2.2	2.4	–0.1	–0.1
On Japanese yen deposits	0.2	0.1	0.1	0.2	—	–0.1

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during July 1–28, 2003.
[1]Using updated purchasing-power-parity weights, summarized in the Statistical Appendix, Table A.
[2]Includes Indonesia, Malaysia, the Philippines, and Thailand.
[3]Includes Malta.
[4]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil. The average price of oil in U.S. dollars a barrel was $24.96 in 2002; the assumed price is $28.50 in 2003, and $25.50 in 2004.

rate restructuring and continued positive risk appetite. In currency markets, the U.S. dollar continued to depreciate through mid-May, reflecting a combination of relatively low interest rates and continued investor concerns about the large U.S. current account deficit, though since then it has strengthened somewhat. Overall, since its peak in early 2002, the U.S. dollar has fallen by some 12 percent in nominal effective terms, matched by a substantial appreciation of the euro, the Canadian dollar, and some other industrial country currencies.

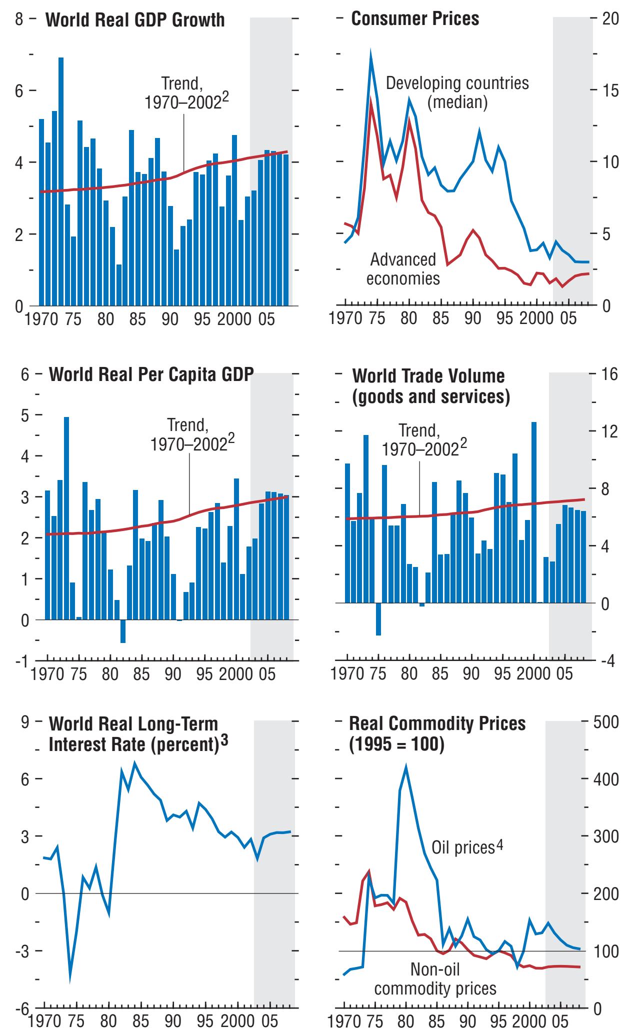
In emerging markets, financing conditions eased significantly through June, aided by low industrial country interest rates and improved sentiment toward a number of key markets, notably Brazil. Financing costs have risen since then, reflecting higher U.S. interest rates, but spreads have continued to decline (Figure 1.5); and while primary issuance has slowed, this appears to have been largely discretionary, with little evidence of an underlying tightening of market access. With capital outflows from many countries slowing, net private capital inflows to emerging markets are projected to rise to over $110 billion in 2003, the highest level since the mid-1990s (Table 1.2). Emerging market currencies have in general been little affected by the fall in the U.S. dollar—indeed, most have depreciated in nominal effective terms since the dollar peak (Figure 1.6). In Asia, which has continued to run large surpluses on both current and capital accounts, this has been accompanied by a very large increase in reserves (see the second essay in Chapter II, "Are Foreign Exchange Reserves in Asia Too High?").

Commodity markets have continued to be heavily influenced by geopolitical developments, the cyclical situation, and supply shocks. After peaking at over $34 a barrel before the war, oil prices fell back sharply in April, but by end-August had returned to $30 a barrel, reflecting a slower-than-expected recovery in Iraq's oil production, persisting tight industrial country inventories, and concerns about the sustainability of current production levels in Nigeria and

Figure 1.1. Global Indicators[1]

(Annual percent change unless otherwise noted)

Global growth in 2003 is expected to remain subdued, but to return close to trend in 2004.



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

[2]Average growth rates for individual countries, aggregated using purchasing-power-parity weights; the aggregates shift over time in favor of faster growing countries, giving the line an upward trend.

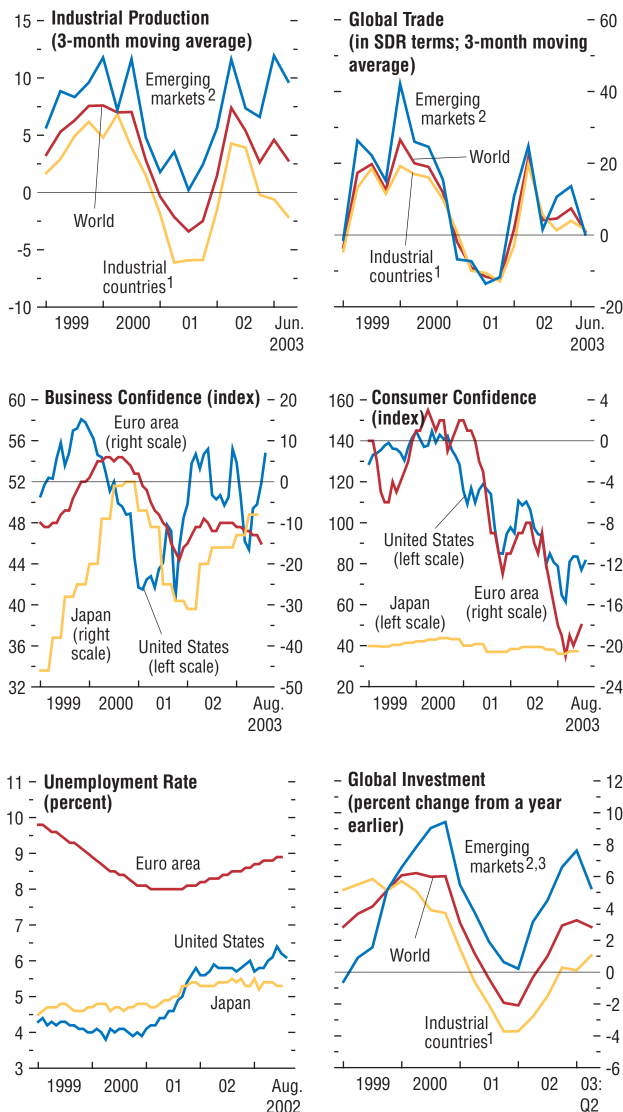
[3]GDP-weighted average of the 10-year (or nearest maturity) government bond yields less inflation rates for the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada. Excluding Italy prior to 1972.

[4]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil.

Figure 1.2. Current and Forward-Looking Indicators

(Percent change from previous quarter at annual rate unless otherwise noted)

Industrial production and trade growth remained weak in the second quarter of 2003, particularly in industrial countries; forward-looking indicators have improved somewhat, most clearly in the United States.



Sources: Business confidence for the United States, the National Association of Purchasing Managers; for the euro area, the European Commission; and for Japan, Bank of Japan. Consumer confidence for the United States, the Conference Board; for the euro area, the European Commission; and for Japan, Cabinet Office (Economic Planning Agency). All others, Haver Analytics.

[1] Australia, Canada, Denmark, euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom, and the United States.

[2] Argentina, Brazil, Chile, China, Colombia, Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Pakistan, Peru, the Philippines, Poland, Russia, Singapore, South Africa, Taiwan Province of China, Thailand, Turkey, and Venezuela.

[3] Data for China, India, Pakistan, and Russia are interpolated.

Venezuela. In early September, oil prices fell back, and—while they are expected to remain elevated during the remainder of 2003—they are projected to drop to an average $25.50 a barrel in 2004 in the face of rising supply, including from Iraq; indeed, many oil market analysts see a possibility of a significantly larger price decline. (See Appendix 1.1, "Longer-Term Prospects for Oil Prices.") In contrast, nonfuel commodity prices are projected to rise moderately, aided by rising global activity and the fading of earlier supply shocks (see Appendix 1.2 "Nonenergy Commodity Prices and Semiconductor Markets").

At the current conjuncture, several issues remain important in assessing the speed and nature of the recovery, including:

- *How long will the aftereffects of the bubble—defined broadly as discussed below—persist?* As stressed at the time of the last *World Economic Outlook*, the recent weakness of the world economy has not just been due to the war. The equity boom in the late 1990s was the largest in modern history: the unwinding of its effects is uncharted territory, and it is perhaps not surprising that most observers, including the *World Economic Outlook*, have found it difficult to gauge the aftermath. While the direct impact of equity market losses on household consumption growth should now have peaked, household balance sheets in some countries, notably the United States, remain stretched and housing markets—boosted in part by the aggressive easing of monetary policy in the last three years—are unlikely to provide the same support to the recovery going forward as they did in the past. In addition, the adjustment process in the corporate sector and, to a lesser extent, in the financial sector—eliminating excess capacity, restructuring of balance sheets, and rebuilding defined benefit pension funds—still has some way to go, particularly in Europe; and recent accounting scandals may continue to weigh on corporate confidence.
- *Will the U.S. dollar experience a renewed depreciation, and, if so, will the euro continue to bear the*

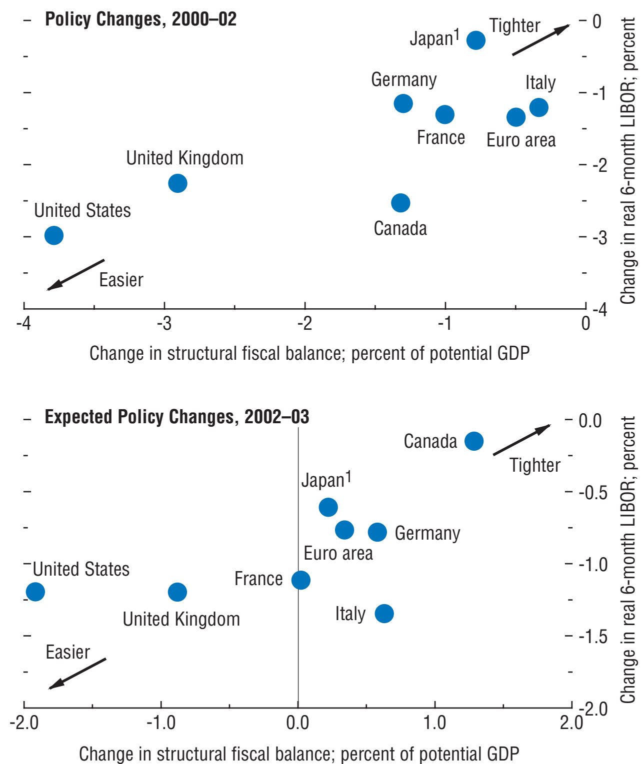
brunt of the offsetting adjustment? To date, the decline in the U.S. dollar has been relatively orderly and—given the large U.S. current account deficit—generally welcome, and the resulting tightening in financial conditions in the euro area has been largely offset by European Central Bank (ECB) interest rate cuts (see Box 1.1, "Recent Changes in Monetary and Financial Conditions in the Major Currency Areas," p. 14). While the World Economic Outlook projections are, as usual, based on the assumption that real effective exchange rates remain constant, further substantial dollar depreciation cannot be ruled out and would have significant implications for the outlook, especially if the offsetting appreciation continued to be focused on the euro area rather than spread more widely.

Consistent with the signs of renewed recovery discussed above, the IMF staff's baseline forecast continues to project an upturn from the second half of 2003 (Figure 1.7). Global GDP growth is expected at 3.2 percent in 2003, rising to 4.1 percent—close to trend—in 2004, underpinned by reduced geopolitical uncertainties, policy stimulus in the pipeline, a pickup in inventories, the projected decline in oil prices, and a gradual diminution of the aftereffects of the bubble (see Box 1.2, "How Should We Measure Global Growth?" p. 18). Monetary policies are expected to remain accommodative, with a gradual withdrawal of stimulus unlikely to begin until 2004; in Japan, the quantitative easing policy is expected to continue. Looking across individual countries and regions:

- Among the *industrial countries*, recovery will continue to be led by the United States where—despite a weak labor market and considerable excess capacity—current data have shown greatest signs of improvement, forward-looking indicators are strongest, and there is the most policy stimulus in the pipeline (Table 1.3). In the euro area, the forecast has once again been significantly reduced, reflecting continued disappointing private domestic demand and the appreciation of the euro. With the overall policy stance less supportive

Figure 1.3. Fiscal and Monetary Easing in the Major Advanced Countries
(Percent)

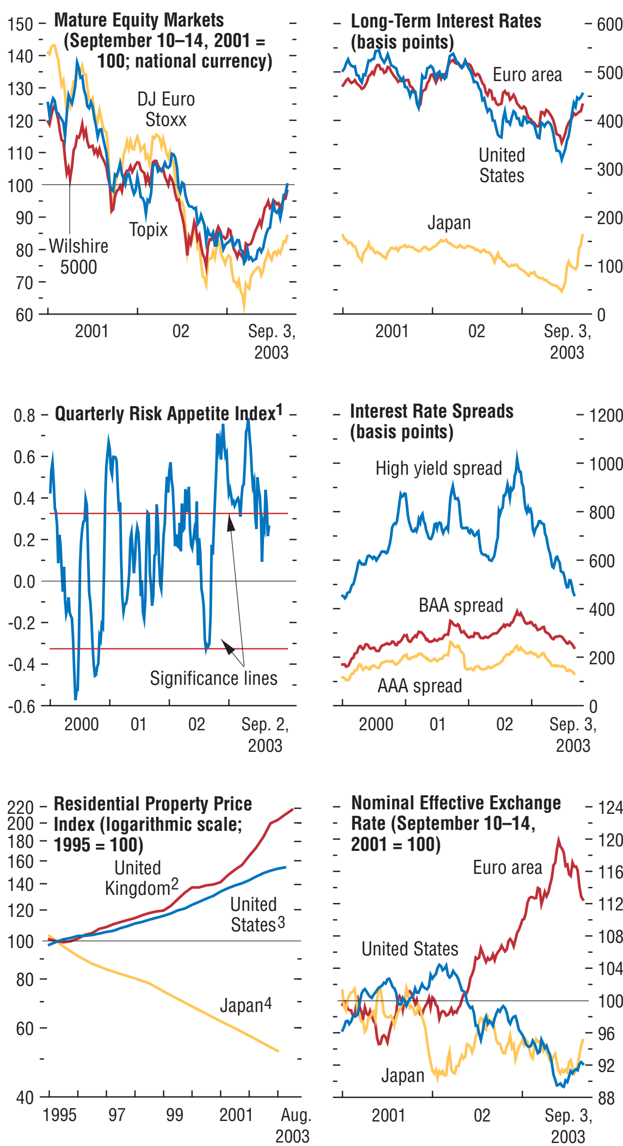
Monetary and fiscal policies remain significantly more expansionary in the United States and the United Kingdom than in the euro area and Japan.



Source: IMF staff estimates.
[1]For Japan, excludes bank support.

Figure 1.4. Developments in Mature Financial Markets

Long-run interest rates have rebounded since mid-June, but remain relatively low by historical standards. Equity markets have continued to rise, accompanied by falling credit spreads.



Sources: Bloomberg Financial Markets, LP; State Street Bank; HBOS plc.; Office of Federal Housing Enterprise Oversight; Japan Real Estate Institute; and IMF staff estimates.

[1] IMF/State Street risk appetite indicators.

[2] Halifax housing index as measured by the value of all houses.

[3] House price index as measured by the value of single-family homes.

[4] Urban land price index: average of all categories in six large city areas.

and the region-wide outlook adversely affected by the continuing difficulties in Germany, the projected pickup is expected to be relatively gradual, supported mainly by a gradual pickup in private consumption (underpinned by lower interest rates and the automatic stabilizers) and inventories, and the expected improvement in external demand. In Japan, given the stronger-than-expected second quarter outturn, the stock market pickup, and heightened optimism about the U.S. recovery, the forecast has been revised upward significantly for both 2003 and 2004. However, with the outlook still clouded by deflation and corporate and banking system weaknesses, the pace of recovery is still expected to remain moderate.

- The outlook for *emerging markets* continues to be driven—to differing extents—by developments in industrial countries, external financing conditions, geopolitical factors, and country-specific developments. In emerging markets in Asia, with the effects of SARS now waning, growth is expected to pick up in the second half of 2003 and remain strong in 2004, aided by timely additional policy easing and continued robust growth in China. However, much will depend on a prompt rebound in domestic demand, as well as the pace of the global recovery and a continuation of the nascent recovery in the information technology (IT) sector. Activity in much of Latin America appears to be stabilizing and external confidence in the region—particularly Brazil—has improved markedly. Nonetheless, the recovery remains fragile and, with a number of countries facing significant debt problems and political uncertainties, the region remains vulnerable to a reversal in financial market sentiment. In the Middle East, while the quick end to the conflict in Iraq has boosted confidence, the fragile security situation remains a major source of uncertainty; GDP growth forecasts for the region have been revised upward in 2003 owing to higher oil production, but lower oil prices will adversely affect the outlook in 2004. Reduced geopolitical concerns

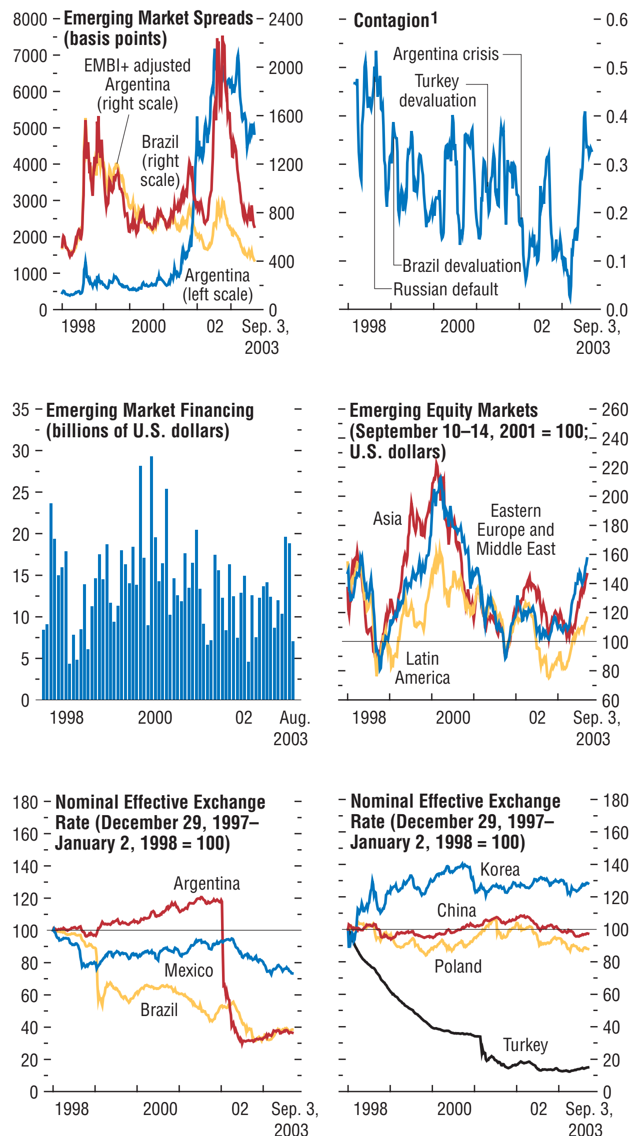
also benefit Turkey although, to maintain investor confidence, the authorities need to firmly maintain the sustainability of the fiscal position. Growth in the transition countries remains solid, led by Russia and Ukraine; European Union (EU) accession countries continue to benefit from strong direct investment inflows, although weak euro area demand remains an important risk.

- Among the *poorest countries,* GDP growth in sub-Saharan Africa (excluding South Africa) is projected to rise to 3.6 percent in 2003, with the positive effects of improved macroeconomic policies, rising commodity prices, and debt relief under the Heavily Indebted Poor Countries (HIPC) initiative partly offset by continued political instability and adverse weather conditions (the latter—together with the high incidence of HIV/AIDS—contributing to serious food shortages in the Horn of Africa and Southern Africa). GDP growth is expected to pick up markedly in 2004 but, as in the past, this baseline outcome critically depends on a significant improvement in political stability and favorable weather conditions.[2]

Inflationary pressures remain very low. In advanced countries, inflation is projected to be below 2 percent in 2003 for the second year in succession and to fall to 1.3 percent in 2004, the lowest level for 30 years; inflation in developing countries is expected to fall to 5 percent, also a historical low. Against this background, and given the weakness of the global recovery, the possibility of deflation has attracted increased attention.[3] Recently, there has been overt deflation in only a few countries, most importantly Japan; however, inflation in a number of advanced countries is projected at below 1 percent in 2004, uncomfortably close to zero (especially given the general upward bias to measured

Figure 1.5. Emerging Market Financial Conditions

Emerging markets spreads have fallen sharply and equity markets have picked up in concert with developments in mature markets.



Sources: Bloomberg Financial Markets, LP; Capital Data; and IMF staff estimates.
[1]Average of 60-day rolling cross-correlation of emerging debt market spreads.

[2]In fall *World Economic Outlooks*, sub-Saharan African growth for the year ahead has been overestimated on average by 1.5 percentage points over the past decade, in part because such expectations were not in fact fulfilled.

[3]See Kumar and others (2003) for a detailed discussion.

Table 1.2. Emerging Market Economies: Net Capital Flows[1]

(Billions of U.S. dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total[2]										
Private capital flows, net[3]	192.9	226.5	132.6	77.8	86.7	47.1	42.7	80.3	113.1	93.8
Private direct investment, net	101.5	116.2	143.9	156.0	175.4	165.7	180.9	142.9	143.9	145.2
Private portfolio investment, net	23.9	83.2	63.3	11.0	19.5	–3.8	–51.2	–52.9	–22.9	–16.8
Other private capital flows, net	67.4	27.1	–74.6	–89.2	–108.2	–114.9	–87.1	–9.7	–8.0	–34.6
Official flows, net	49.5	–1.8	42.6	57.6	7.6	–12.8	21.1	7.1	10.1	–16.0
Change in reserves[4]	–117.9	–104.6	–71.1	–49.7	–88.4	–117.2	–122.4	–211.6	–255.1	–148.5
Memorandum										
Current account[5]	–95.2	–89.0	–71.1	–51.1	34.5	126.7	79.1	133.2	128.9	82.3
Africa										
Private capital flows, net[3]	11.3	10.1	4.2	8.1	12.2	0.2	5.2	5.0	8.1	9.5
Private direct investment, net	1.9	3.6	7.8	6.8	9.7	7.9	24.0	11.2	13.3	11.6
Private portfolio investment, net	2.5	2.8	7.0	3.7	8.2	–2.2	–8.8	–0.7	–0.7	0.2
Other private capital flows, net	6.9	3.7	–10.6	–2.4	–5.8	–5.5	–10.0	–5.5	–4.5	–2.3
Official flows, net	5.6	–2.3	3.9	5.6	4.5	5.1	3.5	3.5	4.8	4.4
Change in reserves[4]	–3.1	–6.6	–11.2	2.7	–3.5	–13.1	–12.6	–7.2	–13.9	–11.0
Developing Asia[6]										
Private capital flows, net[3]	99.3	124.6	10.8	–42.1	4.6	–3.3	25.2	57.0	62.4	13.7
Private direct investment, net	55.8	55.0	59.8	60.9	60.6	58.4	50.9	57.8	66.5	59.6
Private portfolio investment, net	22.3	30.0	7.3	–17.2	11.5	4.3	–13.5	–21.1	–10.9	–16.5
Other private capital flows, net	21.2	39.6	–56.3	–85.8	–67.5	–66.0	–12.2	20.2	6.8	–29.4
Official flows, net	3.8	–13.0	17.1	26.1	3.9	1.9	–9.7	–9.9	–7.1	–7.6
Change in reserves[4]	–42.9	–46.9	–15.1	–67.8	–78.9	–49.0	–84.9	–167.1	–159.9	–93.7
Memorandum										
Hong Kong SAR										
Private capital flows, net[3]	–3.5	–7.1	10.8	–8.5	1.1	4.2	–6.6	–24.9	–27.7	–25.6
Middle East and Turkey[7]										
Private capital flows, net[3]	8.1	9.7	17.0	9.6	–1.2	–14.1	–33.6	–15.1	–17.0	–8.0
Private direct investment, net	6.4	5.0	5.3	6.2	4.9	7.9	11.2	6.3	9.3	8.5
Private portfolio investment, net	2.0	1.8	–0.8	–13.0	–1.9	–11.1	–19.5	–16.6	–10.8	–6.1
Other private capital flows, net	–0.3	2.9	12.6	16.4	–4.3	–10.8	–25.4	–4.9	–15.4	–10.3
Official flows, net	4.8	6.5	6.2	4.0	2.4	–5.8	9.6	1.8	2.4	2.2
Change in reserves[4]	–11.8	–22.6	–20.5	9.3	–6.9	–28.7	–8.2	–10.1	–22.5	–11.3
Western Hemisphere										
Private capital flows, net[3]	43.4	76.4	74.4	74.4	53.4	55.3	29.8	7.8	28.3	41.8
Private direct investment, net	24.5	40.3	56.1	61.0	76.3	68.1	69.0	39.6	29.1	36.3
Private portfolio investment, net	3.5	48.0	29.1	25.3	2.5	8.7	–3.8	–7.9	3.7	7.0
Other private capital flows, net	15.4	–11.9	–10.8	–12.0	–25.5	–21.5	–35.3	–23.9	–4.5	–1.4
Official flows, net	19.7	–4.8	9.2	10.2	–2.8	–10.2	23.4	13.6	12.7	–13.0
Change in reserves[4]	–22.9	–28.3	–14.4	7.8	8.6	–2.8	1.1	–1.8	–29.0	–8.9
Countries in transition[8]										
Private capital flows, net[3]	30.7	5.6	26.1	27.8	17.7	9.0	16.0	25.6	31.2	36.7
Private direct investment, net	12.9	12.3	14.9	21.2	23.8	23.4	25.9	27.9	25.8	29.2
Private portfolio investment, net	–6.4	0.5	20.7	12.1	–0.9	–3.4	–5.7	–6.7	–4.2	–1.4
Other private capital flows, net	24.2	–7.2	–9.4	–5.5	–5.2	–11.0	–4.2	4.4	9.6	8.9
Official flows, net	15.6	11.8	6.2	11.7	–0.4	–3.8	–5.6	–1.9	–2.7	–2.1
Change in reserves[4]	–37.2	–0.2	–10.0	–1.7	–7.7	–23.7	–17.8	–25.4	–29.8	–23.5
Memorandum										
Fuel exporters										
Private capital flows, net[3]	5.0	–20.2	9.5	2.6	–27.9	–55.5	–37.2	–52.6	–37.8	–20.2
Nonfuel exporters										
Private capital flows, net[3]	187.9	246.7	123.1	75.1	114.6	102.5	79.8	132.9	150.9	114.0

[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. Emerging markets include developing countries, countries in transition, Korea, Singapore, Taiwan Province of China, and Israel.
[2]Excludes Hong Kong SAR.
[3]Because of data limitations, other private capital flows, net may include some official flows.
[4]A minus sign indicates an increase.
[5]The sum of the current account balance, net private capital flows, net official flows, and the change in reserves equals, with the opposite sign, the sum of the capital and financial account and errors and omissions. For regional current account balances, see Table 27 of the Statistical Appendix.
[6]Includes Korea, Singapore, and Taiwan Province of China in this table.
[7]Includes Israel and Malta.
[8]Historical data have been revised, reflecting cumulative data revisions for Russia and the resolution of a number of data interpretation issues.

inflation). The risk of a global deflationary spiral appears remote, and inflationary expectations have recently edged up, reflecting increasing expectations of recovery and recent policy measures. However, in an environment of low inflation, the possibility of a temporary period of price declines in the event of an adverse shock remains significant in a number of countries, most importantly Germany, adding to arguments for maintaining a relatively accommodative monetary stance.

While the baseline forecast for global growth is little changed from a few months ago, the balance of risks has improved significantly. Given the quick end to the war, the likelihood of worst-case scenarios has been much reduced since the last *World Economic Outlook*, while policies have been further eased. Indeed, as recent developments in financial markets underscore, it is possible that growth may pick up more quickly than currently expected, particularly in the United States, where productivity growth has been most robust, corporate balance sheet restructuring appears most advanced, and the policy stimulus in the pipeline is particularly large (and, given the expected supplementary budget to finance expenditures in Iraq and Afghanistan, is likely to increase further). While stronger U.S. growth would, of course, benefit the rest of the world, it would come at the cost of exacerbating the already large U.S. current account deficit, underscoring the need to accelerate implementation of measures to reduce the associated medium-term risks, as discussed below. The possibility that oil prices could be lower than expected in 2004 and beyond is also a potential upside risk to global activity.

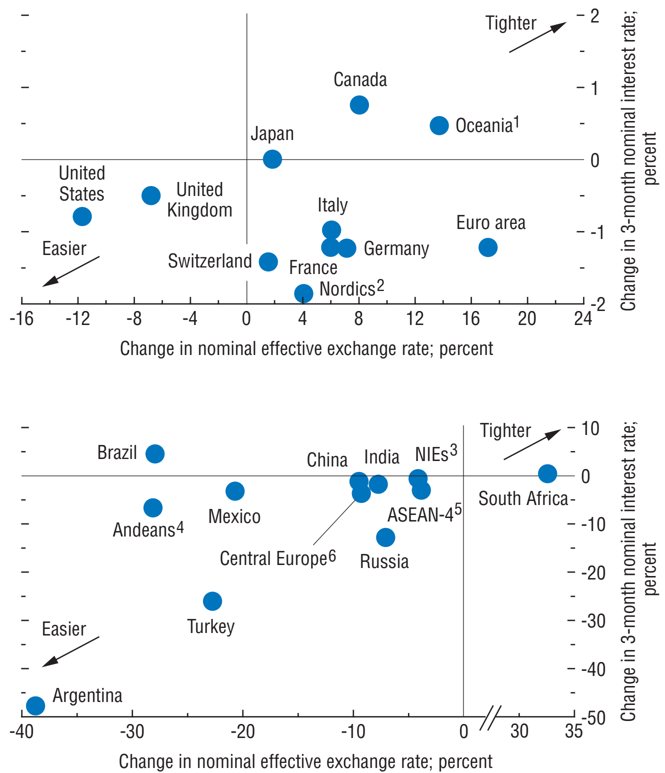
At the same time, however, downside risks remain, particularly in 2004 and beyond. While geopolitical risks have declined since April they are far from eliminated, as recent tragic events in a number of countries underscore. In addition, beyond the specific risks in Japan, and to a lesser extent Germany, key concerns include the following:

- *The current account imbalances in the global economy and, associated with that, the continued*

Figure 1.6. Selected Countries: Exchange Rate and Interest Rate Developments

(Movement since February 2002; percent)

The fall of the U.S. dollar since its peak in February 2002 has been matched by appreciation in the euro area, Canada, and some smaller industrial countries; in most of the last group, the contractionary impact has been partly or fully offset by monetary easing. Emerging market currencies have generally depreciated.

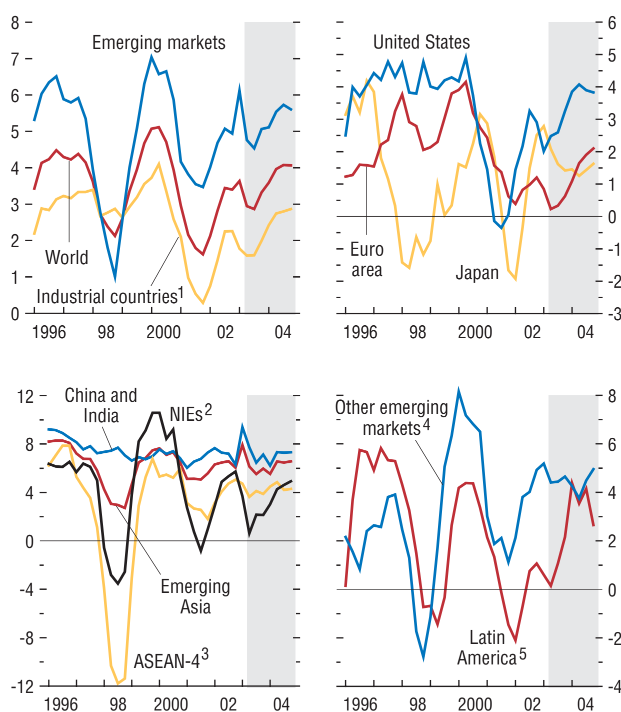


Sources: Bloomberg Financial Markets, LP; and Global Insight.
[1]Australia and New Zealand.
[2]Denmark, Norway, and Sweden.
[3]Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.
[4]Chile, Colombia, Peru, and Venezuela.
[5]Indonesia, Malaysia, the Philippines, and Thailand.
[6]Czech Republic, Hungary, and Poland.

Figure 1.7. Global Outlook

(Real GDP; percent change from four quarters earlier)

After weakening from late 2002, the global recovery is expected to resume in the second half of 2003, led by the United States.



Sources: Haver Analytics; and IMF staff estimates.
[1]Australia, Canada, Denmark, euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom, and the United States.
[2]Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.
[3]Indonesia, Malaysia, the Philippines, and Thailand.
[4]Czech Republic, Hungary, Israel, Pakistan, Poland, Russia, South Africa, and Turkey.
[5]Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

dependence of the world on the outlook for the United States remain a serious concern (Table 1.4). Despite the depreciation of the U.S. dollar, the U.S. current account deficit is projected at 5 percent of GDP in 2003, falling only to 4 percent of GDP by 2008, suggesting that further adjustment will be needed to achieve medium-term sustainability. While the extent, nature, and timing of further dollar adjustment is impossible to predict, history suggests that even an orderly adjustment is likely to be associated with a slowdown in U.S. growth—and, if growth in the rest of the world remains weak, in global growth as well.[4] In addition, a disorderly adjustment—or overshooting—remains an important risk, particularly if the offsetting appreciation continues to be concentrated on a few currencies. Volatility among the major currencies—often associated with currency misalignment—could also be a cause for concern, particularly for developing countries with fixed exchange rates or significant mismatches between the currency structure of trade and external debt (see the third essay in Chapter II, "Is G-3 Exchange Rate Volatility a Serious Concern for Developing Countries?").

- *The recent pickup in investment may not prove enduring, depending in part on the extent to which aftereffects of the bubble persist.* Apart from the direct costs, a more prolonged period of slower growth would make the global economy more vulnerable to new adverse shocks, especially given the still heavy dependence on developments in the United States, the relatively low level of inflation in some countries, and the increasingly limited room for policy maneuver in many countries.
- *In financial markets, as noted in the September* Global Financial Stability Report, *a further sharp rise in bond yields could adversely affect the recovery, particularly if that were not driven by expectations of higher growth.* This would be especially so in countries where house prices have

[4]See "How Worrisome Are External Imbalances?" in Chapter II of the September 2002 *World Economic Outlook*.

Table 1.3. Advanced Economies: Real GDP, Consumer Prices, and Unemployment
(Annual percent change and percent of labor force)

	Real GDP				Consumer Prices				Unemployment			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
Advanced economies	**1.0**	**1.8**	**1.8**	**2.9**	**2.2**	**1.5**	**1.8**	**1.3**	**5.9**	**6.4**	**6.7**	**6.6**
United States	0.3	2.4	2.6	3.9	2.8	1.6	2.1	1.3	4.8	5.8	6.0	5.7
Euro area[1]	1.5	0.9	0.5	1.9	2.4	2.3	2.0	1.6	8.0	8.4	9.1	9.2
Germany	0.8	0.2	—	1.5	1.9	1.3	1.0	0.6	7.9	8.6	9.5	9.8
France	2.1	1.2	0.5	2.0	1.8	1.9	1.9	1.7	8.5	8.8	9.5	9.7
Italy	1.8	0.4	0.4	1.7	2.7	2.6	2.8	2.0	9.5	9.0	9.0	9.0
Spain	2.7	2.0	2.2	2.8	2.8	3.6	3.1	2.7	10.5	11.4	11.4	11.0
Netherlands	1.2	0.2	–0.5	1.4	5.1	3.9	2.6	2.0	2.0	2.3	4.2	4.5
Belgium	0.8	0.7	0.8	1.9	2.4	1.6	1.4	1.4	6.7	7.3	8.1	8.3
Austria	0.7	1.0	0.7	1.5	2.3	1.7	1.3	1.2	3.6	4.1	4.4	4.4
Finland	0.7	1.6	1.3	2.6	2.7	2.0	1.8	1.7	9.1	9.1	9.3	9.3
Greece	4.1	4.0	4.0	3.9	3.7	3.9	3.8	3.0	10.4	9.9	9.8	9.7
Portugal	1.6	0.4	–0.8	1.6	4.4	3.7	3.1	2.0	4.1	5.1	6.5	6.7
Ireland	6.2	6.9	1.0	3.8	4.0	4.7	4.0	2.6	3.9	4.4	5.1	5.6
Luxembourg	1.0	0.5	1.5	4.0	2.7	2.1	2.0	1.7	2.6	2.8	3.2	3.3
Japan	0.4	0.2	2.0	1.4	–0.7	–0.9	–0.3	–0.6	5.0	5.4	5.5	5.4
United Kingdom[2]	2.1	1.9	1.7	2.4	2.1	2.2	2.8	2.5	5.1	5.2	5.2	5.2
Canada	1.9	3.3	1.9	3.0	2.5	2.3	2.8	1.7	7.2	7.6	7.9	7.7
Korea	3.1	6.3	2.5	4.7	4.1	2.8	3.3	3.0	3.8	3.1	3.4	3.3
Australia	2.7	3.6	3.0	3.5	4.4	3.0	2.9	2.3	6.7	6.3	6.1	6.0
Taiwan Province of China	–2.2	3.5	2.7	3.8	—	–0.2	0.1	0.8	4.6	5.2	5.3	5.0
Sweden	1.1	1.9	1.4	2.0	3.0	1.6	1.5	2.0	4.0	4.0	4.5	4.2
Switzerland	0.9	0.1	–0.4	1.4	1.0	0.7	0.4	0.5	1.9	2.8	4.2	3.8
Hong Kong SAR	0.5	2.3	1.5	2.8	–1.6	–3.0	–2.6	–1.9	5.1	7.3	7.8	7.5
Denmark	1.4	2.1	1.2	1.8	2.4	2.3	2.5	2.0	4.9	4.9	5.7	5.6
Norway	1.9	1.0	0.6	2.3	3.0	1.3	2.7	1.0	3.6	3.9	4.6	4.7
Israel	–0.9	–1.0	0.7	2.1	1.1	5.7	1.1	0.2	9.4	10.3	10.8	10.6
Singapore	–2.4	2.2	0.5	4.2	1.0	–0.4	0.6	1.2	3.3	4.4	4.9	4.2
New Zealand[3]	2.6	4.4	2.6	2.9	2.7	2.7	2.0	2.0	5.3	5.2	5.4	5.3
Cyprus	4.1	2.2	2.0	3.8	2.0	2.8	3.6	3.5	3.0	3.2	3.4	3.3
Iceland	2.9	–0.5	2.3	3.7	6.6	4.8	2.2	2.1	1.4	2.5	3.0	2.5
Memorandum												
Major advanced economies	0.8	1.6	1.8	2.8	2.0	1.3	1.8	1.1	5.9	6.5	6.8	6.7
European Union	1.7	1.1	0.8	2.0	2.4	2.3	2.2	1.8	7.4	7.7	8.2	8.3
Newly industrialized Asian economies	0.8	4.8	2.3	4.2	1.9	1.0	1.5	1.7	4.1	4.1	4.4	4.2

[1]Based on Eurostat's harmonized index of consumer prices.
[2]Consumer prices are based on the retail price index excluding mortgage interest.
[3]Consumer prices excluding interest rate components.

risen sharply in recent years (notably the United Kingdom, Australia, Ireland, the Netherlands, and to a lesser extent the United States), where such an eventuality would reduce the support that is presently being provided to demand in most of these countries and could increase the risk of a housing bust. In addition, if growth and corporate earnings were to disappoint, the recent rise in equity markets could prove ephemeral, putting renewed pressure on household, corporate, and financial balance sheets.

- *In emerging markets, the recent improvement in financing conditions owes much to temporary cyclical factors and could be reversed if industrial country interest rates were to rise rapidly.* This underscores the need to use the current relatively benign financing conditions to press ahead with measures to address significant medium-term vulnerabilities. In this connection, public sector debt in emerging markets, on average now higher as a percentage of GDP than in industrial countries, is a serious concern, and in many cases is well above the

Table 1.4. Selected Economies: Current Account Positions
(Percent of GDP)

	2001	2002	2003	2004
Advanced economies	**–0.8**	**–0.7**	**–0.9**	**–0.8**
United States	–3.9	–4.6	–5.1	–4.7
Euro area[1]	0.2	0.9	0.8	0.8
Germany	—	2.3	2.4	2.1
France	1.7	1.8	1.2	1.6
Italy	–0.1	–0.6	–1.1	–0.9
Spain	–2.8	–2.4	–2.7	–2.7
Netherlands	2.1	1.3	3.8	3.3
Belgium	4.0	4.7	4.0	4.4
Austria	–2.2	0.7	0.1	–0.2
Finland	7.1	6.9	6.1	5.8
Greece	–6.2	–6.1	–6.6	–6.6
Portugal	–9.6	–7.3	–4.9	–4.2
Ireland	–0.7	–0.7	–1.7	–1.1
Luxembourg	9.3	10.4	10.0	9.8
Japan	2.1	2.8	2.9	2.9
United Kingdom	–1.3	–0.9	–1.0	–0.9
Canada	2.4	2.0	1.6	1.6
Korea	1.9	1.3	1.6	1.8
Australia	–2.4	–4.4	–5.2	–4.8
Taiwan Province of China	6.4	9.1	8.5	8.8
Sweden	3.9	4.5	4.5	3.6
Switzerland	9.1	12.3	10.5	10.5
Hong Kong SAR	7.5	10.8	13.9	14.3
Denmark	2.6	2.7	4.2	4.2
Norway	15.6	13.2	12.5	11.4
Israel	–1.6	–1.2	–0.7	–0.8
Singapore	19.0	21.5	23.7	23.0
New Zealand	–2.6	–3.7	–3.7	–4.1
Cyprus	–4.3	–5.6	–4.9	–4.7
Iceland	–4.0	–0.1	–0.9	–2.1
Memorandum				
Major advanced economies	–1.4	–1.4	–1.6	–1.5
European Union[2]	–0.2	0.5	0.5	0.5
Euro area[2]	–0.3	0.8	0.7	0.7
Newly industrialized Asian economies	5.7	6.8	7.2	7.3

[1]Calculated as the sum of the balances of individual euro area countries.
[2]Corrected for reporting discrepancies in intra-area transactions.

level that would be sustainable if countries do not improve on historical growth and budgetary performance (see Chapter III, "Public Debt Sustainability in Emerging Markets").

Overall, there are increasing signs that the expected pickup in global activity is developing, although it is as yet unclear how broadbased and robust it will be. Against this background, and with inflationary pressures very moderate, macroeconomic policies need to remain supportive. At the same time, policymakers face major medium-term challenges: to reduce the dependence of global growth on the United States; to foster an orderly reduction in global imbalances; and to strengthen medium-term fiscal positions, especially in view of future pressures from aging populations. In general, monetary policy remains the short-term instrument of choice, and while sustained low policy interest rates run some risk of exacerbating some imbalances—notably in the housing market—these must be balanced against the need to support the recovery and reduce potential deflationary risks. On the fiscal side, with many countries facing substantial medium-term pressures, difficult trade-offs need to be made. In general, the automatic stabilizers should be allowed to operate; beyond that, much depends on country-specific circumstances and constraints, as well as the conjunctural situation. A slower pace of short-term consolidation—or even underlying budgetary deterioration—is clearly of less concern if accompanied by credible plans for future consolidation, by structural reforms to boost future growth, or—perhaps most importantly—by measures to address the future costs of aging populations (the latter having the advantage of having only a limited short-term impact on demand).

Against this background, the main policy priorities would appear to be the following.

- *In industrial countries, monetary policies need to remain accommodative.* In the United States, the federal funds rate is now at the lowest level in 40 years. Even so, given the continued sluggishness of activity, and the potential risks of deflation, the Federal Reserve has appropriately indicated that rates could remain low for a considerable period. Fiscal policy has provided support to demand, but at the cost of a serious deterioration in the long-run outlook; consequently, there is now a pressing need for a credible medium-term framework to restore balance (excluding Social Security) and put Social Security and Medicare on a sound footing (Table 1.5). In the euro area, where inflationary pressures have declined amid weak activity and the appreciation of the euro, the ECB's 50-basis-point reduction in interest rates in June was welcome. Further easing will

Table 1.5. Major Advanced Economies: General Government Fiscal Balances and Debt[1]
(Percent of GDP)

	1987–96	1997	1998	1999	2000	2001	2002	2003	2004	2008
Major advanced economies										
Actual balance	–3.8	–2.1	–1.6	–1.2	–0.3	–1.8	–3.8	–5.1	–4.7	–2.8
Output gap[2]	–0.3	–0.3	–0.2	0.1	1.0	–0.7	–1.4	–2.0	–1.6	—
Structural balance	–3.6	–1.8	–1.4	–1.2	–1.1	–1.7	–3.3	–4.2	–3.8	–2.8
United States										
Actual balance	–4.2	–1.3	–0.1	0.5	1.2	–0.7	–3.8	–6.0	–5.6	–3.0
Output gap[2]	–1.2	–0.5	0.4	1.2	1.8	–1.0	–1.6	–2.1	–1.4	—
Structural balance	–3.8	–1.1	–0.2	—	0.6	–0.5	–3.2	–5.1	–4.9	–3.0
Net debt	54.4	56.4	52.7	48.2	43.3	42.6	44.9	49.1	52.2	54.5
Gross debt	68.4	69.8	65.9	62.7	57.1	57.0	58.8	62.5	65.0	64.8
Euro area										
Actual balance	. . .	–2.6	–2.3	–1.3	0.1	–1.7	–2.3	–3.0	–2.8	–0.7
Output gap[2]	. . .	–1.2	–0.5	0.1	1.2	0.5	–0.7	–2.2	–2.4	–0.1
Structural balance	. . .	–1.6	–1.8	–1.2	–1.5	–2.0	–2.0	–1.7	–1.4	–0.6
Net debt	. . .	62.9	61.4	60.8	58.6	58.4	58.4	59.5	60.0	56.2
Gross debt	. . .	75.4	73.7	72.6	70.2	69.3	69.2	70.4	70.7	65.4
Germany[3]										
Actual balance	–2.4	–2.7	–2.2	–1.5	1.3	–2.8	–3.5	–3.9	–3.9	–1.2
Output gap[2]	0.4	–0.5	–0.4	–0.1	0.9	0.3	–0.9	–2.4	–2.5	—
Structural balance[4]	–2.5	–2.0	–1.7	–1.2	–1.6	–2.9	–2.9	–2.3	–2.3	–1.2
Net debt	31.9	53.4	53.3	54.9	52.8	53.5	55.4	57.8	60.1	59.2
Gross debt	46.4	61.0	60.9	61.2	60.2	59.5	60.8	63.2	65.5	64.6
France										
Actual balance	–3.6	–3.0	–2.7	–1.8	–1.4	–1.4	–3.1	–4.0	–3.5	–0.2
Output gap[2]	–0.8	–3.1	–1.7	–1.0	0.7	0.4	–0.6	–2.1	–2.4	—
Structural balance[4]	–3.0	–1.0	–1.6	–1.1	–1.8	–1.8	–2.8	–2.7	–2.1	–0.2
Net debt	32.6	49.6	49.8	48.8	47.5	48.2	49.2	51.6	53.2	49.3
Gross debt	41.6	59.3	59.5	58.5	57.1	56.8	58.9	61.3	62.9	59.0
Italy										
Actual balance	–10.0	–2.7	–2.8	–1.7	–0.6	–2.6	–2.3	–2.8	–2.6	–1.7
Output gap[2]	0.2	–0.3	–0.1	—	1.0	0.6	–1.0	–2.3	–2.3	—
Structural balance[4]	–9.9	–1.9	–2.8	–1.8	–2.4	–3.1	–2.7	–2.1	–1.7	–1.7
Net debt	101.5	113.8	110.1	108.4	104.5	103.7	101.0	100.9	99.8	93.0
Gross debt	107.3	120.2	116.4	114.6	110.4	109.5	106.7	106.6	105.4	98.3
Japan										
Actual balance	–0.9	–3.8	–5.5	–7.2	–7.4	–6.1	–7.5	–7.4	–6.5	–6.2
Excluding social security	–3.7	–6.0	–7.2	–8.7	–8.5	–6.3	–7.8	–7.6	–6.3	–5.5
Output gap[2]	0.9	1.1	–1.5	–2.5	–1.1	–1.9	–2.8	–2.0	–1.7	–0.1
Structural balance	–1.1	–4.2	–5.0	–6.2	–7.0	–5.4	–6.5	–6.7	–5.9	–6.2
Excluding social security	–3.9	–6.2	–6.9	–8.1	–8.2	–5.9	–7.1	–7.1	–6.0	–5.5
Net debt	18.9	35.3	46.2	52.8	58.6	63.7	72.2	80.0	86.9	103.7
Gross debt	77.6	105.5	117.1	130.5	138.7	148.4	158.4	166.8	174.1	183.2
United Kingdom										
Actual balance	–3.6	–2.2	0.2	1.1	4.0	0.9	–1.3	–2.5	–2.7	–2.5
Output gap[2]	–0.2	0.2	0.5	–0.3	0.2	—	–0.4	–1.1	–1.2	0.1
Structural balance[4]	–3.5	–2.1	—	1.0	1.7	0.8	–1.2	–2.1	–1.9	–2.4
Net debt	28.8	45.4	42.4	40.3	34.4	33.0	33.1	33.5	34.8	38.3
Gross debt	43.0	50.4	47.3	44.8	41.9	38.7	38.3	39.0	40.2	43.7
Canada										
Actual balance	–6.1	0.2	0.1	1.6	3.0	1.4	0.8	1.5	1.5	1.6
Output gap[2]	0.2	–0.9	–0.8	0.6	2.0	0.4	0.4	–0.9	–0.8	–0.1
Structural balance	–6.1	0.8	0.5	1.4	2.1	1.2	0.8	2.1	2.0	1.6
Net debt	73.9	85.8	83.1	74.8	64.7	59.1	56.1	51.7	47.8	33.6
Gross debt	105.8	118.6	116.2	110.8	101.8	99.6	96.0	89.5	83.9	63.4

Note: The methodology and specific assumptions for each country are discussed in Box A1 in the Statistical Appendix.
[1]Debt data refer to end of year. Debt data are not always comparable across countries. For example, the Canadian data include the unfunded component of government employee pension liabilities, which amounted to nearly 18 percent of GDP in 2001.
[2]Percent of potential GDP.
[3]Data before 1990 refer to west Germany. For net debt, the first column refers to 1988–94. Beginning in 1995, the debt and debt-service obligations of the Treuhandanstalt (and of various other agencies) were taken over by general government. This debt is equivalent to 8 percent of GDP, and the associated debt service, to ½ to 1 percent of GDP.
[4]Excludes one-off receipts from the sale of mobile telephone licenses (the equivalent of 2.5 percent of GDP in 2000 for Germany, 0.1 percent of GDP in 2001 and 2002 for France, 1.2 percent of GDP in 2000 for Italy, and 2.4 percent of GDP in 2000 for the United Kingdom). Also excludes one-off receipts from sizable asset transactions.

Box 1.1. Recent Changes in Monetary and Financial Conditions in the Major Currency Areas

Exchange rates among the industrialized countries have been substantially realigned since the peak of the U.S. dollar (in nominal and real effective terms) in February 2002. Most significant has been the dollar's depreciation against the euro—a fall of 20 percent from early 2002 to the end of August 2003—but also noteworthy has been the dollar's weakening against the yen, the pound sterling, and the Canadian dollar (down 10 to 12 percent in each case) and against the Australian dollar (down 20 percent). This box assesses the implications of these movements for short-term prospects in the major regions, especially when developments in interest rates, equity values, and property prices are also taken into account.

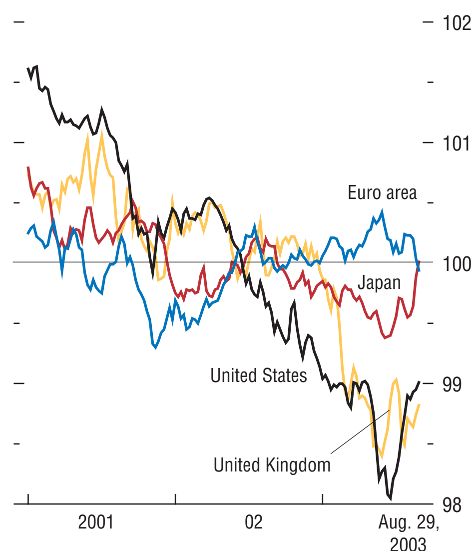
Trade-weighted currency movements have been less dramatic than bilateral changes (see Figure 1.4). The U.S. dollar has fallen by 11 percent in nominal effective terms since February 2002—partly reflecting the fact that about one-half of U.S. trade is with developing countries, some of whose currencies have remained stable or depreciated against the dollar over recent years. China and Mexico, for example, are the next-largest suppliers of U.S. imports after Canada, with China maintaining a de facto fixed exchange rate against the dollar and the Mexican peso depreciating about 17 percent against the dollar since February 2002. Individual euro area economies have also faced much smaller effective exchange rate appreciations than suggested by the euro/dollar change—reflecting the significance of intra-European trade, together with the increasing volume of trade with central and eastern Europe. For example, Germany and France have experienced nominal effective exchange rate appreciations of only 5 to 6 percent since early 2002.

Furthermore, recent currency movements have generally been consistent with medium-term fundamentals. As pointed out repeatedly in the *World Economic Outlook* (and elsewhere) over recent years, the decline in the value of the U.S. dollar is likely to reflect market concerns about the sustainability of current account imbalances across the major regions—especially the large U.S. deficit. Global current account imbalances eventually will need to be resolved through some reconfiguration of exchange rates and relative demand growth rates. The exchange rate adjustments over the past 18 months are in the direction needed to reduce such imbalances, although the dollar still appears substantially overvalued from a longer-term perspective—implying the likelihood of further downward adjustment. For example, current projections suggest that the U.S. current account deficit may decline by only about 1 percentage point—from 5 to 4 percent of GDP—over the next five years, with the effects of the weaker dollar partly offset by the more rapid recovery expected in the United States than in the euro area and Japan.

In most regions, monetary policy changes have reinforced, or helped to offset, the impact of recent exchange rate developments on overall monetary conditions (a weighted average of the exchange rate, short-term interest rates, and long-term rates). In the United States and the United Kingdom, monetary conditions have eased significantly since early 2002 as a result of both lower interest rates and weaker currencies (see the figure). In the euro area, monetary conditions have been broadly stable over this period, with interest rate reductions offsetting the impact of the euro's appreciation. In Japan, even with massive foreign exchange market intervention, the authorities have only managed to stem the appreciation of the yen, rather than engineer a desirable easing of monetary conditions to combat entrenched deflation. It is also notable that in developing Asia, which by virtue of relatively strong growth rates and external balances would be well placed in comparison with the euro area and Japan to absorb some appreciation, implicit or explicit links to the U.S. dollar have limited the extent to which local currencies have appreciated since the dollar's peak. Overall, then, the cyclically weakest

Note: The main author of this box is Maitland MacFarlan.

Monetary Conditions Index[1]
(January 2, 2001 to August 29, 2003 = 100)



Sources: Bloomberg Financial Markets, LP; Global Insight, Inc.; and IMF staff calculations.
[1]Weighted average of nominal short-term and long-term interest rates and the nominal effective exchange rate.

regions appear to have been the hardest hit by recent currency movements.

This asymmetric impact of changes in monetary conditions across the main regions has in some cases been reinforced by movements in equity and property prices. In general, asset price movements tend to have a stronger influence on consumption and investment in the more capital-market-based financial systems of the United States and United Kingdom, compared with the predominantly bank-based systems of continental Europe and Japan.[1] Over recent years, rising property prices in the United States and, especially, the United Kingdom have offset the downward pressures on household spending from the fall in equity markets (see the first table). While this also appears to be the case in France, property prices in Germany have provided little offset to the large decline in equity market capitalization and, in Japan, falling property prices have reinforced the negative wealth effects from earlier falls in equity markets.

To what degree should recent exchange rate developments influence monetary policy? The *direct* impact of exchange rates on consumer prices appears to have diminished over recent decades, particularly in response to falls in the level and variability of inflation, and may now be very small. While there is substantial variation in estimates of pass-through elasticities—the per-

[1]See the essay on "Is Wealth Increasingly Driving Consumption?" in Chapter II of the April 2002 *World Economic Outlook*. Note that the estimated effects on consumption spending from changes in wealth are spread out over a number of years.

Impact on Household Spending of Asset Price Changes
(Percent change)

	United States	Euro Area	Germany	France	Japan	United Kingdom
Equity markets						
Capitalization[1]	–6	–21	–26	–19	5	–15
Impact on spending	–0.4	–0.2	–0.2	–0.2	—	–1.4
Property markets						
Valuation changes[2]	7	. . .	1	7	–8	30
Impact on spending	0.6	. . .	0	0.3	–0.4	2.4

Sources: National sources; DataStream International; Office of Federal Housing Enterprise Oversight; HBOS plc; Japan Real Estate Institute; and Bundesbank calculations based on Bulwein data.
[1]Percent change from February 2002 to August 2003.
[2]Data for the United States and Japan cover the period Q1:2002 to Q1:2003; for Germany and France, Q4:2001 to Q4:2002; and for the United Kingdom, February 2002 to June 2003.

Box 1.1 *(concluded)*

CPI Impact of Exchange Rate Changes
(February 2002 to end-August 2003)

	Pass-Through Elasticity	Change in Nominal Effective Exchange Rate	CPI Impact
United States	.03	–11	0.3
Euro area	.02	15	–0.3
Japan	.03	4	–0.1
United Kingdom	.08	–7	0.6

Sources: IMF staff estimates; and Gagnon and Ihrig (2002).
Note: Pass-through elasticities for the United States, Japan, and the United Kingdom from Gagnon and Ihrig (2002). The elasticity for the euro area is from IMF (2003a) and may not be strictly comparable—it is prepared on a different methodology and refers to the *core* rather than headline CPI.

cent decrease (increase) in consumer prices in response to a 1 percent appreciation (depreciation) in the exchange rate—some recent studies suggest these may now be only 0.02 to 0.03 in several of the advanced economies (including the United States, the euro area, and Japan).[2] Import prices tend to respond more strongly to exchange rate changes (an estimated one-for-one response in the euro area, for example), but the impact of these changes on consumer prices is moderated by the substantial role of local distribution costs as well as "pricing-to-market" strategies. On this basis, core consumer

[2]See Gagnon and Ihrig (2002) and IMF (2003b).

prices in the euro area would be expected to decline by about 0.3 percent in response to the euro's appreciation since early 2002, the full impact coming through by the end of 2004.[3] Elsewhere, CPI increases (in response to exchange rate depreciations) would also be rather small (see the second table).

The case for monetary policy adjustment to exchange rate changes would be strengthened, however, by the *indirect* impacts of such changes on prices—especially through the demand channel. In the euro area in particular, the potential impact of the stronger euro on exports—the typical growth engine in the initial stages of European recoveries—may further weaken demand, delay recovery prospects, and add to downward pressures on inflation. Hence, recent exchange rate changes may provide scope for further reductions in official euro area interest rates. In the United States and United Kingdom, in contrast, the weakening of exchange rates and overall monetary conditions during the current cycle would tend to add support to the recovery and bring forward the time when a steady withdrawal of monetary stimulus becomes appropriate.

[3]Although less relevant for monetary policy, the impact on *headline* inflation would be higher than this, mainly as a result of the stronger pass-through of oil price changes.

be needed if inflation threatens to undershoot significantly: for instance, if activity fails to pick up quickly or the euro appreciates significantly. In the larger European countries, medium-term fiscal consolidation remains a priority. In these cases, underlying adjustment of ½ percent of GDP a year or, where underpinned by tangible and credible quality consolidation measures and structural reform efforts, cumulative adjustment of 1½ percent of GDP over 2004–06 would appear to provide scope for a reasonable compromise between short- and medium-term policy trade-offs. Automatic stabilizers should be allowed to operate fully around the consolidation path, even if that results in breaches of the 3 percent of GDP deficit limit. In Japan, despite stronger-than-expected recent data, a much more aggressive monetary policy—accompanied by a clear communication strategy and a commitment to end deflation in a short period—remains essential to turn around deflationary expectations. Given the very high public deficit and debt, modest structural fiscal consolidation appears appropriate. In almost all industrial countries, addi-

tional pension and health sector reform is essential to address the future pressures from aging populations.

- *In emerging markets, the policy priorities vary widely across regions.* In Latin America, recent currency appreciation has increased the room for monetary easing in some countries, but—notwithstanding the improvement in financing conditions—it will be critical to ensure that the pace of fiscal consolidation and structural reform is sustained. In Asia, the scope for policy maneuver is greater, and macroeconomic policies have appropriately been eased in a number of countries, in part to offset the impact of SARS. As discussed in Chapter III, in many emerging and developing countries a broad-based effort to improve medium-term public debt sustainability—encompassing tax reforms, improved expenditure control, institutional strengthening, and structural reforms to boost growth—is a central priority.
- *Given the continued need to reduce global dependence on growth in the United States and address global imbalances, the case for structural reform takes on new urgency.* As has been discussed many times in the *World Economic Outlook*, the priorities include labor and product market reforms to boost potential growth in Europe; corporate and financial restructuring in Japan; a greater reliance on domestic demand in emerging markets in Asia, again supported by continued corporate and financial sector reform; and in the United States, measures to boost national savings, particularly through strengthening the medium-term fiscal position. Over the past several years, progress has unfortunately been limited, and in some aspects—notably the U.S. fiscal outlook—the situation has deteriorated. In marked contrast to the situation in the mid-1980s, when the United States last ran a current account deficit of this size, neither Japan nor, to a lesser extent, Europe is well placed to pick up the slack if growth in the United States were to slow. This underscores the need for accelerated efforts to address the issues listed above. In this connection, the recent initiatives in Europe—especially Agenda 2010 in Germany and the recent pension reform in France—are encouraging, although there is much further to go. In many countries, continued efforts to strengthen corporate governance are also required.
- *Policymakers will need to stand ready to manage the effects of a further depreciation in the U.S. dollar, if it were to occur.* To date, the brunt of the adjustment to the depreciation of the dollar has been borne by the euro, the Canadian dollar, and a number of smaller industrial country currencies. As discussed in Box 1.1, this has been broadly in line with medium-term fundamentals, and in most cases there has been scope for offsetting monetary easing. Were the U.S. dollar to depreciate significantly further, most of these countries still have some room for policy action; however, with the degree of undervaluation much less than before, it would be desirable for the necessary currency appreciation to be spread more broadly. The critical need for a more aggressive monetary policy to address deflation in Japan implies, if anything, some downward pressure on the yen. In these circumstances, greater upward exchange rate flexibility in emerging markets in Asia—which is relatively well placed from a cyclical perspective—would significantly facilitate the global adjustment process, given the region's importance in global trade, as well as being desirable for domestic reasons (Chapter II).

In those countries where poverty remains a major concern, GDP growth has remained relatively resilient despite the weakness of the global economy. However, substantial differences across countries remain. In China and, to a lesser extent, India, per capita GDP growth is quite robust; but in sub-Saharan Africa it remains below 1 percent, far from sufficient to meet poverty reduction targets under the Millennium Development Goals. In this connection, it is notable that per capita GDP growth has been significantly stronger in those African countries where political stability has been achieved and where the most progress has been made toward

Box 1.2. How Should We Measure Global Growth?

As estimates of global growth are a key output of global forecasts, such as those reported in the *World Economic Outlook* (WEO), it comes as something of a surprise that the exchange rates used to aggregate growth vary widely across forecasters, with material consequences for the estimated figures. The WEO, together with the Organization for Economic Cooperation and Development (OECD) and a number of private sector organizations, uses purchasing-power-parity (PPP) exchange rates—the exchange rate that equates the cost of a "typical" basket of goods across countries. By contrast, the World Bank and other groups in the private sector use market rates—the rate at which transactions occur in exchange markets. Still others use hybrids between these two main alternatives.

Clearly, the appropriate weighting scheme can depend on the issue being considered. Market weights are appropriate when the outcome is closely linked to the current exchange rate—for example, current accounts. In addition, the well-known identity that the global current account should sum to zero holds only when using market rates. Similar considerations apply to many nominal concepts, as well as some real variables, such as effective demand for a given country, since the profitability of exporters depends on current exchange rates. Reflecting these considerations, the WEO aggregates many variables using market rates, as well as reporting an alternative measure of global growth on this basis in Table 1 of the Statistical Appendix. The main disadvantage of using market rates is their instability over time. For example, the market rate of the euro has appreciated by over one-fourth in real terms against the U.S. dollar since early 2002. Using market rates to add up world GDP would imply that euro area workers have massively increased their productivity compared with their U.S. counterparts over a period when the United States appears to be experiencing a more robust recovery.

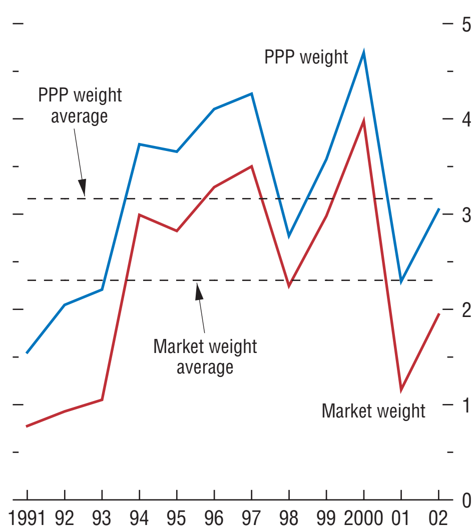
Note: The main author of this box is Tamim Bayoumi

Partly as a consequence, PPP exchange rates are generally regarded as providing a better measure of the change in global economic well-being. The greater stability of real exchange rates implied by using PPP means that the resulting estimate of (say) global growth is less affected by short-term changes in the relative importance of countries and regions. In addition, PPP exchange rates are generally thought to provide a more balanced estimate of the relative importance of rich and poor countries. Market rates imply that the vast majority of world output comes from advanced countries, a result generally attributed to the fact that market rates only equate prices of traded goods, and that nontraded goods are relatively more expensive in rich countries. For example, a haircut is much more expensive in New York than in Bombay although the outcome is similar. PPP exchange rates adjust for this bias, so that the weight of advanced countries in global output falls from four-fifths to just over one-half (see Box A1 of the May 2001 *World Economic Outlook*).

PPP weights imply significantly higher global growth than those based on market exchange rates. As developing countries generally grow faster than their industrial counterparts, using PPP exchange rates leads to a higher underlying rate of global growth (see the figure). The differential has become particularly large in recent years, averaging almost 1 percent a year since 1990, largely reflecting rapid growth in China and stagnation in Japan, the major countries whose weights are most affected by the switch from market to PPP exchange rates. Japan's weight in world output halves from 15 to 7½ percent when PPP weights replace market ones, while China's increases from 3½ to 11½ percent.[1] When China and Japan are excluded, the gap between the two weighting schemes falls by over half.

[1]The PPP weight for China is subject to some controversy, as discussed in an appendix available via the Internet at http://pwt.econ.upenn.edu, the website of the Penn World Tables.

Global Growth: Purchasing-Power-Parity Versus Market Exchange Rates
(Percent a year)



Global Growth Using Different Weights, 1990–99
(Percent a year)

	Full Sample	Excluding China and Japan
Penn World Tables PPP weights	3.4	3.0
WEO PPP weights	3.6	3.0
Market exchange rates	2.6	2.7

Sources: Penn World Tables; WEO database; and IMF staff calculations.

One complication with using PPP exchange rates is that, while the exchange rate is adjusted for price distortions between traded and non-traded goods, similar adjustments are difficult to make to national data. As a result, the growth rate for (say) China may be based on internal market prices that put too high a weight on rapidly growing traded goods and too little weight on slower growing services. This implies that global growth may be overstated when PPP exchange rates are used, unless these weights are adjusted over time to reflect the changing pattern of domestic prices. Fortunately, there is a data source—the Penn World Tables—that aggregates output across countries by first converting its components into dollars using U.S. relative prices, thus avoiding this bias. Unfortunately, such calculations are cumbersome. While not practicable for WEO purposes, they can provide a useful benchmark for more flexible schemes.

Assuming PPP rates are appropriate, the bias coming from using unchanging PPP exchange rates is small compared with that from using market values. The table sets out the growth rate of GDP aggregated across all countries available in the Penn World Tables from 1990–99 using data from the Penn World Tables themselves, as well as aggregating using WEO PPP weights and those derived from market exchange rates. While the WEO PPP aggregation creates an upward bias of 0.2 percent a year, this is considerably smaller than the downward bias from using market exchange rates of 0.8 percent a year. Indeed, once China and Japan are excluded from the calculation, the WEO PPP calculation has no discernable bias, while the market rates continue to show lower growth than the benchmark.

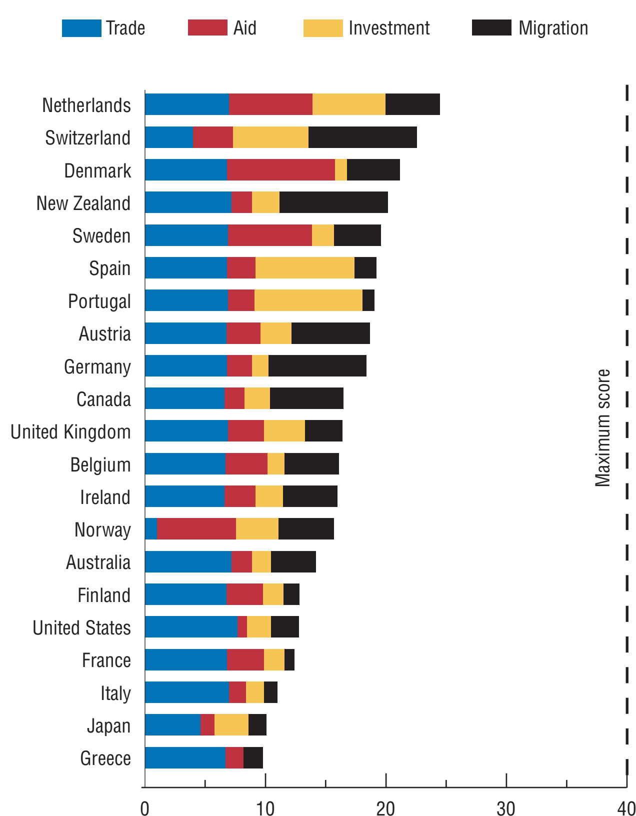
Overall, assuming one wishes to calculate global growth using PPP weights, the current WEO approach provides a relatively accurate estimate of global growth. Further refinements, however, might be able to reduce the upward bias that still occurs compared with calculations using PPP weights calculated on a more careful, but less practical, basis.

macroeconomic stability and structural and institutional reform. This underscores the need to press forward with the region-wide implementation of the New Partnership for Africa's Development (NEPAD), which fully embodies these objectives.

But while improved domestic policies in Africa are crucial, they are not enough: addi-

Figure 1.8. How Much Do Developed Country Policies Help Developing Countries?[1]
(Commitment to development index)

Developed country policies appear only modestly supportive of development, particularly in the largest countries.



Source: Center for Global Development.
[1]The index measures the impact of advanced country policies on development in the areas of trade, aid, investment, and migration; the maximum score in each category is 10. For details of the calculations, see Birdsall and Roodman (2003).

tional financial assistance from the international community is also essential and—provided appropriate domestic policies are followed—can be effectively absorbed (see Box 1.3, "Managing Increasing Aid Flows to Developing Countries"). Following the Monterrey Summit, progress has been made, including the establishment of the Millennium Challenge Account and additional funding to address the AIDS pandemic by the United States; and the United Kingdom has put forward innovative proposals for an International Financing Facility to finance the achievement of the Millennium Development Goals. While the impact of aid and other key macroeconomic policies in industrialized countries is difficult to measure precisely, recent analysis by the Center for Global Development suggests that in most cases they are far from supportive of development, underscoring the need for further progress to help developing countries meet the Millennium Development Goals (Figure 1.8).

A central and immediate challenge for the global community is to achieve further multilateral trade liberalization under the Doha Round. This would clearly be of enormous benefit to the globe as a whole: as the IMF's Managing Director has stressed, ". . . lowering barriers to trade . . . has been the foundation of the tremendous expansion in global trade and prosperity in the second half of the twentieth century."[5] Moreover, with nearly three-fourths of the world's poor working in the rural sector, competing with industrial country farmers who receive a third of their income in subsidies and other forms of protection, it is clearly also critical for poverty reduction. The developing countries themselves have much to do—and much to gain—from reducing their own trade barriers. But progress in the Doha Round requires leadership from the largest industrial countries, as well

[5]See "Cooperation in Trade and International Financial Integration," speech by Horst Köhler, IMF Managing Director at the WTO General Council Meeting on Coherence, Geneva, May 13, 2003 (available via the Internet: http://www.imf.org/external/np/speeches/2003/051303.htm).

Box 1.3. Managing Increasing Aid Flows to Developing Countries

At the Millennium Summit of the United Nations in September 2000, the global community adopted the Millennium Development Goals encompassing eight socioeconomic objectives related to poverty reduction—including health, gender, education, environment, and global partnership for development—with the number of poor to be halved between 1990 and 2015. Recognizing that achieving these goals would require substantial additional external resources, in the March 2002 Monterrey Consensus the industrial countries were urged to make concrete efforts toward achieving a level of Official Development Assistance (ODA) of 0.7 percent of GNP, a longstanding target so far met by only a handful of industrial countries.

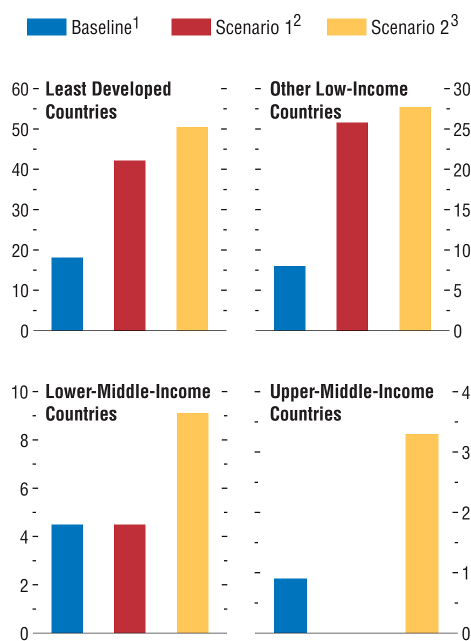
If all industrial countries were to increase their ODA to 0.7 percent of GNP, aid flows to developing countries would increase very substantially (see the figure). Aid flows, which presently average 0.24 percent of industrial countries' GNP, would nearly triple and could reach 70–90 percent of some recipient countries' GDP.[1] Such flows would be unprecedented in size—much higher, for example, than peak capital flows to emerging markets in the mid-1990s (14–15 percent of GDP). Aid has also typically been volatile—in some countries in the 1990s, for example, absolute changes in aid flows exceeded 30 percent of GDP in a single year. With underdeveloped financial markets and relatively closed capital accounts, how should the economies of recipient countries deal with both the large volume and volatility of aid flows?

One concern that has often been raised with respect to aid flows is the so-called Dutch disease. An increase in aid generally increases the demand for both traded and nontraded goods. With the supply of nontraded goods less elastic, higher demand drives up their price relative to that of traded goods and causes the real exchange rate to appreciate. This, in turn, draws resources away from the traded goods sector and causes it to shrink, raising concerns if the traded goods sector is the main source of productivity growth in the economy and aid flows are volatile.[2]

That said, Dutch disease concerns should not be overstated. Recent preliminary results by Prati, Sahay, and Tressel (2003) suggest that a doubling of aid inflows from 10 percent to 20 percent of GDP would lead to a real apprecia-

Distributing 0.7 Percent of GDP in Official Development Assistance (ODA) Under Different Scenarios

(ODA in percent of GDP)



Source: Heller and Gupta (2002).
[1]1996 aid allocation.
[2]Based on Collier and Dollar's (1999) poverty-efficient aid allocation, scaled up for the higher level of allocation implied by the 0.7 percent. China and India are constrained to receive no more than their 1996 share of total aid.
[3]All countries receive the ODA they got in 1996 plus an incremental amount allocated according to Collier and Dollar's (1999) criteria. China and India are constrained to receive no more than their 1996 share of total aid.

Note: The main author of this box is Ratna Sahay.
[1]See Heller and Gupta (2002).
[2]See Bulíř and Hamann (2001).

Box 1.3 *(concluded)*

tion of only 6 percent on impact. This effect may vary across countries and could be even smaller if aid translates mostly into higher imports. Moreover, in a number of cases, countries have been able to intervene in the foreign exchange market to limit the exchange rate impact of foreign aid inflows (through buying foreign exchange) and sterilize the monetary impact of the intervention (by selling government paper). Such sterilized intervention can be an effective way of preventing real appreciation in countries with relatively closed capital accounts, but can be expensive because domestic interest rates are generally higher than the interest received on foreign assets.

Managing increasing aid flows requires also choosing their most appropriate form. Grants—as opposed to loans—are the optimal form of aid when aid is intended to raise consumption of the poorest segments of the population, to respond to natural disasters or food shortages, and to provide humanitarian assistance and help the peace process during conflicts. Grants are also appropriate when the magnitude and timing of the returns to public investment are highly uncertain and where the government has limited ability to recoup them through taxation to service debt. If the GDP growth rate of the economy does not increase in response to this type of aid it should not come as a surprise. But grants would help prevent future generations from inheriting debt and reduce the need for debt forgiveness.[3]

Overall, the key issue remains the effectiveness with which aid is used. The main challenges relate to the administrative capacity to manage and use the resources efficiently, the volatility and uncertainty of aid flows, and the potential for fueling corruption. If aid flows are used to finance productivity-increasing investments—for example, in education, health, or infrastructure—Dutch disease concerns are correspondingly reduced. However, raising expenditure on education and health sporadically will not be sufficient—the spending will need to be well targeted and monitored. In addition, given that it takes time for the quality of human capital to improve, some mechanism will need to be devised to ensure that a higher level of resources can be sustained for at least 10 to 15 years.

If good governance is not in place, the resource transfer is easily captured by the elite with no positive effect on productivity and a worsening of the income distribution in the recipient country. Donors may sometimes face a dilemma if aid helps reduce the absolute number of the poor in a country but at the same time also worsens the income distribution (this is possible when the resource transfer to the elite is much larger than that to the poor). Under these conditions, the overall welfare of the population may increase but corruption may also rise. While in the past, aid appears to have been given to corrupt and noncorrupt governments alike (Alesina and Weder, 2002), greater attention should be paid going forward to the quality of local institutions in future aid decisions. External assistance should be increasingly focused on supporting countries that implement governance reforms and invest in quality human and physical capital, strengthening institutions through technical assistance, and increasing country ownership of programs and projects through the Poverty Reduction Strategy Paper (PRSP) process.

What if policy performance and institutions cannot be strengthened in the short run? Rather than cut off aid, donors should announce multiyear aid commitments with disbursements conditional on good political and economic performance and the dire needs of the poor, thus creating the incentives for recipient countries to reform and making future aid flows more certain. At the same time, countries with good policies and institutions should be allowed to save part of the aid so that the adverse consequences of aid volatility are reduced and disbursements are made commensurate to the absorptive capacity of the country. Dependency on aid can be expected to decline over time as low-income countries succeed in meeting their development goals.

[3]Helbling, Mody, and Sahay (forthcoming).

as a clear commitment by the developing countries to trade integration as a core element of their development strategy. Regrettably, progress to date has generally been disappointing, although recent steps by the European Union toward agricultural reforms are welcome, if still somewhat partial. At the Evian G-7 Summit in May, industrial country leaders renewed their commitment to ensure a successful Doha Round; the WTO Cancun Ministerial meeting in September—which was under way as the *World Economic Outlook* went to press—must be the occasion to match words with action.

North America: Can the United States Remain the Engine of Global Growth?

After a year of recovery, GDP growth in the United States slowed markedly from about mid-2002, owing both to rising geopolitical uncertainties in the run-up to the war in Iraq and to the continued aftereffects of the bursting of the equity price bubble. Amid weak demand and continued substantial excess capacity, inflation has fallen considerably, with core CPI inflation still well below 2 percent. With the substantial depreciation of the U.S. dollar over the past year only just beginning to have an effect, the external current account deficit has continued to break new records; in contrast to previous years, it has been financed primarily by sales of government agency and corporate paper, including to a number of Asian central banks, rather than by equity inflows.

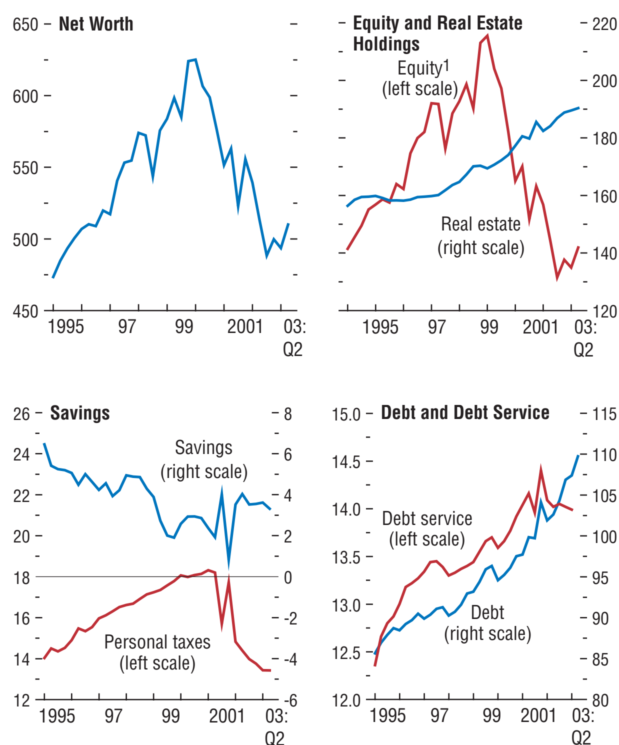
Following the end of the war in Iraq, the recovery has begun to regain momentum. Second quarter GDP data proved stronger than expected, aided by a sharp rise in government expenditures, as well as increasing signs of a pickup in consumption (albeit in part due to very strong automobile sales) and private investment. While labor markets remain sluggish and significant excess capacity persists, forward-looking indicators—notably consumer and business confidence—have strengthened, and monetary and financial conditions have eased further. Fiscal policy has become even more stimulative with the passage of further tax cuts and higher defense expenditures; equity prices have risen markedly; the dollar has fallen significantly since its peak in early 2002; and long-term interest rates, despite a strong rebound since mid-June, are still low by historical standards. Against this background, the IMF staff continues to project a renewed recovery in the second half of 2003 and 2004, at a somewhat stronger pace than earlier expected, with GDP growth rising above potential from the third quarter onward.

Given the very substantial macroeconomic and other stimuli now in train, a stronger economic upturn is clearly possible. That said, the pace and extent of the pickup in investment may be constrained by relatively high excess capacity along with continued corporate caution in the wake of recent accounting scandals; corporate and household balance sheets, while improving, remain stretched (Figure 1.9); and the substantial support to consumption provided by the housing sector is unlikely to be sustained, while labor market conditions remain relatively soft. More broadly, the record current account deficit—now matched by an equally large general government deficit (Figure 1.10)—is still an important vulnerability. Despite its depreciation over the last year, the dollar still appears overvalued from a medium-term perspective, and the risk that its adjustment may become disorderly—or that it might overshoot—cannot be ruled out.

Against this background, U.S. policymakers have faced a difficult task balancing the need to provide short-term support to the economy while minimizing the risk of exacerbating long-run problems, a task made no easier by the weakness of demand in the rest of the world. Monetary policy has been highly accommodative, and the Federal Reserve has appropriately indicated that this can be maintained for a considerable period; the adoption of a medium-term inflation target could help to anchor inflationary expectations and reduce the risk of an adverse shock leading to unwanted downward pressure on inflation. With low interest rates contributing to a continued boom in house prices, which—after adjustment for inflation—are about 30 percent above

Figure 1.9. United States: Household Balance Sheets
(Percent of disposable income)

Household balance sheets have stopped deteriorating, aided by still buoyant house prices, but remain stretched. The increase in household savings has been financed entirely by lower taxes.



Source: Haver Analytics.
[1]Excluding mutual fund shares, at market value.

their previous peak, concerns have been raised that the current stimulus has been achieved at the risk of a future housing bust, which could have a serious impact on consumption and growth. Such concerns need, however, to be balanced against the certainty of greater current economic weakness in the absence of monetary easing and the risks that it would pose for the United States—and the global economy—at the current conjuncture. And with policy interest rates not expected to be raised until the recovery is on a firm footing, the impact of eventual housing price adjustment would likely be offset by strength elsewhere in the economy. Even so, the elevated level of housing prices is a potential risk, particularly if long-term interest rates were to continue to rise strongly.

On the fiscal side, the general government deficit (covering both the federal government and the states) is projected at over 6 percent of GDP in 2003, compared with a surplus of over 1 percent in 2000—the largest swing in the fiscal position over three years in at least three decades. While this has provided short-term support to the recovery, it has come at the cost of a substantial deterioration in the medium-term fiscal position—in practice, with the U.S. Administration's expenditure and revenue projections appearing relatively optimistic and a further supplementary budget expected to cover expenditures related to Iraq, the outlook may well prove worse. If sustained, higher deficits would offset the longer-term benefits from tax cuts—already reduced by complex and untransparent phasing and sunset arrangements—and make an orderly adjustment of the current account deficit more difficult. In addition, with public debt no longer projected to decline in coming years, no fiscal cushion will be built up in advance of the coming pressures from the retirement of the baby boomers. This would be of less concern if early action to reduce future costs of aging populations were envisaged, but that does not presently appear to be the case (recent proposals in fact increase Medicare spending). Consequently, implementation of a credible medium-term framework to restore

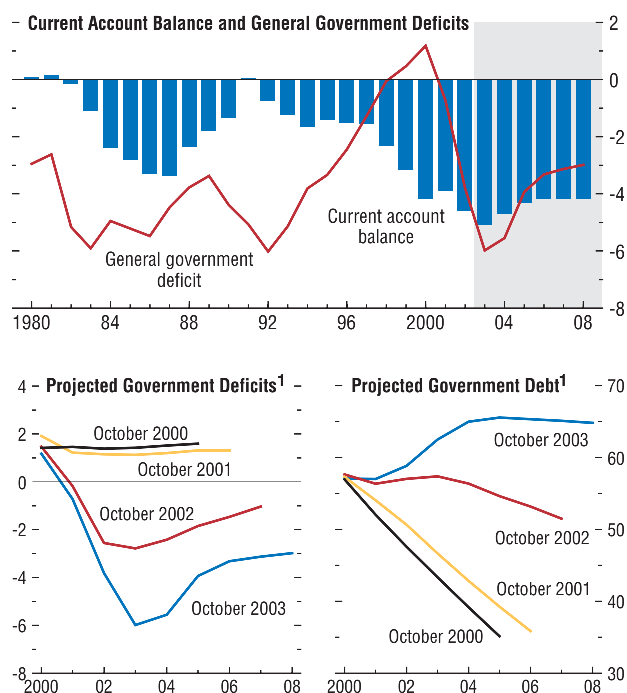
broad budgetary balance (excluding Social Security) over the cycle is now even more pressing, along with measures to put the Social Security and Medicare systems on a sound financial footing.

The continued robust growth of labor productivity remains a key strength of the outlook. While this partly reflects the effects of recent labor retrenchment, productivity growth should remain solid in coming years—although not as fast as in the late 1990s—buoyed by continued advances in information technology and the gradual spread of IT-related productivity gains to other sectors of the economy.[6] This, in turn, has been underpinned by the flexibility and investment-friendliness of the U.S. economy, strengths that should continue to be built on in the future, including by continuing to strengthen corporate governance and accounting standards. That said, as noted above, a number of downside risks remain, and based on historical experience even an orderly current account adjustment would likely be accompanied by weaker growth of both GDP and—even more—domestic demand. While such risks are clearly reduced by strong productivity growth, looking forward it seems unlikely that the United States can or should provide the degree of support to the global economy over the medium term that it has in the past.

Following impressive growth in the first three quarters of 2002, GDP growth in Canada has slowed considerably in recent months, reflecting the rapid and sizable appreciation of the Canadian dollar, weaker foreign demand, and a slower pace of inventory accumulation as well as the temporary impact of SARS and mad cow disease. Reflecting these factors, as well as the drop in core inflation to well within the 1–3 percent target range, the Bank of Canada acted in July and September to partially reverse earlier interest rate hikes. Reflecting the projected strengthening in U.S. activity, improving confidence, and

Figure 1.10. United States: Return of the Twin Deficits
(Percent of GDP)

The sharp deterioration in the U.S. fiscal position has led to a reemergence of the twin deficits of the 1980s. With fiscal deficits expected to persist, government debt will now not be reduced in advance of the retirement of the baby boomers.



[1]Projections from previous *World Economic Outlooks.*

[6]See "Is the New Economy Dead?" Box 1.2, April 2003 *World Economic Outlook.*

the fading impact of the recent adverse shocks, growth is expected to pick up toward the end of the year. The 2003/04 budget has maintained the commitment to fiscal prudence, and with continued small surpluses projected in the next two years, public debt is expected to be reduced below 40 percent by 2004/05.

Western Europe: Prolonged Weakness with Tentative Signs of a Turnaround

The slowdown in the euro area has been deeper and more prolonged than earlier expected, although recent indicators—notably increases in equity prices and in business confidence—may portend an improvement in economic prospects. Nevertheless, there are still relatively few signs of a broader pickup in real activity: GDP declined in the euro area as a whole in the second quarter of 2003, including in Germany, France, and Italy, implying that Germany and Italy, together with the Netherlands, were in recession; despite some recent strengthening in expectations, indicators of household and business confidence generally remain at depressed levels; unemployment continues to edge up; and industrial production has yet to show a sustained upward trend. The German economy remains weak for the third year in a row, adding to the subpar performance of the euro area as a whole and threatening to hold back the region's recovery prospects. Reflecting these developments, growth projections for the euro area have again been marked down—by about ½ percent in 2003 and 2004—and risks in some countries still appear to be tilted to the downside.

What accounts for these ongoing difficulties in the euro area? Looking at the main components of demand, investment spending has been a key weakness over recent years—driven down by the general over-leveraging of corporate balance sheets during the asset price bubble of the late 1990s and the subsequent slow pace of adjustment. Exacerbating this downturn has been low business confidence and—in Germany—the continued unwinding of the post-reunification construction boom. Corporate difficulties and the broader legacy of the global equity market bubble have also hit euro area financial institutions. For example, increased loan-loss provisions since 2000 have lowered the capital cushions of euro area banks. The German financial sector had a particularly difficult year in 2002 and, although there have been encouraging signs recently that this deterioration has been arrested—helped by more positive developments in financial markets—further delay in the recovery would nevertheless put additional strains on an already stretched system.

While still uneven across the area, consumption has picked up slowly over the past year, and should receive more support from rising real incomes as inflation declines. Household balance sheets appear to be in generally good shape, with lower debt levels and higher savings rates than in the United States. But offsetting these fundamental strengths has been the poor state of household confidence, influenced by rising unemployment. External trading conditions have also been unfavorable to growth. While exports have been held down mainly by weak demand among the major economies, the substantial appreciation of the euro over the past two years may tend to reduce prospects for an export-led recovery that is as strong as in past regional upturns (Figure 1.11). This appreciation is in the direction implied by medium-term fundamentals, however, and its impact on monetary conditions in the euro area has been largely offset through lower interest rates (see Box 1.1).

Overall, although the worst may now be over, the short-term regional outlook still appears quite weak: recovery prospects are mainly dependent on a pickup in external demand, the low level of interest rates, and a winding down of corporate balance sheet adjustments. Both domestic and external weaknesses appear particularly acute in Germany and, while the recent uptick in the key IFO index of business confidence is encouraging, the economy is not expected to grow in 2003, with a modest upturn in 2004. Growth in France may reach ½ percent this year and about 2 percent in 2004, and the

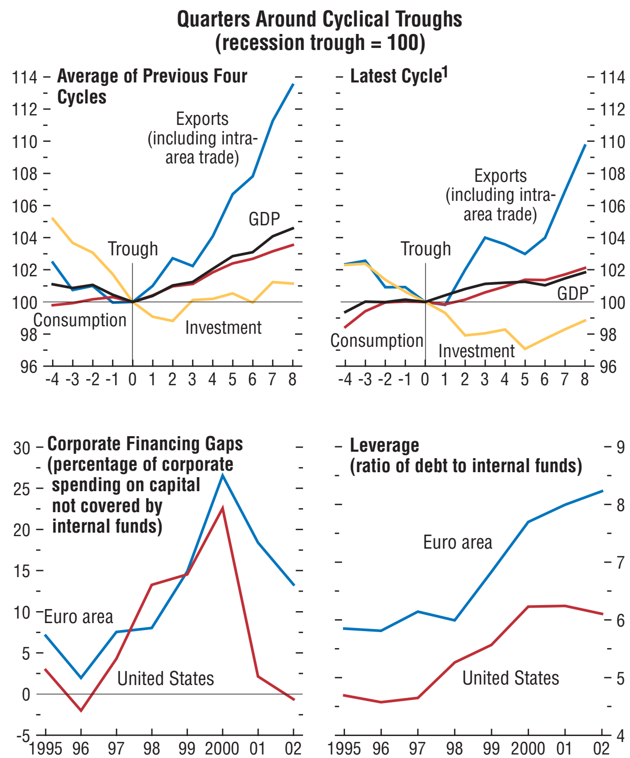
outlook for Italy is slightly lower than this. But, with confidence still weak and an unhelpful external environment, recoveries in these countries may remain hesitant and patchy for some time. Among the smaller euro area countries, domestic activity is particularly depressed in the Netherlands and Portugal; weak growth—1 percent or less in 2003 for the third year in a row—may persist in Austria and Belgium; and growth in Ireland has fallen sharply this year. Growth should remain somewhat more resilient, however, in Spain and especially Greece, aided by relatively buoyant domestic demand (including the impact of Olympic Games–related investment in Greece and stronger investment in Spain). Core inflation in the euro area has declined below 2 percent and is expected to fall further in 2004. There is even a possibility of a period of mildly declining prices in Germany, while above-average inflation rates of some of the smaller economies are expected to diminish—including sizable falls in Ireland, the Netherlands, and Portugal.

Against the background of declining inflation and weak activity, the ECB's decision to lower interest rates by ½ percent in June was fully appropriate. Additional easing will be needed if there is a serious risk of a significant undershooting of inflation—which could occur, for example, if growth does not recover quickly or if the euro were to appreciate significantly. The central bank's clarification that its price stability objective is consistent with inflation below but close to 2 percent indicates its desire to avoid deflation while also accommodating inflation differentials across individual countries. More generally, although monetary policy needs to focus on area-wide conditions, a more activist approach may in certain cases be warranted—especially when downside shocks to individual countries have potentially area-wide spillovers.

Beyond the support provided by the automatic stabilizers, there has been limited scope for fiscal policy to counteract current economic weaknesses, especially in the largest economies. Fiscal deficits in Germany and France are projected to be well above 3 percent of GDP this year and next, and will be close to this level in

Figure 1.11. Euro Area: A Relatively Weak Cyclical Upturn

Euro area exports have picked up less strongly during the latest cycle compared with previous upturns, and investment—hampered by slow corporate balance sheet adjustment—has been particularly weak.



Sources: European Central Bank; U.S. Federal Reserve; and IMF staff estimates.
[1]Latest cyclical trough is taken as 2001:Q4.

Italy, notwithstanding substantial one-off measures. In Germany, tax relief has been advanced to 2004 to support the weak economy, and durable cuts in subsidy and entitlement programs are planned. Looking forward, all euro area economies face significant fiscal pressures from aging populations—especially from about 2010 onward. Public spending on old-age pensions could rise by about 4–5 percent of GDP in several euro area countries over the next 50 years, with increased government spending on health and long-term care amounting to a further 3–4 percent of GDP in some cases. Without offsetting policy measures, these increases would put unbearable strains on public finances and debt burdens. In such circumstances, there is a compelling case for strengthening medium-term fiscal balances. In this regard, countries with weak positions, including the larger economies, should aim to achieve underlying consolidation of ½ percent of GDP a year, or—if backed by tangible and credible quality consolidation measures and structural reform efforts—cumulative adjustment of 1½ percent of GDP over 2004–06; in each case, the automatic stabilizers should be allowed to operate fully around the consolidation path. Such goals should allow countries to achieve a reasonable compromise between short- and medium-term policy trade-offs.

Structural reforms remain key to improving the euro area's economic performance, including meeting the challenges that population aging will imply for longer-term fiscal positions, labor supply, and economic growth. As discussed in the April 2003 *World Economic Outlook*, reforms to improve the competitiveness of European labor and product markets could yield significant dividends in terms of regional output. Several countries have recently introduced or at least proposed substantive reforms, including further liberalization of labor and product markets in Germany, and pension reforms in France, Italy, and Austria. Full implementation of such measures, while important and encouraging, would represent only the beginning of the necessary reform agenda. For example, the recent pension reforms in France—adopted despite substantial public protest—will nevertheless resolve only about two-fifths of the budgetary impact of aging on public pension systems. And the improvements in European labor market performance since the mid-1990s will need to be sustained and deepened if targets adopted at the Lisbon Summit in 2000 are to be reached. The employment rate of older workers, for example, is still under 40 percent (and only 32 percent in France and 28 percent in Italy)—well short of the 50 percent target. Raising effective retirement ages and facilitating employment opportunities for older workers are key elements in a strategy to support labor supply and potential growth in the years ahead.

Turning to countries outside the euro area, growth in the United Kingdom weakened in the first half of 2003, reflecting a slowing of investment and—to a lesser extent—private consumption, as well as a deterioration of external demand. Recent indicators, including business surveys and retail sales, point to an improving outlook. Annual house price inflation has eased in recent months but, at nearly 17 percent in the year to August, remains high. Thus, the risk of an abrupt unwinding cannot yet be ruled out. The labor market has been resilient, with continuing low unemployment and relatively stable earnings growth. In July 2003, the Bank of England cut the policy interest rate by ¼ percent to 3½ percent, responding appropriately to weakening economic prospects, even though inflation remained somewhat above the 2½ percent target owing to temporary factors. Fiscal policy has provided important support for activity during the current slowdown, drawing on the room for maneuver built up over the preceding years. These supportive macroeconomic policies, together with relatively favorable domestic conditions and a gradual improvement in external trade, should support stronger growth in the period ahead.

Elsewhere, 2003 growth projections for Denmark, Norway, and Sweden have been marked down, reflecting weak domestic confidence, rising unemployment, and the poorer international climate. Central banks in all three

countries have reduced interest rates since early June and, with inflation declining, further reductions could be considered if weak activity persists. However, policy support already in the pipeline together with an improvement in external conditions is expected to lead to a slow pickup in growth in the second half of 2003 and in 2004. Activity in Switzerland is expected to contract in 2003, although a strengthening in trade and supportive macroeconomic policies should contribute to a modest improvement in 2004. Should recovery again falter, further monetary easing—probably using quantitative measures, as interest rates are close to zero—may be needed to reduce deflation risks, backed by structural policies to improve the dynamism and robustness of growth.

Japan: Bold Measures Needed to Accelerate Restructuring and End Deflation

The initial estimate of second quarter growth in Japan significantly exceeded expectations and this, together with a further upward revision to the first quarter GDP outturn, an improved external environment, and the pickup in stock prices, has led to sizable increases in growth projections for 2003 and 2004. On a more cautious note, however, monthly data have been mixed: exports have been growing strongly and industrial production picked up in July (after falling in the second quarter), but retail sales continue to fall and the apparent strength of business fixed investment in the national accounts data appears at odds with weaker trends in shipments of capital goods and construction materials. Financial conditions are also providing uneven support for recovery: while recent increases in equity prices are encouraging, bond yields have rebounded substantially from their all-time lows reached earlier this year.

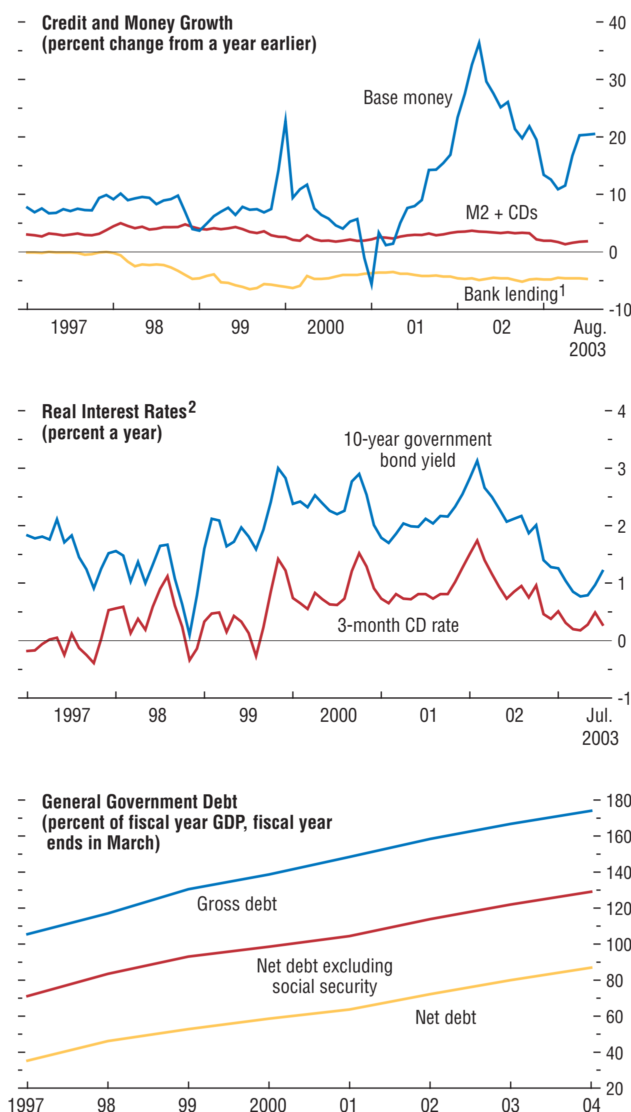
Looking forward, although risks have become more balanced, the outlook remains clouded by entrenched deflation and by persistent weaknesses in corporate, financial, and public sector balance sheets. While a stronger global recovery could provide some upside for activity in the remainder of 2003 and 2004, the economy remains vulnerable to a range of domestic and external shocks. Given the limited progress with bank and corporate restructuring, potential falls in equity or bond prices could weaken corporate and financial balance sheets, triggering a rapid cutback in bank lending and dampening investment. Other risks include the impact of a sustained appreciation of the yen on corporate profits, investment, deflation, and net exports; the potential for a pickup in household saving rates if uncertainty about the outlook increases; and the possibility that rising public debt (in the absence of a strategy to restore fiscal sustainability) could trigger sharply higher real interest rates.

To contain these risks, a bold strategy is needed that tackles the underlying weaknesses in the economy. Such a strategy would include rapid and forceful measures to accelerate disposal of nonperforming loans (NPLs) and address the poor quality of capital in the banking sector (building on the Program for Financial Revival announced in October 2002); actions to promote more rapid corporate restructuring, including effective use of the newly established Industrial Revitalization Corporation of Japan (IRCJ); a public commitment by the Bank of Japan to end deflation, backed up by more aggressive quantitative easing and clear communication of this strategy; and a detailed and ambitious plan to restore sustainability to Japan's public finances.

Corporate and financial restructuring remain key to a sustained turnaround in Japan's economic prospects. Both sectors have made some progress in tackling their problems, but severe difficulties persist. The major banks, for example, have continued to lower their NPLs and exposure to equity risk, but the weak economy and stock market have created new problem loans and losses on equities—bringing major banks' losses to nearly 1 percent of GDP in the year to March 2003. Furthermore, the quality of bank capital remains poor, with tax deferred assets (which are only usable if a bank makes

Figure 1.12. Japan: Monetary, Financial, and Fiscal Indicators

Bank lending is still falling, despite rapid base money growth and very low interest rates, while government debt is reaching unsustainable levels.



Sources: Bloomberg Financial Markets; Cabinet Office; Nomura Security; and IMF staff estimates.
[1]End-period.
[2]Deflated by CPI adjusted for changes in indirect taxes and administered prices.

profits, and are not available to meet losses if it fails) accounting for a large share of Tier-1 capital. An external audit that limited the use of such assets in reported capital precipitated the sharp weakening, and subsequent recapitalization with public funds, of Resona Bank in May. This recapitalization, the first under the new Deposit Insurance Law, appears to have gone smoothly, with no enduring financial market fallout, but it needs to be supported by broader reforms to strengthen bank and corporate governance, improve recognition and facilitate disposal of NPLs, and promote bank consolidation. Accelerated disposal of NPLs and targeted use of public funds to recapitalize weak but systemically important banks remain essential to ending the sector's decade-long deterioration. Elsewhere in the financial sector, an improved regulatory framework is needed for life insurance companies, including tighter solvency standards to promote a more accurate assessment of insurers' financial condition.

Financial sector reforms need to be complemented by accelerated corporate restructuring. While aggregate corporate profits have improved over the past year and debt-equity ratios have come down, many companies continue to suffer from high leverage, poor profitability, and excess capacity. Restructuring has been particularly slow among small and medium-sized enterprises and in the construction and retail sectors. Contributing to these delays, banks lack incentives to push ahead with corporate restructuring because of their weak capital bases. Individual banks have also had difficulties in coordinating with other creditors over restructuring plans—an area where the IRCJ could help. To be effective, the IRCJ will need to be insulated from political interference.

While the Bank of Japan's quantitative easing policy has kept short-term interest rates at zero and helped to stabilize the financial system, it has been unable to end deflation, ease deflationary expectations, or promote growth in broad money and bank credit (Figure 1.12). In view of these difficulties, a more aggressive policy approach is clearly needed. This should include

setting and communicating a time frame for eliminating deflation; a transparent medium-term inflation target; and sizable purchases of a broader array of assets, which would potentially let monetary policy work through asset prices as well as through the liquidity channel, would help raise the price level, and would allow a strong expansion of base money. Additional purchases of Japanese government bonds (JGBs) would have the added benefit of reducing the private sector's holdings of government debt and hence lowering future interest payments from the public sector to the private sector. Concerns about potential Bank of Japan losses on JGB holdings should not be allowed to detract from the pursuit of price stability, and can in any case be mitigated through loss-sharing arrangements between the central bank and the Ministry of Finance.

The rapid buildup of government debt over the past decade and impending pressures from population aging underscore the need for fiscal consolidation. In view of these concerns, the small reduction in the structural deficit (excluding bank support) envisaged for FY2003 is appropriate. More critical, however, is the need to lay out a clear medium-term strategy to return public finances to a sustainable basis, which may need to go beyond the official targets of keeping expenditure at its current level relative to GDP until FY2006 and eliminating the primary deficit (excluding social security) by the early 2010s. Such a strategy would involve reductions in public spending and revenue-enhancing measures, including broadening of the tax base. Specific measures could include cutting back further on low-value public investment projects, reforming public pension and medical systems, strengthening the corporate and personal income tax bases, and raising the consumption tax.

Latin America: Emerging Stability Provides Opportunity to Accelerate Crisis-Proofing

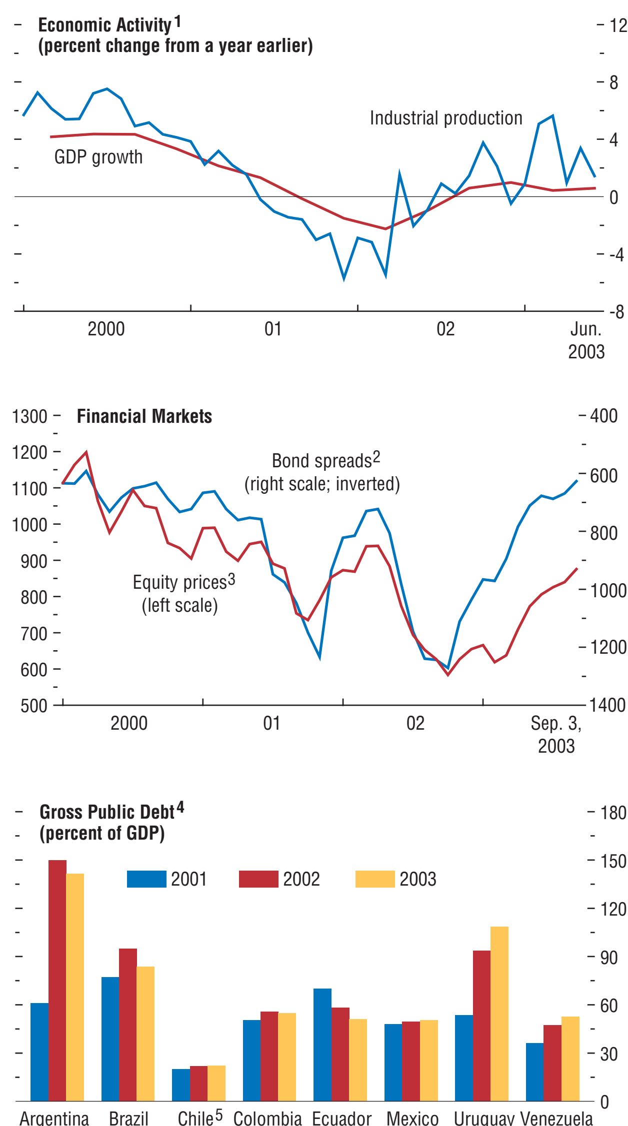
A tentative recovery appears to be emerging in much of Latin America, although growth is highly differentiated across the region and political uncertainty continues to weigh heavily in some cases. The recovery reflects a number of factors, including a pickup in exports, helped by stronger global growth and substantial real exchange rate depreciations; an improvement in risk appetite, which has underpinned a rally in emerging bond markets and, in a number of cases, pushed secondary market spreads to near all-time lows; and expectations of improved policy fundamentals in some cases.

The recovery nevertheless remains fragile, even under the baseline of gradually improving global growth. A key risk is that the rally in emerging bond markets is not sustained, undercutting growth prospects and macroeconomic stability. A fallback in risk appetite, rising industrial country interest rates, or better prospects for mature-market investments are potential triggers. Sentiment could also be affected by policy slippages in the region or by further sovereign rating downgrades of heavily dollarized economies. Though regional contagion is possible in such circumstances, investment-grade borrowers such as Mexico and Chile would be less vulnerable. Finally, political instability in some countries could undermine a gradually improving economic situation and progress with structural reforms.

The fragility of the recovery underscores the need to implement reforms to make the region more resilient to economic shocks—in short, to "crisis-proof" Latin America's economies. The agenda involves a range of measures, a central one—as suggested in Chapter III—being to bring down public debt to levels more robust to adverse shocks (Figure 1.13), but also including strengthening banking systems and central bank autonomy to pursue low inflation; trade, labor market, regulatory, and judicial reforms; and institutional reforms to improve social equity and governance. It is clear that for some countries, such as Brazil, financial markets are anticipating continued progress on such reforms in the period ahead (see below). The benefits from ambitious reforms are evident—Mexico and Chile's experience in weathering the fallout from

Figure 1.13. Selected Western Hemisphere Countries: Economic Activity, Financial Indicators, and Public Debt

A fragile recovery is under way following the sharpest downturn in two decades. A key policy challenge is to improve the resilience of Latin America's economies to shocks, including by reducing public debt.



Sources: Bloomberg Financial Markets, LP; Haver Analytics; and IMF staff estimates.
[1]Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. Purchasing-power-parity weighted.
[2]EMBI+ in basis points.
[3]MSCI index in U.S. dollars.
[4]Total external and domestic debt. Data for 2003 are IMF staff projections.
[5]General government and public enterprises.

the crisis in Argentina owes much to their efforts to establish more resilient fiscal, monetary, and banking institutions. Equally, however, markets are likely to penalize inaction with higher spreads or lack of access to new funding—thus further delaying the transition to stable growth and magnifying the costs of the downturn.

Turning to individual countries, economic activity (including industrial production and construction) is recovering from a very low base in Argentina; monthly inflation remains low; and the trade balance has posted large surpluses, initially due to import compression, but subsequently reflecting strong growth in exports (Table 1.6). Restrictions on time deposits (the corralón) were successfully removed in April without triggering much impact on bank deposits. Indeed, market indicators have been broadly stable, with the peso appreciating substantially since end-2002, short-term interest rates easing somewhat, and gross international reserves rising. While macroeconomic policies—including a better-than-expected primary fiscal surplus in the first quarter—have been supportive of financial stability, the emerging recovery remains vulnerable to several factors, including unsustainable public finances, lack of progress in dealing with weak banks, a high level of corporate arrears, continuing legal uncertainties, and widespread poverty. The new government needs to press ahead with implementing a credible plan to restore public finances and restructure sovereign debt; strengthen the banking system; advance the restructuring of private corporate debt; and ensure that the poor remain adequately protected during the ensuing transition. In Uruguay, the successful debt exchange has helped to reduce near-term financing needs and improve the debt profile; key challenges remain in the fiscal and banking areas, including the need for firm spending control to meet the government's primary fiscal surplus targets, and faster operational restructuring and asset disposals to reduce remaining fragilities in the banking system.

In Brazil, progress on the policy front has helped strengthen confidence, as seen in the

Table 1.6. Selected Western Hemisphere Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
Western Hemisphere	**0.7**	**–0.1**	**1.1**	**3.6**	**6.4**	**8.7**	**10.9**	**7.0**	**–2.7**	**–0.9**	**–0.8**	**–1.1**
Mercosur[3]	**—**	**–1.1**	**2.2**	**3.2**	**4.9**	**11.6**	**14.8**	**6.7**	**–3.5**	**0.4**	**0.5**	**–0.2**
Argentina	–4.4	–10.9	5.5	4.0	–1.1	25.9	14.3	7.7	–1.7	10.3	5.4	4.5
Brazil	1.4	1.5	1.5	3.0	6.8	8.4	15.0	6.2	–4.6	–1.7	–0.8	–1.5
Chile	3.1	2.1	3.3	4.5	3.6	2.5	3.4	3.0	–1.7	–0.8	–1.0	–1.2
Uruguay	–3.4	–10.8	–1.0	4.5	4.4	14.0	21.6	18.9	–2.8	1.6	1.8	1.3
Andean region	**2.0**	**–0.6**	**–2.9**	**4.9**	**10.6**	**10.1**	**13.3**	**13.7**	**0.4**	**1.6**	**1.3**	**1.4**
Colombia	1.4	1.5	2.0	3.3	7.8	6.3	6.9	5.3	–1.5	–2.2	–2.4	–2.4
Ecuador	5.1	3.4	3.1	5.0	37.7	12.6	8.2	4.4	–2.4	–4.2	–3.8	–2.4
Peru	0.6	5.3	4.0	4.0	2.0	0.2	2.5	2.5	–2.2	–2.1	–2.0	–1.5
Venezuela	2.8	–8.9	–16.7	7.7	12.5	22.4	34.0	40.8	3.1	8.2	9.2	8.2
Mexico, Central America, and Caribbean	**0.3**	**1.1**	**1.4**	**3.2**	**6.6**	**5.1**	**5.9**	**4.5**	**–3.1**	**–2.6**	**–2.5**	**–2.7**
Dominican Republic	3.2	4.1	–3.0	0.5	8.9	5.2	26.1	20.1	–3.4	–4.0	1.0	1.0
Guatemala	2.3	2.2	2.4	3.5	8.9	6.3	5.0	4.0	–5.9	–5.1	–5.5	–4.4
Mexico	–0.2	0.7	1.5	3.5	6.4	5.0	4.6	3.4	–2.9	–2.2	–2.2	–2.7

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Includes Argentina, Brazil, Paraguay, and Uruguay, together with Bolivia and Chile (associate members of Mercosur).

real's further appreciation, sharp narrowing of spreads, and the sovereign's early return to the capital markets (with the *real*'s strength facilitating a reduction of the share of exchange rate–linked debt). Nevertheless, growth remains weak—with GDP declining in the second quarter on a seasonally adjusted basis and domestic demand yet to rebound—and the country remains vulnerable to shifting sentiment in the event of policy slippages, given its large external borrowing requirement; the slowing of foreign direct investment inflows; and the fact that spreads are still high in absolute terms. Fiscal discipline remains essential to underpin confidence—especially adherence to the 4¼ percent of GDP primary budget surplus target this year and in the medium term. The recent shift toward monetary policy easing has been appropriate, given the impact of weak activity and the *real*'s appreciation on future inflation. Beyond this, recent progress toward tax and pension reforms needs to be maintained.

In Venezuela, despite the recovery of oil production following the end of the strike in February, real GDP is expected to decline by 17 percent this year, bringing the cumulative decline to 26 percent over the past two years. Restoration of macroeconomic stability will depend on addressing fiscal and banking vulnerabilities—especially through public sector reform to bring down the non-oil fiscal deficit and implementation of a strategy to deal with the impact on banks' asset quality of the recession in the non-oil sector. Monetary policy tightening is needed to curb pressures on the exchange rate and inflation. A relaxation of foreign exchange controls and structural measures to bolster the non-oil sector remain crucial to securing the reestablishment of investor confidence, economic recovery, job creation, and poverty reduction.

Elsewhere in the Andean region, the outlook depends on making progress in addressing key vulnerabilities. In Colombia, implementation of the authorities' program to ease the public debt burden (including the target of a 2½ percent of GDP fiscal deficit this year) and advance pension and health reforms will be essential to achieving

faster growth and low inflation; addressing the nonperforming loan problem in the mortgage banks is another key priority. In Peru, the uncertain political situation underscores the need to maintain an adequate reserve position, keep the flexibility of the exchange regime, preserve the credibility of monetary policy, and follow through on reforms—including tax reform and granting legal protection for bank supervisors—to address the vulnerabilities stemming from the high level of public debt and the high degree of financial dollarization. Containing fiscal and banking vulnerabilities are also key challenges in Ecuador, where political fragmentation is undermining the implementation of reforms, and wage and price trends are inconsistent with the constraints of full dollarization. In Bolivia, while financial conditions have stabilized even as political tensions remain high, there is a need to press ahead with reducing the public sector deficit (while allowing for some increase in poverty-reducing spending), and to implement measures to address bank and corporate sector weaknesses.

Mexico and Chile have both been largely immune from the difficulties affecting many Latin American countries over the past two years, with access to international capital markets on favorable terms having been broadly maintained, downward exchange rate pressures having eased, and Mexico having successfully issued bonds with collective action clauses (CACs) earlier this year. For Mexico, recovery is expected to gather pace in the second half of this year, in line with a pickup in U.S. growth and the pass-through of the recent easing of monetary conditions. A window of opportunity to pursue structural reforms following the July lower house elections should be used (especially to improve labor market flexibility, the bank resolution framework, and private participation in the electricity sector), while further efforts to build consensus on a medium-term fiscal framework are needed to sustain fiscal consolidation. In Chile, earlier cuts in the policy interest rate are helping domestic demand to recover. Monetary policy should continue to focus on the inflation target, with the exchange rate floating freely except in exceptional circumstances. The fiscal target is broadly adequate and appropriately allows room for the automatic stabilizers to operate. While vulnerabilities remain contained owing to the soundness of the banking system and low public debt, the large external financing needs of the private sector are a potential source of risk going forward, although the majority of corporates' external debt corresponds to companies with foreign parents, which recently have tended to support subsidiaries in difficulty. Moreover, the liquid assets of the private sector cover a significant portion of their short-term external liabilities, with a strong reserve position at the central bank as a healthy backup.

Asia-Pacific Region: Greater Exchange Rate Flexibility Needed for More Balanced Growth

Despite the slowdown since early 2003, the Asia-Pacific countries are again set to be the world's fastest growing region this year and growth is expected to pick up further in 2004 (Table 1.7). A notable feature of recent performance has been the support to output growth provided by net exports, even excluding the crisis period when substantial real depreciations led to very large contributions from external demand (Figure 1.14). While domestic demand is clearly playing a greater role in the region than in the period immediately following the crisis, the global cycle remains a key determinant of cyclical developments in the region, as discussed in the April 2003 *World Economic Outlook*. In the present conjuncture, however, with the U.S. dollar's decline necessitating a rebalancing of global demand, the need to boost the domestic component of growth in Asia is even more pressing. While accelerating structural reforms should be the centerpiece of a strategy to achieve this goal, greater exchange rate flexibility in some countries would also help. The further buildup of foreign exchange reserves in 2002–03 (see the second essay in Chapter II, "Are Foreign

Table 1.7. Selected Asian Economies: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
Emerging Asia[3]	**5.1**	**6.2**	**5.9**	**6.2**	**2.6**	**1.8**	**2.3**	**2.7**	**2.8**	**3.8**	**3.2**	**2.9**
Newly industrialized Asian economies	**0.8**	**4.8**	**2.3**	**4.2**	**1.9**	**1.0**	**1.5**	**1.7**	**5.7**	**6.8**	**7.2**	**7.3**
Hong Kong SAR	0.5	2.3	1.5	2.8	–1.6	–3.0	–2.6	–1.9	7.5	10.8	13.9	14.3
Korea	3.1	6.3	2.5	4.7	4.1	2.8	3.3	3.0	1.9	1.3	1.6	1.8
Singapore	–2.4	2.2	0.5	4.2	1.0	–0.4	0.6	1.2	19.0	21.5	23.7	23.0
Taiwan Province of China	–2.2	3.5	2.7	3.8	—	–0.2	0.1	0.8	6.4	9.1	8.5	8.8
ASEAN-4	**2.9**	**4.3**	**4.1**	**4.4**	**6.6**	**5.9**	**3.9**	**3.3**	**5.2**	**5.6**	**4.4**	**3.6**
Indonesia	3.4	3.7	3.5	4.0	11.5	11.9	6.6	5.4	4.9	4.3	2.7	1.9
Malaysia	0.3	4.1	4.2	5.3	1.4	1.8	1.7	2.2	8.3	7.6	8.2	7.1
Philippines	4.5	4.4	4.0	4.0	6.1	3.1	3.0	3.4	1.8	5.4	2.6	1.9
Thailand	1.9	5.3	5.0	5.1	1.5	0.6	1.4	0.1	5.4	6.0	5.3	4.8
South Asia[4]	**4.0**	**4.6**	**5.5**	**5.8**	**3.8**	**4.2**	**4.0**	**4.7**	**–0.2**	**1.2**	**0.8**	**0.3**
Bangladesh	4.8	4.9	5.4	5.8	1.5	3.8	4.5	4.1	–0.8	0.5	0.5	0.3
India	4.2	4.7	5.6	5.9	3.8	4.3	4.0	4.8	–0.2	1.0	0.6	0.3
Pakistan	2.7	4.4	5.4	5.1	3.1	2.9	3.6	4.0	0.4	4.1	3.3	1.0
Formerly centrally planned economies[5]	**7.4**	**7.9**	**7.4**	**7.5**	**0.7**	**–0.6**	**0.9**	**1.6**	**1.5**	**2.7**	**1.3**	**1.1**
China	7.5	8.0	7.5	7.5	0.7	–0.8	0.8	1.5	1.5	2.8	1.4	1.3
Vietnam	5.0	5.8	6.0	7.0	–0.4	4.0	4.0	3.5	2.2	–1.1	–3.6	–3.2

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Includes developing Asia, newly industrialized Asian economies, and Mongolia.
[4]Includes Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka.
[5]Includes Cambodia, China, Lao People's Dem. Rep., Mongolia, and Vietnam.

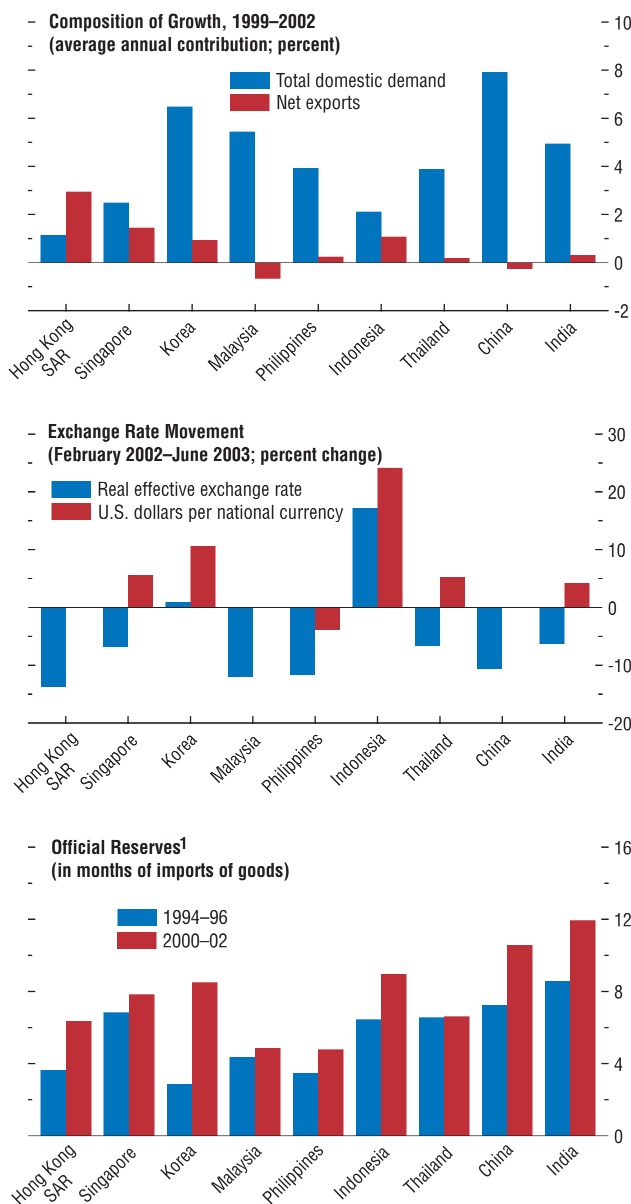
Exchange Reserves in Asia Too High?") and the depreciation of effective exchange rates in a number of countries with implicit or explicit links to the U.S. dollar are at least suggestive that incentives for domestically sourced growth may still be blunted in some cases. From a policy standpoint, moreover, further exchange rate flexibility would confer a number of benefits—including reducing risks of future crises, making domestic growth less dependent on the vagaries of the global cycle, lowering holding costs of official reserves, and raising consumption opportunities for local residents in cases where exchange rates may be undervalued—while also helping to resolve global imbalances.

Against this background, the regional slowdown evident since early 2003—which is mostly due to weaker domestic demand—is a concern. Domestic demand slowed markedly, initially reflecting war-related uncertainties and surging oil prices, and subsequently the impact of SARS. The fall in household credit growth in Korea, due to a tightening of prudential regulations, slower housing price rises, and rising credit card delinquencies, was another factor. Notwithstanding the rapid expansion of intraregional trade, export growth slowed in the early months of the year in several countries—including Korea and the Philippines—reflecting mainly weakness in the electronics sector, although exports are expected to rebound strongly next year given the projected pickup in the United States. While activity surged in China in the first quarter (with GDP growth of 10 percent year-on-year), led by exports and strong investment, growth slowed in the second quarter, mainly reflecting the impact of SARS.

The epidemic's impact has been most visible in tourist arrivals and retail sales, especially in Hong Kong SAR and Singapore (despite the

Figure 1.14. Asia: Composition of Growth, Exchange Rate Volatility, and Reserves

Although domestic demand is playing a larger role than in the immediate aftermath of the crisis, net exports continue to provide a key support for growth in much of the region. Sizable current account surpluses and capital inflows have not resulted in notable real effective exchange rate appreciations, including in the face of the U.S. dollar's weakening since last February, but have been reflected instead in a record buildup of official reserves.



Sources: CEIC Data Company Limited; and IMF staff calculations.
[1]End of period. Average 1995–96 for Indonesia.

larger number of cases in China), but there could be lagged effects on output owing to delayed investment and further effects if the epidemic recurs in the winter. While SARS now appears to have been broadly contained, softness in the IT sector (despite the resolution of war-related uncertainties) remains another key risk, particularly given the recent slowing of electronics exports and weakness of forward-looking indicators, including the book-to-bill ratio. Finally, a reversal of favorable borrowing conditions for emerging markets could create difficulties for countries with very high public debt (e.g., the Philippines), particularly if policies take insufficient account of the risk of a reversal of historically low spreads.

For the most part, the policy response to weaker growth has been appropriate. With inflation contained, monetary policy has been eased in a number of countries, though the continued buildup of official reserves suggests that reforms to increase exchange rate flexibility remained largely on hold. Fiscal stimulus has also been provided in a number of countries to offset the impact of SARS on hard-hit sectors. The scope for easing fiscal policies, however, is much more constrained in countries with chronically high public debt levels, such as India and the Philippines, or significant banking weaknesses. Beyond macroeconomic policies, the key issues remain to resolve nonperforming loan problems (China, Indonesia, the Philippines, Thailand); strengthen insolvency laws to facilitate loan workouts and corporate restructuring (India, Korea, the Philippines, Thailand); implement further corporate governance reforms, including strengthening accounting and auditing practices (Korea); and return banks to private ownership to ensure market-based intermediation practices (Indonesia, Korea).

Turning to individual countries, among the newly industrialized economies, domestic demand remains lackluster in Korea, which may call for further fiscal stimulus, even if the result is a small deficit (excluding the social security balance) this year. Persistent deflation and high unemployment in Hong Kong SAR underscore

the need for reforms to bolster competitiveness, while fiscal consolidation over the medium term is needed to underpin confidence in the exchange rate link. Among the ASEAN-4, economic activity in Malaysia and Thailand appears well sustained, partly reflecting supportive macroeconomic policies. In the Philippines, while market pressures have abated, strong efforts are needed to achieve the balanced-budget target even by 2009, and secure a more rapid disposal of banks' NPLs. In Indonesia, growth continues to be fueled by private consumption, with investment remaining sluggish. Sustaining progress on structural reforms (including measures to strengthen the investment climate) remains critical to consolidate the recovery.

In China, the expectation remains that SARS will constitute a temporary shock, with no lasting impact on the medium-term growth outlook, and activity is likely to rebound from the third quarter, helped by continued strong investment and rapid credit expansion, including for consumer lending. The strength of the external position, the desirability of gearing monetary policy more toward domestic stabilization objectives, and the need to facilitate adjustment to structural changes over the medium term underscore the importance of moving gradually to greater exchange rate flexibility. Fiscal consolidation remains a key objective for the medium term, given the sizable contingent liabilities associated with banking weaknesses, pension reform costs, and the need to improve the social safety net and health care. Banking reform, faster asset disposals by asset management companies, and restructuring and privatization of state-owned enterprises remain key structural reform priorities.

In India, while growth is expected to pick up later this year on the back of a recovery in the agricultural sector following last year's drought, the expansion remains well below the 8 percent rate targeted by the authorities, undermining official goals for reducing poverty and regional disparities. A key issue remains the slow pace of fiscal and structural reform. With the general government deficit set to reach about 10 percent of GDP for a fifth year, and debt plus recorded contingent liabilities nearing 100 percent of GDP, fiscal policy is clearly on an unsustainable path. The absence of consolidation efforts in this year's budget and delays in introducing the value-added tax (VAT) are thus of deep concern. A new fiscal responsibility law was recently approved by India's parliament, providing a framework for the central government to formulate a clear and time-bound plan to achieve a balanced current budget by the target date of 2008. Beyond this, the limited degree of exchange rate flexibility, in the face of continued strong foreign exchange inflows, has contributed to a record buildup of foreign exchange reserves, complicating the implementation of monetary policy. Accelerating structural reforms—including ending regulatory impediments to consolidation in labor-intensive industries; labor market and bankruptcy reforms; and agricultural and trade liberalization—remain essential to stimulate potential growth and reduce poverty. Elsewhere on the subcontinent, while growth has picked up in Pakistan, bold measures are needed to reduce public debt—including by improving tax compliance and reducing subsidies to public enterprises and consumers, while creating room for human development expenditure to address a huge social gap. Although economic recovery is under way in Bangladesh thanks in part to a strengthening of macroeconomic policies, structural reforms—including, on the fiscal side, a sustained revenue effort and a shift in spending toward infrastructure and human capital, reform of the nationalized commercial banks and state-owned enterprises, and trade reform—are critical to raise potential growth and reduce poverty in line with the Millennium Development Goals.

In Australia and New Zealand, the pace of economic growth is expected to slow in 2003, reflecting a number of factors, including the sizable appreciations of the Australian and New Zealand dollars over the past two years, declining commodity prices, and the lingering impact of drought. In Australia, while monetary policy

Table 1.8. European Union Candidates: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
EU candidates	**—**	**4.3**	**3.9**	**4.3**	**21.1**	**15.8**	**10.1**	**7.3**	**–2.8**	**–3.4**	**–4.1**	**–3.6**
Turkey	–7.5	7.8	5.3	5.0	54.4	45.0	26.0	13.4	2.3	–0.9	–3.2	–1.9
Excluding Turkey	3.1	2.9	3.3	4.1	9.8	5.7	4.1	4.8	–4.5	–4.3	–4.5	–4.4
Baltics	**6.6**	**6.3**	**5.5**	**5.9**	**2.7**	**1.5**	**1.3**	**2.5**	**–6.6**	**–7.6**	**–7.5**	**–6.8**
Estonia	5.0	5.8	5.0	5.1	5.8	3.6	1.7	2.0	–6.1	–12.4	–12.6	–9.2
Latvia	7.9	6.1	5.5	6.0	2.5	1.9	3.0	3.0	–9.6	–7.8	–7.3	–6.8
Lithuania	6.5	6.7	5.8	6.2	1.3	0.3	—	2.5	–4.8	–5.3	–5.7	–5.9
Central Europe	**2.2**	**2.2**	**2.7**	**3.6**	**6.3**	**2.8**	**2.3**	**3.6**	**–4.2**	**–4.2**	**–4.2**	**–4.2**
Czech Republic	3.1	2.0	1.7	2.6	4.8	1.8	0.6	3.5	–5.7	–6.5	–5.7	–5.1
Hungary	3.8	3.3	3.0	3.5	9.2	5.3	4.7	5.5	–3.4	–4.0	–5.7	–5.4
Poland	1.0	1.4	2.9	4.1	5.5	1.9	0.8	2.2	–3.9	–3.5	–3.3	–3.8
Slovak Republic	3.3	4.4	4.0	4.0	7.3	3.3	8.5	8.1	–8.6	–8.2	–6.3	–5.0
Slovenia	2.9	3.2	2.2	3.0	8.4	7.5	5.9	5.0	0.2	1.7	0.9	0.4
Southern and south-eastern Europe	**5.1**	**4.6**	**4.6**	**5.0**	**25.1**	**16.9**	**11.2**	**9.5**	**–5.4**	**–4.0**	**–4.7**	**–4.7**
Bulgaria	4.1	4.8	5.0	5.5	7.5	5.8	2.6	4.2	–6.2	–4.4	–4.6	–4.4
Cyprus	4.1	2.2	2.0	3.8	2.0	2.8	3.6	3.5	–4.3	–5.6	–4.9	–4.7
Malta	–1.2	1.2	2.8	3.8	2.9	2.2	2.0	2.0	–4.5	–3.9	–3.4	–3.4
Romania	5.7	4.9	4.7	5.0	34.5	22.5	15.1	12.0	–5.5	–3.4	–4.8	–4.8

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year as is the practice in some countries.
[2]Percent of GDP.

has been on hold since the initial withdrawal of stimulus in mid-2002 (not least out of concern that further interest rate cuts could fuel further house price increases), in New Zealand the Reserve Bank cut the overnight cash rate by 25 basis points on three occasions (April, June, and July 2003), citing the impact of slowing economic activity and the sharp appreciation of the currency for the inflation outlook. The short-term outlook for Australia is subject to considerable risks, including a resumption in the appreciation of the Australian dollar, uncertainties about the recovery from the drought, and a rapid cooling off in the housing market following the boom of the past three years. Fiscal policy remains sound in both countries, with public debt continuing to be paid down consistent with principles set out in each country's fiscal responsibility legislation. On the structural side, the priorities include welfare reform to improve work incentives in both Australia and New Zealand and steps to improve labor market flexibility (including liberalizing employment protection) in Australia.

European Union Candidates: Coping with Weakness in the Euro Area

In European Union (EU) accession countries, growth is picking up and the short-term outlook is generally favorable (Table 1.8). Recently, growth in most countries has been supported by both exports and private consumption. GDP is expected to accelerate in 2004, driven by exports, which—along with strengthening corporate profits—are also projected to stimulate investment spending. While exports have thus far been strong, growth prospects in EU accession countries are heavily dependent on the pace of recovery in the euro area, as merchandise exports to the euro area account for 10–35 percent of GDP in most countries (Figure 1.15). Another threat to growth is the appreciation of the euro since February 2002, which has led to some real effective appreciation in those countries whose currencies are closely tied to the euro. Countries with greater shares of exports to the euro area and larger real effective appreciations have seen more highly negative contributions of net exports to growth in 2002–03.

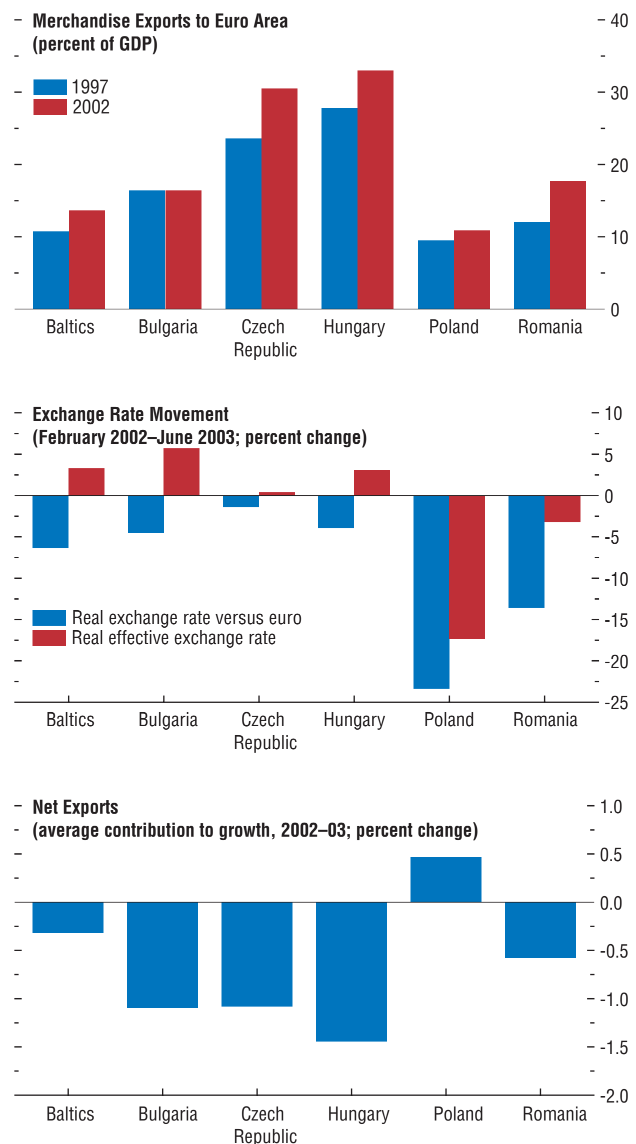
While structural reforms and EU accession will underpin growth over the medium term, there nevertheless are a number of risks around a broadly favorable baseline, even abstracting from the possibility of weaker-than-projected external demand. Fiscal positions are already difficult in many countries and will be exacerbated by population aging and spending pressures from complying with EU environmental standards and absorbing EU development funds (which require domestic fiscal cofinancing). Banking systems appear mostly sound, but private credit has recently grown rapidly and EU entry will likely stiffen bank competition and put pressure on margins. External current account deficits are generally large and, in some countries, are already in unwelcome territory. Finally, there is the risk of sudden capital outflows, as some of the recent inflows appear to have been driven largely by short-term considerations, including convergence trades (that is, the expectation that interest rates will converge to levels prevailing in the euro area as euro adoption nears).

In light of these risks, it is essential to make early and substantial progress on fiscal consolidation, to enhance monitoring of banking systems, and to aggressively pursue growth-enhancing structural reforms. The still-favorable economic environment in the accession countries is conducive to undertaking such reforms. With EU membership slated for mid-2004 in most countries, EU candidates' *goal* of adopting the euro could be an important disciplining force for delivering policies that promote macroeconomic stability, though the *process* of adopting the euro should not be rushed.

Turning to individual countries, growth in Poland is expected to accelerate this year and next, driven by a pickup in investment (as corporate profits rise) and exports (as the recovery in western Europe gains momentum). The large output gap is expected to keep core inflation pressures subdued, possibly allowing a further reduction in interest rates under the inflation targeting framework for monetary policy. However, there are important risks to the out-

Figure 1.15. Selected European Union Accession Countries: Impact of Euro Area and Euro Appreciation

Growth prospects in EU accession countries are heavily dependent on the pace of recovery in the euro area and changes in the value of the euro. Exports to the euro area account for an increasing share of GDP and exchange rates in some countries are closely tied to the euro, with implications for the contribution of net exports to growth.



Sources: Haver Analytics; and IMF staff estimates.

look, including the dependence on growth in western Europe, the large fiscal deficit, and the deterioration in credit quality. To improve prospects for durable growth and reduce vulnerabilities, timely implementation of fiscal reform that would significantly reduce the structural budget deficit in the medium term is also essential. Rejuvenating the privatization process is needed to promote enterprise restructuring and reduce fiscal subsidies. Finally, keeping a close watch on bank health is critical.

In Hungary, the devaluation of the forint through July and increases in interest rates underline the dilemma faced by monetary policy, which by itself cannot aim simultaneously to lower inflation and support external competitiveness. As rapid wage growth has fueled inflationary pressures and weakened external competitiveness, wage moderation—especially in the public sector—is essential, including keeping wage increases below the inflation target and encouraging closer cooperation between the social partners. Sizable and early fiscal consolidation is also critical, including restraining spending by securing parliamentary approval for expenditure ceilings in core areas. While the financial system is generally healthy, risks need to be monitored carefully, including rapid credit growth and the adequacy of hedging against foreign exchange risk.

In the Czech Republic, growth is being supported by a widening of the general government deficit, but this fiscal stimulus is unsustainable. The government's recent decision to reduce the deficit to 4 percent of GDP by 2006 is welcome; it will be important to place the largest burden of the adjustment on expenditure restraint, as taxation levels are already high compared with neighboring countries. Given the recent boom in household credit, tighter supervision of banks' internal risk management systems would be desirable. Continued structural reforms, especially strengthening the legal framework and reducing labor market frictions, are essential to a durable improvement in growth. In Slovakia, the large current account and general government deficits underline the importance of permanent reductions in fiscal expenditure, supplemented by pension reform. The forthcoming tax reform is expected to improve the transparency and simplicity of the tax code, though the authorities should be ready to address potential fiscal slippages.

In the Baltic countries, the favorable outlook for growth and inflation reflects the solid track record of policies geared toward macroeconomic stability and structural reform. While inflows of foreign direct investment have remained strong, large current account deficits are a concern. As monetary policy is largely constrained by fixed exchange rates, fiscal policy needs to focus on durably reducing nonpriority expenditure to make room for spending needs associated with EU accession, and moving cautiously with respect to tax cuts—either ensuring the revenue-neutrality of reforms (by curtailing tax exemptions and strengthening tax administration) or implementing corresponding expenditure reductions. While banking systems remain healthy, the rapid growth of credit—especially the increase in the ratio of foreign currency loans to foreign currency deposits—underlines the importance of careful credit risk assessments by banks and effective banking supervision.

In Bulgaria and Romania, robust domestic demand is expected to underpin growth, but current account deficits are projected to widen in 2003. In Bulgaria, domestic demand is being fueled by the strong growth of private sector credit, which calls for vigilance from the authorities, including better monitoring of corporate borrowers' foreign currency exposure and hedging. The rapid growth in credit and the widening of the current account deficit point to the need for a continued tight fiscal stance in the remainder of 2003 and 2004. Improvements in tax administration and compliance, as well as implementation of structural reforms in the health, railway, and energy sectors, are essential to achieving a balanced general government budget by 2005. In Romania, domestic demand and inflation are being boosted by rapid wage and credit growth. Further efforts are needed to keep credit expansion under control, to restrain

public sector wages, and—more broadly—to harden budget constraints, especially in the energy sector, complemented by the downsizing or liquidation of loss-making state-owned enterprises.

Elsewhere in southeastern Europe, the economic outlook has also continued to improve, though political tensions persist in most countries. Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, and Serbia and Montenegro have made important strides toward restoring economic growth and reducing inflation, but large current account deficits constitute an important vulnerability. The widening of external deficits in recent months reflected both a dampening of export demand due to the slowdown in western Europe and—in some countries—a surge in imports related to rapid credit growth. To rein in credit growth, monetary conditions have been tightened and prudential supervision of banking systems has been strengthened, but continued careful monitoring is needed. Further progress in fiscal consolidation and structural reform is also essential to stimulate investment and growth and to ensure sustainable external positions.

In Turkey, financial conditions and the short-term economic outlook have improved. Benchmark bond rates have fallen, the currency has appreciated, and the spread on Eurobonds has narrowed. Moreover, with strong output recovery and continued disinflation so far this year, 5 percent output growth and 20 percent inflation in 2003 are within reach. Although the end of the Iraq war has contributed, these results are also partly due to strong actions by the Turkish authorities on reforms related to their candidacy for the European Union and, in the economic sphere, on policies that enabled the completion of the fifth review of the IMF-supported program in early August. Nonetheless, real interest rates remain high, reflecting underlying fragilities and concerns about policy implementation. To address these concerns, the Turkish authorities need to build a strong track record of timely policy implementation and full program ownership. Key in this regard would be the maintenance of fiscal discipline to safeguard the 6½ percent of GNP primary surplus target.

Commonwealth of Independent States: Structural Reforms Key to Sustaining the Growth Upswing

The Commonwealth of Independent States (CIS) countries have continued to weather the growth slowdown in advanced countries and the ensuing uneven recovery considerably better than expected. Over 1999–2002, GDP growth has averaged about 7½ percent, aided initially by Russia's rebound from the 1998 financial crisis, rising oil prices and energy exports, and—linked to this rise—higher government expenditure and energy sector investment. During 2002, GDP growth was additionally boosted by strong private consumption growth, underpinned by substantial wage and pension increases—particularly but not only in Russia and Ukraine—and strong credit growth as remonetization continued apace, and, in the latter part of the year, by rapid export growth in most countries. In contrast, however, investment activity outside the energy sector has remained subdued, partly reflecting the squeeze on profits coming from wage increases, but more fundamentally the continued inhospitable environment for private investment.

Current indicators suggest that economic activity in early 2003 has remained robust, and GDP growth in the region is projected at 5.8 percent for the year as a whole, 1.4 percentage points higher than expected at the time of the last *World Economic Outlook* (Table 1.9). This is largely due to continued strong growth in the net energy exporters, notably Russia (where growth has been sharply revised upward, reflecting the stronger-than-expected momentum arising from strong real wage growth, favorable liquidity conditions in domestic financial markets, and increased access to international capital markets). With a few exceptions—notably the Kyrgyz Republic, where growth is expected to rebound following a disastrous landslide in 2002—GDP growth elsewhere is expected to

Table 1.9. Commonwealth of Independent States: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
Commonwealth of Independent States	**6.4**	**4.9**	**5.8**	**5.0**	**20.4**	**14.5**	**13.1**	**11.7**	**7.9**	**7.0**	**6.5**	**3.8**
Russia	5.0	4.3	6.0	5.0	20.6	16.0	14.4	12.9	10.8	8.9	8.4	5.2
Excluding Russia	9.2	6.0	5.4	5.0	19.9	11.6	10.4	9.4	–0.7	1.0	—	–1.1
More advanced reformers	**9.9**	**6.6**	**6.6**	**5.9**	**9.9**	**2.9**	**5.6**	**5.1**	**–0.2**	**1.6**	**0.1**	**–1.2**
Armenia	9.6	12.9	7.0	6.0	3.1	1.1	2.2	3.0	–9.5	–7.5	–6.5	–6.3
Azerbaijan	9.9	10.6	9.2	9.1	1.5	2.8	2.7	2.5	–0.9	–12.4	–30.5	–32.6
Georgia	4.7	5.3	4.8	4.5	4.7	5.6	4.4	5.0	–5.6	–6.2	–11.5	–10.9
Kazakhstan	13.5	9.5	9.0	8.0	8.3	5.9	6.4	5.9	–4.0	–1.9	1.3	—
Kyrgyz Republic	5.4	–0.5	5.6	4.0	6.9	2.0	3.3	3.8	–3.3	–3.9	–3.0	–3.7
Moldova	6.1	7.2	6.0	5.0	9.8	5.3	8.1	4.5	–6.1	–6.9	–6.0	–5.4
Tajikistan	10.2	9.1	6.0	4.0	38.6	12.2	14.5	5.0	–7.1	–2.8	–5.0	–4.8
Ukraine	9.2	4.8	5.3	4.8	12.0	0.8	5.5	5.3	3.7	7.7	5.6	4.0
Less advanced reformers[3]	**4.4**	**4.1**	**2.4**	**2.9**	**55.7**	**40.9**	**25.9**	**22.6**	**–2.3**	**–0.5**	**–0.2**	**–1.1**
Belarus	4.7	4.7	4.0	3.2	61.1	42.6	29.0	24.1	–3.6	–2.5	–2.8	–3.4
Uzbekistan	4.1	3.2	0.3	2.5	48.9	38.7	21.9	20.7	–1.0	2.5	4.6	3.1
Memorandum												
Net energy exporters[4]	6.2	4.9	6.2	5.2	19.1	14.8	13.4	12.1	9.4	7.7	7.3	4.3
Net energy importers[5]	7.1	4.8	4.4	4.1	24.9	13.7	12.0	10.7	0.3	3.2	2.1	1.0
CIS-7[6]	6.1	5.7	4.1	4.6	22.5	16.9	11.2	10.2	–2.9	–4.3	–9.4	–10.2

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year as is the practice in some countries.
[2]Percent of GDP.
[3]Updated data for Turkmenistan not available.
[4]Includes Azerbaijan, Kazakhstan, Russia, and Turkmenistan.
[5]Includes Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Tajikistan, Ukraine, and Uzbekistan.
[6]Includes Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan.

moderate slightly, mainly reflecting a weakening of consumption growth from earlier elevated rates. GDP growth is expected to ease further in 2004, as the oil market–related boost to output in 2003 is reversed and as the deceleration in consumption growth to more sustainable rates continues. Looking forward, while the region should benefit from the expected upturn in global activity, a number of risks remain, notably with respect to the prospects for the oil market (although these are asymmetric across the region, with the poorest countries gaining substantially from lower oil prices); excessive wage increases in a number of countries; and the continued weakness of non-energy-sector investment.

The external current account surplus of the region is expected to weaken over 2003–04, reflecting continued robust demand growth, the recent fall in oil prices, and increased import demand related to foreign direct investment (Azerbaijan, Georgia, and Kazakhstan). Within this, Russia is expected to remain in continued, if declining, surplus. With net capital inflows having strengthened in a number of countries, reserves have risen substantially in some cases, especially in Russia and Kazakhstan. In contrast, net energy importers—with the exception of Ukraine, which has benefited from strong exports and higher transfers—are projected to register rising and in some cases sizable deficits: this is of particular concern in a number of the poor and highly indebted CIS-7 countries (Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan). While these countries need to maintain appropriately tight fiscal policies, a number also require additional international assistance to ensure progress toward sustainable external debt positions.

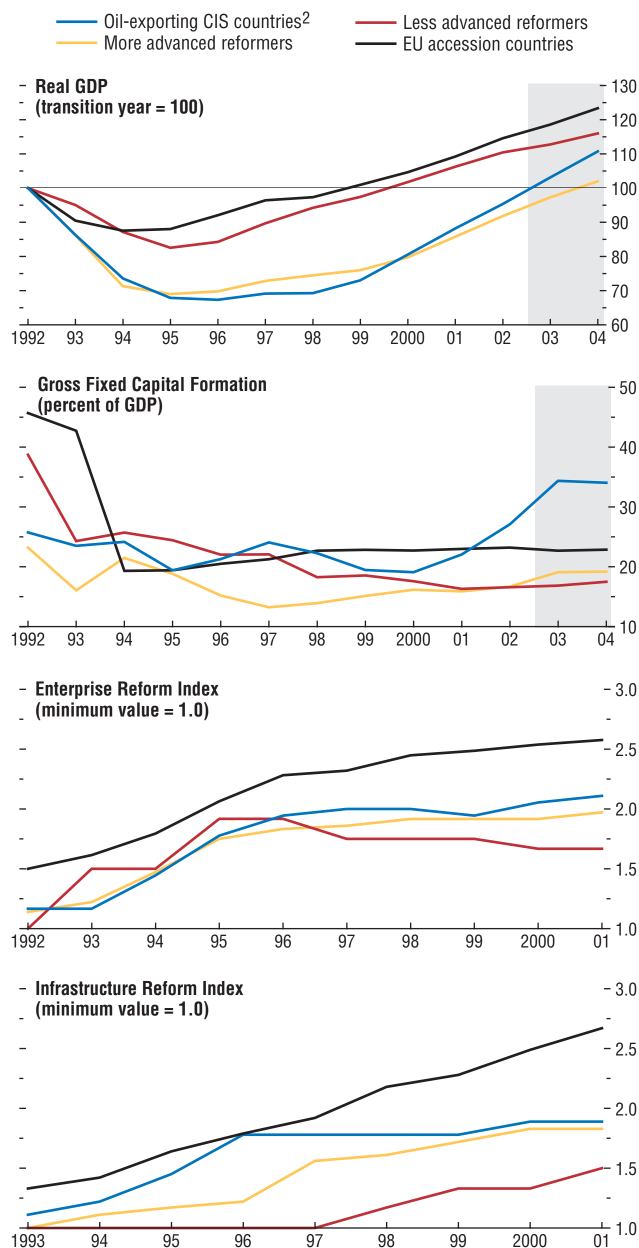
Inflation rates across the region have continued to decline, but remain relatively high compared with other developing countries. Within this, however, the situation varies markedly across the region. Among most of the advanced reformers, inflation is well into single digits. In Russia, however, the pace of disinflation has lagged, largely reflecting the continued dilemma between controlling inflation and seeking to limit appreciation of the ruble in the face of large balance of payments inflows and productivity growth, especially in the tradables sector. A more flexible exchange rate policy would allow the inevitable real appreciation to take place while the central bank could appropriately focus on targeting inflation; establishment of the proposed oil stabilization fund (as in Azerbaijan and Kazakhstan) could be helpful in reducing oil price–related real exchange rate volatility. Inflation in the less advanced reformers, while declining, remains very high, particularly in Belarus and Uzbekistan, underscoring the need to strengthen monetary discipline by reining in credit to inefficient public enterprises. In most of the CIS countries, the process of remonetization continues to pose important challenges. With the pace of remonetization difficult to predict, policymakers face unusual difficulty in judging underlying money demand and—because remonetization is inevitably accompanied by rapid credit growth—in managing banking system risks, underscoring the need for further improvements in prudential regulation and supervision.

Looking forward, with the recent boost from higher oil prices and rising real wages unlikely to be sustained, regional growth prospects depend critically on an acceleration of structural reforms. Over the past year, overall progress in most countries has slowed markedly (except in Armenia and Azerbaijan). While the CIS countries lag the EU accession countries in most structural reform areas, the gap appears to be increasing in areas affecting private sector development—enterprise, infrastructure, and financial sector reforms—which is of particular concern given the weakness in non-energy-sector investment (Figure 1.16). While the priorities

Figure 1.16. Real GDP, Investment, and Structural Reforms in the CIS Countries[1]

(Unweighted averages)

The robust growth performance during 1999–2002 helped the CIS countries in overcoming the adverse output dynamics of the early transition years, but lags in structural reform achievements remain a matter of concern.



Sources: European Bank for Reconstruction and Development, *Transition Reports;* and IMF staff calculations.

[1]The data is shown in transition time, which for the CIS countries corresponds to the years indicated in the figure. For the other countries' initial year (beginning of transition), see Fischer and Sahay (2000).

[2]Includes Azerbaijan, Kazakhstan, and Russia.

Table 1.10. Selected Middle Eastern Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
Middle East[3]	**4.8**	**3.9**	**5.1**	**4.5**	**8.0**	**8.4**	**10.1**	**10.1**	**6.5**	**4.9**	**7.0**	**3.9**
Oil exporters[4]	**5.0**	**4.5**	**6.0**	**5.0**	**10.1**	**10.4**	**12.6**	**12.2**	**8.9**	**6.5**	**9.0**	**5.2**
Saudi Arabia	1.3	1.0	4.7	2.1	–0.8	–0.6	1.1	1.0	5.1	6.2	10.1	5.4
Iran, Islamic Rep. of	5.9	6.7	6.1	5.7	11.4	15.8	18.0	17.0	5.3	3.0	1.1	–1.2
Kuwait	–1.1	–0.9	4.7	2.2	1.7	1.4	2.0	2.0	26.1	20.9	23.8	18.4
Mashreq[5]	**4.0**	**2.3**	**2.5**	**3.1**	**1.8**	**2.2**	**2.9**	**3.7**	**–1.6**	**–0.5**	**–1.3**	**–1.7**
Egypt	3.5	2.0	2.8	3.0	2.4	2.5	3.2	4.2	—	0.6	1.3	0.9
Jordan	4.2	4.9	3.0	5.5	1.8	1.8	2.5	1.8	–0.1	4.9	4.6	0.2
Memorandum												
Israel	–0.9	–1.0	0.7	2.1	1.1	5.7	1.1	0.2	–1.6	–1.2	–0.7	–0.8

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Includes Bahrain, Egypt, Islamic Rep. of Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, United Arab Emirates, and Republic of Yemen.
[4]Includes Bahrain, Islamic Rep. of Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and United Arab Emirates.
[5]Includes Egypt, Jordan, Lebanon, and Syrian Arab Republic.

vary across countries, in Russia there is a need to reinvigorate reforms to strengthen the banking system, introduce competition in the electricity and transportation sectors, and streamline the civil service and public administration; and in Ukraine, to improve the investment climate, including through tax reform, and to address the financial problems of state-owned enterprises in the energy sector. In the poorer CIS countries, structural reforms need to focus on improving governance and the investment climate. In addition, in the poorer, landlocked CIS-countries (Armenia, Kyrgyz Republic, Tajikistan, and Uzbekistan), lagging infrastructure reforms and intra-CIS trade barriers, some of which are related to transit trade and its (informal) taxation or the distribution of energy from net exporters to net importers, are serious impediments to growth that need to be addressed urgently. Advancing infrastructure development will be challenging, however, given the external financing constraints faced by these countries, and will require improved tax policy and administration and enhanced public expenditure management.

Middle East: Fiscal Reforms Key to Stability and Higher Growth

GDP growth in the Middle East is projected to rise to 5.1 percent in 2003, 1.2 percentage points higher than in 2002 (Table 1.10). The bulk of this increase is due to stronger growth in oil-exporting countries, reflecting primarily higher OPEC oil quotas and oil production before the war (particularly in Saudi Arabia and other countries of the Gulf Cooperation Council[7]), higher average oil prices, and—notably in Iran—the continuing positive impact of recent economic reforms. The early end to major hostilities in Iraq is also a positive factor, although the fragile security situation continues to weigh on activity across the region. In contrast, GDP growth in the Mashreq is expected to pick up more moderately, in part reflecting the relatively close economic links of a number of

[7]Members of the Cooperation Council of the Arab States of the Gulf (GCC) are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

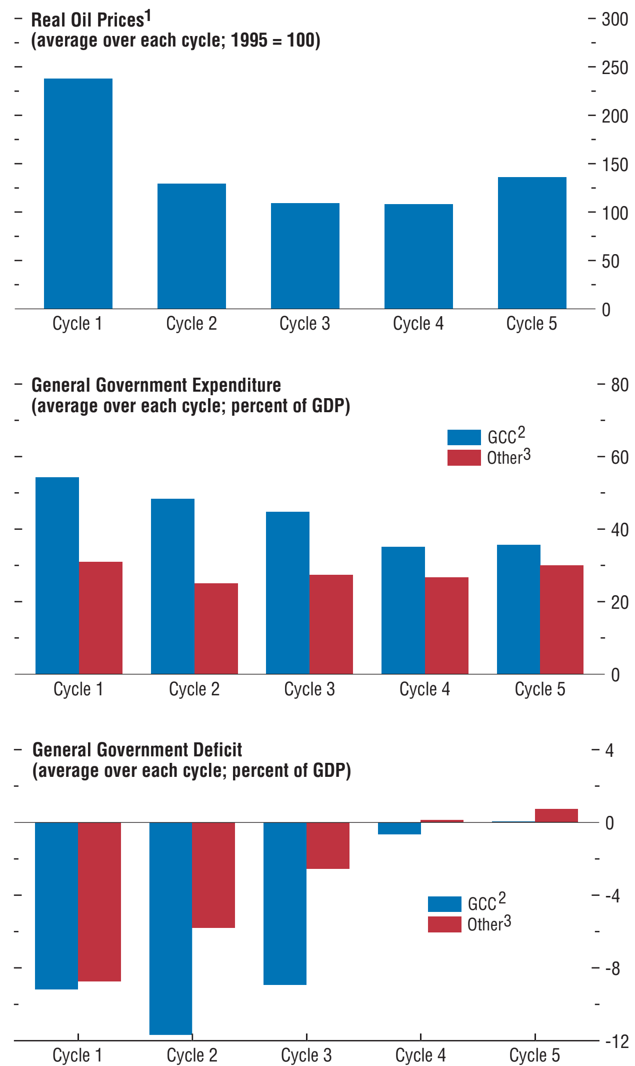
countries with Iraq (Jordan, Syria) and the adverse effects of the regional security situation on tourism (Egypt, Jordan).

Turning to 2004, GDP growth in the region is expected to fall back somewhat, although once again there are significant differences between oil and non-oil countries. GDP growth in the Mashreq countries is expected to rise modestly further, aided by the upturn in the global economy and reduced geopolitical uncertainties; however, GDP growth in oil producers is expected to decrease owing to falling oil prices and production. But while GDP growth in the region is expected to remain high by historical standards—and the rebuilding of Iraq should be a positive factor (see Box 1.4, "Rebuilding Post-Conflict Iraq")—a number of risks remain. In particular, beyond the fragile security situation, the outlook for the oil market remains subject to considerable uncertainty, and many oil market analysts see downside risks to prices over the medium term (Appendix 1.1), which would clearly have significant implications for oil producers in the region. More generally, public debt burdens across the region are high, particularly in the Mashreq but also in some oil exporters (where such concerns would be exacerbated by further falls in oil prices, especially given relatively high levels of public expenditure (Figure 1.17)). Many countries in the region have taken important steps—for example, apart from those discussed below, Saudi Arabia targets a balanced budget in 2003, which involves expenditure reductions of more than 4 percent of GDP despite higher oil revenue, while in Jordan, a package of revenue measures yielding about 2 percent of GDP—including increased petroleum product prices—was implemented to secure the authorities' lower deficit target for 2003. However, as discussed in Chapter III, these efforts will need to be sustained and, in some cases, strengthened over the medium term.

Looking forward, the key policy issue for Middle Eastern countries is accelerating medium-term growth to reduce generally high unemployment rates and absorb the rapidly

Figure 1.17. Oil Price Cycles and Fiscal Policy in the Middle East

Adjusting government expenditure in response to oil price fluctuation has been key to reducing fiscal deficits in the oil-exporting countries of the Middle East.



Source: IMF staff calculations.
[1]Drawing on business cycle analysis and methodology used in Chaper III of the April 2002 *World Economic Outlook*, the oil price cycles are identified on the basis of peaks and troughs in real oil prices. Cycle periods: [1]:1981–87, [2]:1988–90, [3]:1991–96, [4]:1997–2000, and [5]:2001–03.
[2]Cooperation Council of the Arab States of the Gulf: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates.
[3]Islamic Republic of Iran and Libya.

Box 1.4. Rebuilding Post-Conflict Iraq

The role of the IMF in post-conflict situations is primarily to help the countries achieve macroeconomic stability as soon as possible and prepare the ground for long-term sustainable growth. As part of this task, the IMF—in coordination with the World Bank, UN agencies, and other multilateral and bilateral entities—has provided extensive policy advice and technical assistance to improve institutional capacity and policy coordination, as well as its own financial assistance.[1] In terms of policy advice, as a first step the IMF has helped authorities in post-conflict cases develop a macroeconomic framework geared toward quickly restoring macroeconomic stability, with the World Bank playing a supporting role by providing an assessment of sectoral reconstruction and rehabilitation needs. As regards technical assistance, the areas supported by the IMF have included central banking, banking supervision, payments system, public expenditure management, tax policy, compilation of macroeconomic statistics, and external debt monitoring. In the area of policy coordination, the IMF has played a lead role in coordinating policy advice with all institutions involved, while providing support in the preparation and organization of consultative group (CG) and donors' meetings.

In carrying out this work in post-conflict situations, some critical lessons have been learned. Of utmost importance is that institutional and administrative capacity must be restored or enhanced at an early stage; that a macroeconomic framework—underpinned by a simple but realistic policy stance—must be quickly put in place to restore macroeconomic stability and set the ground for a quick resumption of growth; and that a careful and realistic assessment of external aid flows must be made. The IMF is making use of these lessons on its work in Iraq.

Although Iraq was one of the founding members of the IMF, the IMF has had little official contact with the government of Iraq since the early 1980s. Since that time, Iraq's economy has suffered from the effects of three wars, political repression, intrusive state ownership and control, and international sanctions—all of which has made it difficult to conduct an assessment of the country's economic situation. In addition, there are very few recent economic statistics on Iraq and those that exist cannot be easily interpreted. There is an incomplete recording of transactions, and the use of artificial and highly distorted prices and exchange rates in constructing economic accounts reduces the usefulness of these data.

A UN Security Council Resolution (1483) that lifted all sanctions previously imposed on Iraq (except those relating to arms sales) has facilitated the reintegration of Iraq into the international community. The resolution defines interim institutional arrangements in the country. Among its key provisions, the resolution creates a new structure that governs the treatment of Iraq's assets, revenues, and expenditures until "such time as an internationally recognized, representative government of Iraq is properly constituted." In that context, a Development Fund for Iraq has been established to receive oil export proceeds (net of war reparations) and specified Iraqi assets—including transfers of unused balances from the UN Oil-for-Food Program, which is to be phased out by November 2003. Resources in the Development Fund for Iraq are to be disbursed in a transparent manner at the direction of the Coalition Provisional Authority, in consultation with the Iraqi interim authority. The Development Fund for Iraq—as well as exports of hydrocarbon products—will be audited by independent public accountants to be approved by an International Advisory and Monitoring Board—which is to consist of representatives of the UN

Note: The main author of this box is Carlos Piñerúa.

[1]The IMF's Executive Board has approved post-conflict financial assistance since 1995 to Albania, Bosnia and Herzegovina, Burundi, Republic of Congo, Rwanda, Guinea-Bissau, Sierra Leone, Tajikistan, and the Federal Republic of Yugoslavia. The IMF has also been involved in the economic rebuilding of Afghanistan, Kosovo, and East Timor.

Secretary General, the Managing Director of the IMF, the President of the World Bank, and the Director-General of the Arab Fund for Economic and Social Development.

An IMF staff mission visited Baghdad in June to conduct an initial assessment of the economic and financial situation, and to explore early priorities for advice and technical assistance in the IMF's core areas of responsibility to quickly improve the institutional capacity for policymaking in the country. The IMF has already begun to provide technical assistance in the areas of introduction of a new currency; central bank legislation, commercial bank licensing, and payments system; budget execution and public expenditure management; and the compilation and dissemination of economic statistics. As regards macroeconomic policy, IMF staff is assisting in the development of a macroeconomic framework—including a fiscal budget for 2004 and a monetary and exchange rate policy regime—to ensure that macroeconomic stability is quickly restored and growth resumes as soon as possible. In terms of external assistance, the staff is supporting the work of the Core Group of donors that is organizing a meeting to take place in the second half of October to channel assistance for the rehabilitation and reconstruction of Iraq. Moreover, the staff is helping in the effort to obtain information about the external debt of Iraq as a first step in developing a debt restructuring strategy.

growing labor force. With macroeconomic imbalances outside Lebanon generally moderate—although inflation in Iran remains somewhat high, underscoring the need to slow liquidity growth—the central issues are structural and institutional in nature. As discussed in detail in the second essay in Chapter II ("Why Has Economic Growth in the Middle East and North African Region Lagged Behind?"), the priorities vary across countries, but include reform of the state leading to a reduction in the role of government, strengthening of institutions and governance more generally, further trade liberalization, and diversification away from oil production. Recent progress in structural reforms in the region has been uneven; key achievements include the partial divestment of government equity shares (Iran, Jordan, Oman, and Saudi Arabia); reductions in nontariff barriers (Iran); liberalization of key sectors to foreign direct investment (Iran, Kuwait, Oman, and Qatar); institutional reforms aiming at increasing efficiency in public services delivery (Bahrain, Jordan, and Saudi Arabia); improved tax administration and policies (Egypt, Iran, Jordan, and Lebanon); and financial sector reform (Saudi Arabia and United Arab Emirates). In the GCC countries, the ambitious goal of establishing a monetary union by 2010 will require far-reaching reforms to reduce divergences in key macroeconomic variables, including fiscal positions, and differences in institutions, legal systems, and regulatory practices in the financial sector to prepare the grounds for a common monetary policy framework (see Box 1.5, "Gulf Cooperation Council: Challenges on the Road to a Monetary Union"). In Egypt, the economic outlook has improved following the end of the war in Iraq, and there are signs that tourism—while still depressed—is beginning to pick up. However, confidence and economic growth remain relatively weak, in part owing to continuing foreign exchange shortages in the official market, despite a step-depreciation following the floating of the currency in January and despite resort to administrative measures to boost liquidity. To facilitate market clearing, the pound should be allowed to adjust as needed. On the fiscal side, a multiyear program to ensure long-run sustainability is a priority; in this connection, measures will be required to strengthen the recently adopted budget for 2003/04. In Lebanon, the authorities' strategy of strong fiscal adjustment, large-scale privatization,

Box 1.5. Gulf Cooperation Council: Challenges on the Road to a Monetary Union

Since its inception in the early 1980s, members of the Cooperation Council of the Arab States of the Gulf (GCC)—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—have built on their cultural, political, demographic, and economic ties and commonalities, and have taken significant steps toward economic integration. Barriers to the free movement of national goods, labor, and capital across the GCC countries have been eliminated, and individuals and corporations in the region have been granted national treatment for tax purposes in each country. The customs union was launched on January 1, 2003, and the common external tariff was introduced. The GCC common market is targeted to come into effect in 2007 under a well-defined timetable for intermediate steps.

Effective January 2003, the GCC authorities initiated steps toward the establishment of a monetary union by 2010 and formally pegged their currencies to the U.S. dollar. With appropriate supporting macroeconomic policies, the monetary union will reinforce the beneficial effects of measures already taken to enhance integration and structural reforms presently under way. Although there is limited intraregional trade, the GCC countries face common shocks emanating from oil price volatility, and the planned monetary union should strengthen their ability to address these shocks by promoting policy coordination. It is also likely to reduce transaction costs and increase price transparency, thus resulting in a more stable environment for business and facilitating investment decisions in an expanded market. Moreover, regional growth prospects are likely to benefit from the unification and development of the region's bond and equity markets and improvement in the efficiency of financial services. However, given the similar resource endowment and limited complementarity among the GCC countries, the trade creation effects could be relatively small. Finally, the cost of monetary union for member countries—in terms of the loss of monetary policy independence and exchange rate flexibility—is likely to be low, because they have not relied on these tools for quite some time under their pegged exchange rate regimes and, given their heavy dependence on oil, external shocks induced comparable effects across GCC countries.

Notwithstanding past progress toward integration, differences in economic performance and policy preferences will necessitate critical decisions for an effective monetary union. Although inflation has traditionally been low in the GCC area, it differs across countries, leading to diverging paths for CPI-based real effective exchange rates. Real growth disparities have also emerged, particularly in non-hydrocarbon sectors. Fiscal positions have not been convergent—reflecting differences in oil dependency and levels of expenditure, with some GCC countries recording fiscal deficits. In the process, government debt has increased considerably in a few of these countries. Moreover, although there are practically no restrictions to capital movements in GCC countries, the financial sectors retain important differences, with capital and securities markets in some member countries still at a rudimentary stage. Differences also exist with respect to institutions, legal systems, and regulatory practices. The authorities are presently working on addressing these differences toward designing the monetary union, while efforts continue to diversify GCC economies, exports, and fiscal revenue away from oil. Initiatives have been taken to select quantitative convergence criteria, coordinate policies in key areas, and design the institutions to support the monetary union.

Three key areas will need to be addressed in the period ahead.

- *Gearing economic policies toward eventual monetary union.* This will require maintaining prudent fiscal policies across member countries to promote fiscal convergence. Under a centralized monetary policy, fiscal discipline including a reduction in public debt will be

Note: The main authors of this box are Zubair Iqbal and Ugo Fasano.

crucial to guard against large differences in members' fiscal stances, which could create tensions, leading to political disagreement and hindering other key macroeconomic convergence requirements. Moreover—given the GCC countries' heavy dependence on volatile oil export receipts and the varying degrees of oil reserves, depletion rates, and government financial wealth—the choice of fiscal convergence criteria and the underlying fiscal rules would be a challenge. In the context of a medium-term fiscal framework, consideration could be given to establishing convergence in terms of non-oil primary balance as a ratio to non-oil GDP along with a well-defined path for the reduction in public debt to an agreed norm. In light of changing trade patterns and economic structures, the current decision to peg the common currency to the U.S. dollar—a policy that has served individual GCC member countries well in the past—could be reconsidered in the future. Alternative options could include pegging to a basket of currencies and possibly a more flexible exchange arrangement. Of course, each option carries its own policy implications and operational requirements. Consideration will also have to be given to the choice of the rates at which to irrevocably fix the bilateral rates.

- *Establishing rules and institutions that will support a monetary union.* Prime among these are laying the basis for establishing key monetary institutions, including a common central bank—charged with making monetary policy decisions; overseeing payments systems; and coordinating efforts toward financial integration—and a single set of monetary policy instruments. These will need to be supported by a common regulatory, legal, and institutional framework. Equally challenging will be the strengthened budgetary procedures and a common fiscal accounting framework that would promote convergence while respecting GCC members' individual characteristics.
- *Strengthening data quality and establishing common data standards to facilitate gauging the convergence process.* A common data framework in all GCC countries will likely prove invaluable in determining union-wide economic policies.

A successful monetary union will also require a strong political commitment and the ability to adjust domestic economic policies to deal with the effects of a single currency. In particular, notwithstanding a broadly common resource endowment, different GCC countries may experience differing growth and inflation effects of common exogenous shocks. Experience of other monetary unions has shown that a single monetary policy may not always be optimal for all members of the union. As a result, structural policies that would promote flexibility in labor and product markets will assume greater importance in the planned monetary union.

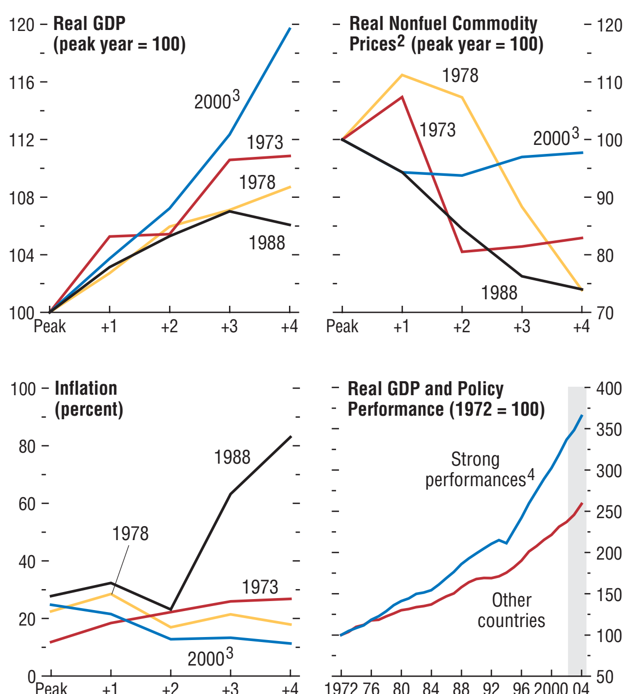
mobilization of external concessional assistance, and burden sharing with the banking system will, if fully implemented, bring the public debt ratio down significantly from its present level of close to 180 percent of GDP. The initial implementation of the strategy boosted confidence and financial indicators have improved in 2003. Nonetheless, the very high stock remains a large vulnerability.

In Israel, following the deepest recession in its history, GDP growth is expected to turn slightly positive in 2003. Domestic demand remains subdued amid fragile confidence and a difficult security situation, and a modest turnaround in exports—aided by the sharp depreciation in the shekel in 2002, as well as falling real wages—has proved difficult to sustain in the face of a weak global recovery. Given the difficult medium-term fiscal situation, the new government appropriately implemented additional budgetary measures in June to offset weaker-than-expected tax revenues. With inflation projected to fall below 1 percent in 2004, aided by the appreciation of the shekel since late 2002, there appears to be

Figure 1.18. Downturns in Advanced Countries, and Reforms and Growth in Sub-Saharan Africa[1]

(Unweighted averages)

The resilient GDP growth in sub-Saharan Africa during 2000–02 reflected favorable commodity price developments but also improved macroeconomic policies.



Source: IMF staff calculations.

[1]Peak years identified by local maxima in annual GDP growth of advanced countries at times of major slowdowns in GDP growth.

[2]Nonfuel commodity prices normalized by advanced countries' GDP deflator.

[3]Includes forecasts for 2003–04.

[4]Strong performers are countries with generally strong macroeconomic and structural policies; comprises Benin, Botswana, Burkina Faso, Cameroon, Mali, Mauritius, Mozambique, Rwanda, Senegal, Seychelles, Tanzania, and Uganda.

scope for further monetary easing to support recovery. Economic activity in the West Bank and Gaza remains very depressed, although indications are that the economy stabilized in late 2002. No significant amelioration is likely without a lasting improvement in the security situation accompanied by substantial external support for infrastructure reconstruction.

Africa: Growth Has Been Resilient But Still Far Too Low

Over the past three years, GDP growth in African countries has remained surprisingly resilient in the face of the slowdown in the advanced economies and the ensuing uneven recovery (Figure 1.18). This partly reflected more favorable developments in nonfuel commodity prices, which did not contract as much as in earlier global slowdowns, as well as debt relief under the HIPC initiative. However, external conditions were not the only factor, with the trend toward improved macroeconomic policies in many African countries also playing an important role. In particular, with some exceptions—notably Zimbabwe, Angola, and, to a lesser extent, Nigeria—inflation is now relatively low and government budget deficits are under control. That said, external current account deficits in many countries in sub-Saharan Africa remain relatively high, reflecting in part continued high debt levels but also low savings rates related to low per capita incomes and structural impediments to economic diversification.

In 2003, African GDP growth is projected to edge up slightly, with the expansionary effects of global recovery and increasing nonfuel commodity prices continuing to be offset by adverse local factors—especially weather conditions, political instability, and conflicts—and geopolitical uncertainties (Table 1.11). Within this, GDP growth is expected to pick up in the Maghreb (reflecting favorable weather conditions, expansionary fiscal policy (Algeria), and economic reforms (Morocco and Tunisia)), in west and central Africa (led by Nigeria, where oil production is forecast to rise), and in southern Africa

Table 1.11. Selected African Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
Africa	**3.7**	**3.1**	**3.7**	**4.8**	**12.9**	**9.3**	**10.6**	**7.7**	**–0.5**	**–1.3**	**–0.7**	**–1.4**
Maghreb	**4.3**	**3.3**	**5.7**	**4.1**	**2.6**	**2.1**	**2.2**	**2.8**	**7.2**	**4.1**	**5.8**	**3.2**
Algeria	2.6	4.1	5.9	3.8	4.2	1.4	2.3	3.5	12.9	7.7	12.2	7.5
Morocco	6.3	3.2	5.5	3.4	0.6	2.8	2.0	2.0	4.8	3.0	1.6	1.2
Tunisia	4.9	1.7	5.5	5.8	1.9	2.8	2.5	2.5	–4.3	–3.5	–3.1	–3.2
Sub-Sahara[3]	**3.8**	**3.1**	**3.6**	**5.9**	**21.4**	**12.7**	**15.7**	**11.2**	**–4.7**	**–4.7**	**–4.2**	**–4.4**
Horn of Africa	**6.1**	**3.8**	**2.6**	**6.4**	**1.8**	**3.6**	**10.3**	**6.2**	**–11.0**	**–8.2**	**–7.6**	**–7.6**
Ethiopia	7.7	1.2	–3.8	6.7	–7.1	–7.2	14.6	5.5	–4.2	–6.0	–6.1	–8.3
Sudan	5.3	5.0	5.8	6.5	4.9	8.3	7.0	5.0	–16.9	–11.0	–10.2	–9.4
Great Lakes	**2.4**	**4.2**	**3.9**	**5.2**	**54.4**	**7.5**	**8.4**	**5.2**	**–5.0**	**–2.5**	**–4.7**	**–6.7**
Congo, Dem. Rep. of	–2.1	3.0	5.0	6.0	357.9	27.7	9.1	6.0	–4.7	–2.9	–3.2	–7.0
Kenya	1.2	1.0	1.3	2.6	4.9	2.0	12.4	3.9	–3.5	0.5	–3.1	–6.9
Tanzania	6.1	6.3	5.5	6.3	5.2	4.6	5.3	5.0	–5.0	–2.7	–7.3	–6.5
Uganda	5.5	6.6	5.4	6.0	4.5	–2.0	5.9	5.9	–7.6	–6.4	–5.7	–5.8
Southern Africa	**2.8**	**2.0**	**2.6**	**6.4**	**35.2**	**38.8**	**48.8**	**35.9**	**–6.5**	**–3.8**	**–4.8**	**–3.9**
Angola	3.2	15.3	4.4	11.4	152.6	108.9	95.2	30.1	–15.1	–5.8	–4.3	–3.2
Zimbabwe	–8.8	–12.8	–11.0	5.1	76.7	140.0	420.0	380.0	–3.8	–2.3	–3.2	–9.6
West and Central Africa	**4.0**	**2.8**	**4.1**	**5.7**	**11.6**	**8.0**	**8.5**	**5.8**	**–2.3**	**–5.2**	**–2.9**	**–3.1**
Ghana	4.2	4.5	4.7	5.0	32.9	14.8	26.4	8.6	–5.3	0.6	–1.4	–1.6
Nigeria	2.8	0.5	5.2	2.8	18.0	13.7	12.3	10.6	2.7	–7.0	–1.0	–2.3
CFA Franc Zone	**4.9**	**3.9**	**3.2**	**7.9**	**4.1**	**3.6**	**2.8**	**2.6**	**–6.1**	**–4.0**	**–3.6**	**–3.0**
Cameroon[4]	5.3	6.5	4.0	4.4	2.8	6.3	2.5	2.1	–1.7	–7.2	–5.5	–5.8
Côte d'Ivoire	0.3	–1.8	–3.0	3.0	4.4	3.1	3.5	2.9	–0.7	9.3	7.7	5.3
South Africa	**2.8**	**3.0**	**2.2**	**3.0**	**5.7**	**9.1**	**7.7**	**4.9**	**–0.3**	**0.3**	**–0.7**	**–0.9**
Memorandum												
Oil importers	3.8	2.9	3.2	4.9	11.9	8.4	10.2	7.6	–2.7	–2.0	–2.6	–2.7
Oil exporters	3.2	3.7	5.5	4.2	16.5	12.5	12.0	8.3	5.3	0.5	4.9	2.5

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Excludes South Africa.
[4]The percent changes in 2002 are calculated over a period of 18 months, reflecting a change in the fiscal year cycle (from July–June to January–December).

(led by Botswana where mining output is expected to rise). In contrast, GDP growth is projected to slow elsewhere, notably in the Horn of Africa (where Ethiopia continues to face a disastrous famine); the CFA franc zone (where activity in Côte d'Ivoire is expected to decline for the second consecutive year in the face of continued political instability); the Great Lakes region (where tourism has been affected by terror-related risks); and South Africa (partly reflecting the temporary effects of policy tightening). Looking forward, GDP growth—for both the continent as a whole and most major regions—is projected to pick up significantly in 2004. Such an outturn, however, depends critically on more favorable weather conditions and a substantial reduction in the incidence of conflict and unrest.

But while growth in Africa has been resilient, it clearly remains far too low. To meet the Millennium Development Goals—most importantly, a halving of poverty between 1990 and 2015—growth in sub-Saharan Africa will need to accelerate substantially to about 7 percent a year, well above the rates enjoyed by even the strongest performers during the past decade (about 5 percent). Africa continues to face a wide range of daunting development challenges—including armed conflicts and political instability that undermine macroeconomic sta-

bility and the long-term growth potential; weak judicial and legal systems that do not sufficiently protect property rights and hinder private lending; adverse weather conditions and natural disasters that generate high output volatility, to the detriment of long-term growth potential; poor infrastructure and health conditions that hold back productivity growth, thereby aggravating the adverse effects of low savings and investment; and the HIV/AIDS pandemic and tropical diseases that reduce life expectancy and have affected growth prospects in a number of countries. As stressed in the New Partnership for Africa's Development (NEPAD), a multifaceted strategy is needed to address them, including policies aimed at reducing conflict, protecting human rights, and improving political governance; the promotion of competition, trade, and foreign investment, underpinned by measures to strengthen macroeconomic policy frameworks; and a policy focus on developing the pro-poor sectors of health care, education, infrastructure, and agriculture. As discussed above, it is essential that domestic reforms be accompanied by additional external assistance, including higher aid flows, debt relief, and—perhaps most importantly—removal of industrial country restrictions on developing country exports.

In implementing this strategy, two points are worth emphasizing. First, as stressed in the NEPAD—and discussed in detail in the April 2003 *World Economic Outlook*—sustained efforts to strengthen weak institutions, which in many African countries remain a major drag on growth, are critical. In a number of countries, significant progress is being made, for instance through strengthening the regulatory and institutional framework governing private investment (Ghana, Mali, Mauritius, Mozambique, Tanzania, and Uganda); improving governance related to revenues from natural resources (Botswana, Cameroon, and Tanzania); and fiscal capacity building (Burkina Faso, Mali, and Tanzania). However, much remains to be done; with institutions generally deeply rooted in a country's history and culture, domestic ownership is critical to ensure that reforms are tailored to meet specific regional conditions and circumstances.

Second, the experience of the strongest performers in Africa confirms that sound policies do pay off (Figure 1.18). Among the many dimensions of sound policies, three appear particularly important.[8] First, trade openness fosters development and technology transfer, and more open economies have typically outperformed more closed economies;[9] trade openness also fosters competition, which in turn tends to reduce benefits derived from rent seeking and vested interests. Second, appropriately flexible exchange rates and prices are critical for economies that are subject to large commodity price shocks, including most sub-Saharan African economies, which, on average, face larger commodity price volatility in their exports than any other developing country region. Finally, if—as is hoped—the international community follows through with its commitment at Monterrey to sharply increase aid flows, efforts will need to focus on securing the administrative and institutional preconditions for these resources to be used efficiently, and to manage carefully the macroeconomic consequences (Box 1.3). In this connection, given African countries' still large debt burdens and their limited capacity to shoulder additional risk, it would appear highly desirable that such assistance be provided in the form of grants rather than loans.

Turning to the continent's largest economies, GDP growth in South Africa has slowed from late 2002, reflecting earlier monetary tightening in response to inflation rates rising above the target range and the weak recovery in industrial countries. With inflationary pressures now easing, aided by a rebound in the rand and declining food prices, interest rates have appropriately been reduced; domestic demand will also be supported by a mild expansionary impulse from the 2003/04 budget. Consequently, the slow-

[8]See also Rogoff (2003).
[9]See Chapter III of the September 2002 *World Economic Outlook* and the references therein.

down is expected to be limited and temporary, with GDP growth picking up to 3 percent in 2004. External vulnerabilities have been significantly reduced with the recent closing of the central bank's net open forward position; however, the economy remains vulnerable to global uncertainties, regional developments, and long-term concerns over HIV/AIDS. The key medium-term policy challenge remains to boost long-run growth so as to reduce very high unemployment rates and poverty; this in turn will require a significant improvement in the investment climate, including through labor market reforms and reduced socioeconomic disparities.

In Nigeria, overall growth in 2003 is projected to pick up sharply on account of oil market developments, while economic activity in the non-oil sectors is expected to remain buoyant. Higher oil prices, together with the peaceful change of government in April's election and a more market-oriented exchange rate policy, have stabilized the international reserves position, which had deteriorated sharply during 2002. However, Nigeria remains highly exposed to oil market developments, and political and civil unrest (as evidenced by the continuing problems in the oil industry). With oil prices projected to fall in coming years, and public debt very high (70 percent of GDP), fiscal consolidation is now urgent and should be accompanied by a more rules-based approach to fiscal policy to avoid oil price–related boom-bust cycles and measures to enhance the transparency and efficiency of public spending. Monetary policy—which was eased substantially in late 2002 and 2003—also needs to be tightened if the authorities' aim of single-digit inflation by end-2003 is to be achieved.

In Algeria, despite an earthquake that rocked the country's center in May, growth in 2003 is projected to strengthen further on account of favorable weather conditions and buoyant construction demand related to demographic conditions but also to reconstruction needs. With earthquake-related increases in expenditures, the fiscal balance in 2003 will weaken further. Given the outlook for oil prices and the deterioration in budget balances since 2001, the fiscal stance needs to be tightened starting in 2004 to keep the public debt on a sustainable path. A key issue remains the high level of unemployment, the reduction of which will require renewed efforts at stepping up privatization and the restructuring of nonfinancial public enterprises, establishing conditions for an effective real estate market, banking reform, and trade liberalization.

Appendix 1.1. Longer-Term Prospects for Oil Prices

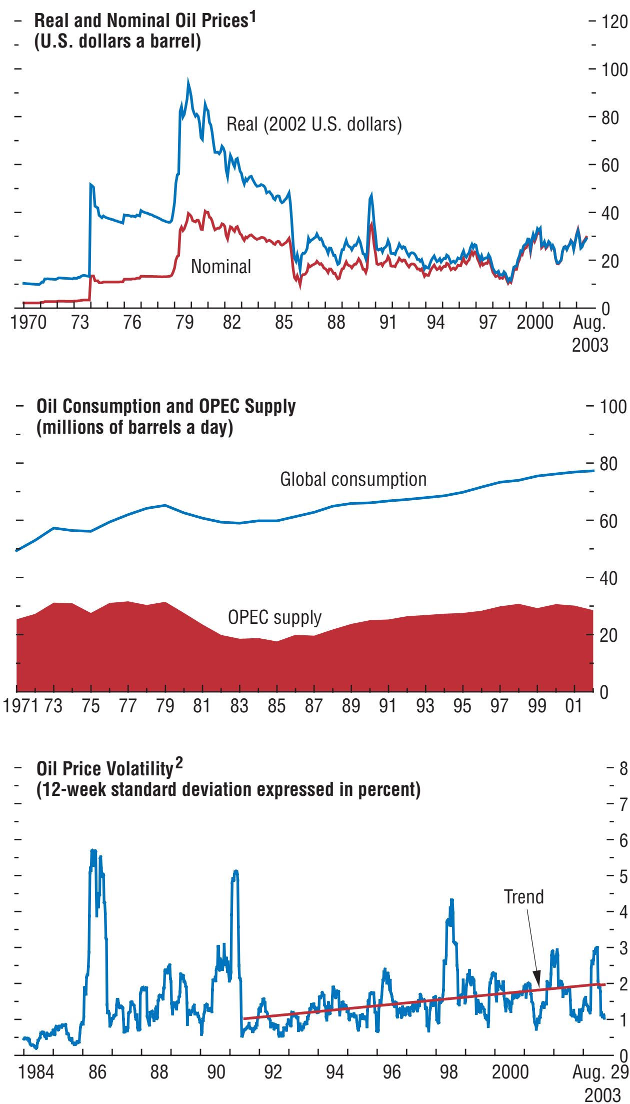
The main authors of this appendix are Aasim Husain, Bright Okogu, and Ximena Cheetham. Paul Nicholson and Chakriya Bowman provided research assistance. The appendix draws on discussions with analysts at Deutsche Bank, Goldman Sachs, J.P. Morgan, Energy Market Consultants, Center for Global Energy Studies, Oxford Institute for Energy Studies, BP, and Shell, as well as officials at the International Energy Agency and the Organization of the Petroleum Exporting Countries.

Oil prices remain a key factor affecting the global economic outlook, as highlighted by recent sharp movements in oil prices and coinciding changes in the pace of economic activity. The decline in the price of oil over the medium term expected by markets and analysts should support global economic prospects, but major shocks in the oil sector could cause oil prices to depart markedly from their projected longer-term path and have serious effects on the overall outlook.

World oil prices have declined markedly in real terms since the late 1970s as the pace of demand growth has moderated and supply has expanded (Figure 1.19).[10] Energy efficiency has

[10]Unless otherwise noted, oil prices refer to the simple average petroleum spot price of West Texas Intermediate, U.K. Brent, and Dubai crudes.

Figure 1.19. Oil Prices and Consumption



Sources: International Energy Agency; Bloomberg Financial Markets, LP; and IMF staff estimates.
[1]Average Petroleum Spot Price (APSP).
[2]Based on West Texas Intermediate crude price.

improved steadily, prompted by the oil price shocks of the 1970s, increased taxation, stricter environmental policies, technological advances, and changes in economic structure. As a result, the energy intensity of global output—the amount of energy required to produce a unit of output—has declined at an average rate of about 1 percent a year over the past three decades.[11] The share of oil in world energy consumption has also eased as the use of lower greenhouse gas–emitting fuels (such as natural gas) has increased and, in some countries, policies to promote self-reliance have led to more intensive use of domestically available energy sources, including nuclear power and coal.

World oil consumption growth has averaged about 1.2 percent a year since 1990, less than half the pace of global economic growth. The share of developing countries in world oil consumption has increased, on account of more rapid income growth than in industrial countries and a higher marginal propensity to consume energy products. On the supply side, the increase in oil prices in the 1970s promoted increased investment in exploration and development of production capacity, especially in countries outside the Organization of the Petroleum Exporting Countries (OPEC). Consequently, OPEC's share in world oil production fell from about one-half in the early 1970s to less than one-third in the mid-1980s. Sharply lower oil prices in the mid-1980s lowered oil sector investment, especially in non-OPEC countries, while boosting demand. As a result, non-OPEC production slowed and OPEC, which held significant spare capacity, was able to expand production. Consequently, OPEC's market share recovered to above 40 percent. In recent years, however, OPEC's market share has eased again as oil output in other countries, especially Russia, has increased markedly. Downward pressure on real oil prices over the past three decades has also come from a reduction in oil production costs on account of improved tech-

[11]See IEA (2000), pp. 56–60.

nology, which has expanded recoverable global oil reserves and made these reserves more accessible.

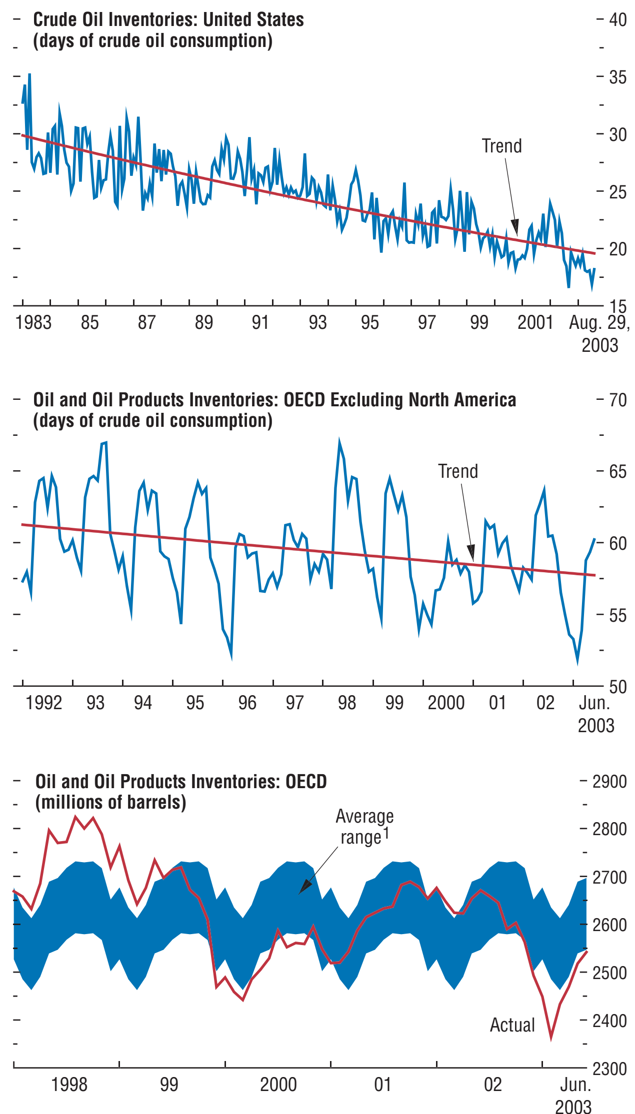
The volatility of crude oil prices has increased over the past decade. Limited spare production capacity—held almost entirely in OPEC countries—and a decline in stocks of crude oil and petroleum products held by private industry, particularly in the United States but also in other OECD countries (Figure 1.20), have contributed to higher oil price volatility as the capacity to respond to temporary shocks with increased output or inventory adjustments has diminished.[12] Changes in OPEC production levels, including temporary disruptions to Iraq's oil production and exports under the oil-for-food program since the late 1990s, have likely contributed to world oil price volatility, as have geopolitical shocks and weather-related shocks to demand. Increased synchronicity of business cycles in the major economies, by widening swings in global oil demand, may also have magnified the amplitude of oil price movements.[13]

Sharp movements in crude oil prices have long been recognized as having a significant effect on the global economy (Figure 1.21). The oil price shocks of the 1970s and the subsequent global economic downturns highlighted the world's dependence on oil. More recent oil price spikes—in 1990 and 2000—were also followed by global economic slowdowns. Indeed, the run-up in oil prices in 2002 and early 2003, as well as the increase in oil price volatility, may have contributed to the slower-than-anticipated pace of the global recovery. Quantitative investigations have found an important relationship between oil prices and economic activity. A recent IMF staff paper considered five channels through which changes in the price of oil could

[12]The adoption of efficiency-improving practices such as "just-in-time" stock holdings, technology improvements, and the increased availability of futures and options to hedge oil price risk have allowed some downward trend in commercial stocks without a loss of flexibility.

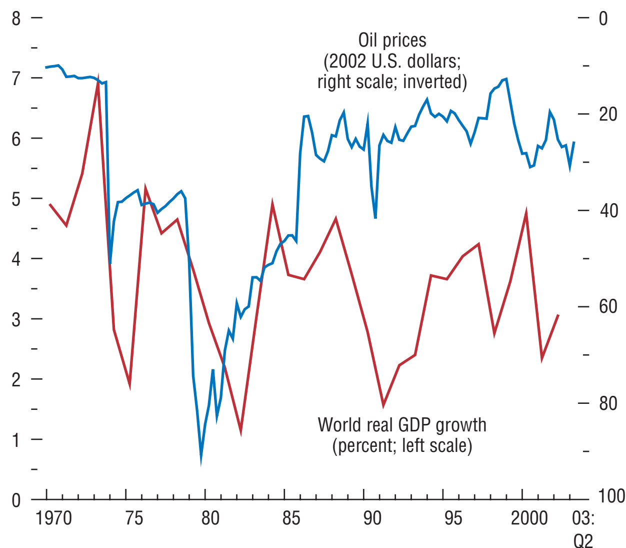
[13]Chapter II of the October 2001 *World Economic Outlook* documents the increased synchronicity of business cycles.

Figure 1.20. Oil Inventories



Sources: U.S. Department of Energy; American Petroleum Institute; International Energy Agency; and IMF staff estimates.
[1]Average of each calendar month during 1992–2002, plus or minus 75 million barrels.

Figure 1.21. Global Economic Growth and Oil Prices



Source: IMF staff estimates.

affect global growth—the transfer of income from oil consumers to producers, changes in the cost of production of goods and services, the impact on overall prices and inflation, the impact on financial markets, and the response of oil supply (through investment) and demand to changes in prices—and found that a sustained $5 a barrel increase in oil prices would lower global economic growth in the following year by 0.3 percent for the world as a whole.[14] Subsequent work has also tried to gauge the effects of confidence and uncertainty in financial markets on economic activity.[15] To the extent that oil price spikes are often associated with sharp declines in confidence and financial asset prices because of common underlying causes, the correlation between oil prices and global growth may well be even higher.

Recent Developments and Near-Term Outlook

The volatility of oil prices has been underscored by their recent sharp rise and subsequent rapid decline. In March 2003, as military action against Iraq became certain, prices fell from over $34 a barrel to $25.5 a barrel in just two weeks. War-related disruptions to oil supply were limited to Iraq, with increases in output by other OPEC members broadly offsetting the loss of Iraqi crude oil exports and a partial loss in Nigerian output in March and April due to civil unrest. The post-strike recovery of Venezuelan production proceeded more quickly than had been anticipated, but questions remain about the extent and sustainability of the recovery. Production in Saudi Arabia also expanded markedly during March to May. A seasonal decline in oil consumption, which followed a surge in demand due to colder-than-expected winter weather in North America, also exerted

[14]IMF (2000). See also Chapter VI of IMF (2003c) for a discussion of the effects of energy price shocks on the U.S. economy.

[15]See Appendix 1.2, "How Will the War in Iraq Affect the Global Economy?" of the April 2003 *World Economic Outlook*.

downward pressure on oil prices. Nevertheless, industry oil inventories, which had in early 2003 fallen to their lowest level in decades, remained low and—together with increased demand by U.S. electricity generation plants and an announcement of a cut in production targets by OPEC[16] as well as setbacks in the recovery of Iraq's oil production—caused oil prices to rise again since May.

The oil price path implied by recent futures contracts suggests that markets expect prices to be sustained near current levels through 2003 before declining to about $25 a barrel by late 2004. The persisting low inventory level, further delays in Iraq's production recovery, and lingering difficulties in Japan's nuclear power sector and the U.S. natural gas sector, which have led to a sizable increase in the use of oil in electricity generation over the past year, could provide support to, and possibly even push up, prices in the near term.[17]

By late next year, however, many analysts believe prices could fall sharply—to levels significantly lower than suggested by current futures prices—once inventories have been replenished and Iraq has returned to near prewar production levels. By late 2004 or early 2005, several large investment projects in deep water facilities in west Africa, Brazil, and the U.S. Gulf of Mexico are also expected to start yielding production, and the completion of the Baku-Tbilisi-Ceyhan pipeline is expected to boost the Caspian region's oil export potential. In such circumstances, barring weather-related or other shocks to oil demand or a resurfacing of political tensions in Nigeria, Venezuela, or elsewhere that could affect supply, there could well be significant downward pressure on oil prices unless OPEC and possibly other major producers lower their production levels.

The divergence between analysts' oil price forecasts for next year and prices implied by current futures contracts may relate to the possibility, albeit remote, of major shocks that could cause oil prices to spike. The futures price—which represents the market's expectation of the probability-weighted average of all potential prices that could prevail at a particular date—does not necessarily correspond to the most likely outcome. For example, if markets were to overwhelmingly expect (with 80 percent probability) prices to decline to $20 a barrel, but at the same time attached some possibility (20 percent) to shocks that would push prices to $40 a barrel in an environment of low oil inventories, the futures price would be about $24 a barrel, markedly higher than the price judged to be most likely.[18] Recent data on options contracts suggest expectations have indeed become somewhat skewed—in late August 2003, markets seemed to be attaching almost a 60 percent probability that spot prices in mid-2004 would be lower than the futures price prevailing at that time (about $26 a barrel), and only a 40 percent chance that spot prices would be higher than the futures price.

Longer-Term Prospects

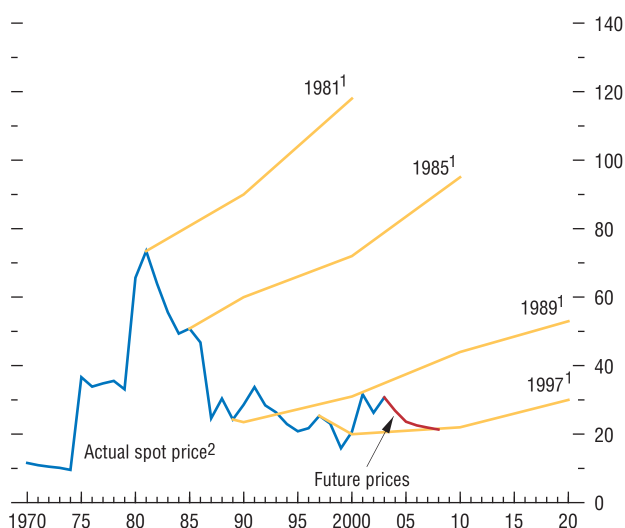
A high degree of uncertainty surrounds any long-term projection of oil prices. The consensus of forecasts prepared in 1981 envisioned oil prices climbing steadily to over $100 a barrel by the mid-1990s as global oil reserves started to decline and world oil production peaked (Figure 1.22). In the event, such fears have

[16]Although the production target was raised in mid-May (effective June 1), the new target represented a cut in actual production from levels in April and May.

[17]Surging U.S. natural gas prices in recent months, and the associated increase in oil consumption, have also contributed to the low U.S. commercial oil inventories position. See Chapter VII of IMF (2003c) for a discussion of energy taxation in the United States.

[18]Calculations using options data by Melick and Thomas (1997) indicate that in mid-January 1991, as military action against Iraq was being launched and markets appeared to perceive some risk of oil supply disruptions, expectations became skewed. Markets seemed to attach about a three-fourths probability to prices declining to below $30 a barrel by April, but also saw about a 15 percent chance that prices would rise above $50 a barrel.

Figure 1.22. Historical Oil Price Forecasts
(2002 U.S. dollars a barrel)



Sources: Bloomberg Financial Markets, LP; Goldman Sachs (2002); and IMF staff estimates.
[1] Average of long-term forecasts prepared by the U.S. Department of Energy and the International Energy Workshop in 1981, 1985, 1989, and 1997, respectively.
[2] West Texas Intermediate petroleum spot price.

proven exaggerated. While shocks have contributed to increased oil price volatility, technological progress, shifts in environmental policies and taxation, and changes in the structure of economies around the world have kept the expected upward trend in oil prices from materializing. Indeed, long-term price forecasts have been revised downward steadily. Even the 1989 consensus forecast, which correctly predicted prices above $30 a barrel in 2000, now appears too high. According to that forecast, oil prices in 2004–05 will average over $35 a barrel, about $12 a barrel above the level implied by current futures contracts maturing in that period.

Current oil futures contracts expiring in 2008 and beyond suggest a further decline in oil prices to about $22 a barrel over the longer term. Notwithstanding the thin trading volumes of futures contracts at distant maturities, the view that oil prices are likely to continue to soften appears to be fairly widespread. Indeed, many market analysts believe that in the absence of serious supply disruptions, longer-term oil prices could well be significantly lower, possibly in the $16–20 range.

Projections for global oil demand growth by various agencies and analysts are in the range of 1–2 percent a year over the long term. Assuming a continued decline in the energy intensity of global output at a pace in line with the trend over the past three decades, and a further moderate decline in the share of oil in primary energy consumption, this range for oil demand growth is broadly consistent with purchasing-power-parity-weighted global real GDP growth of 3–4 percent a year. The bulk of the increase in demand over the longer term will come from developing countries, where the income elasticity of oil demand and the rate of real income growth is expected to be higher than in industrial economies. According to projections prepared by the International Energy Agency (IEA), for example, the share of developing countries in world primary energy demand is expected to rise from 30 percent in 2000 to 34 percent in 2010. Oil consumption in China, in particular, is expected to grow rapidly, and its net oil imports

are projected to rise to 9.8 million barrels a day (mbd) by 2030, close to the net imports of the United States in 2000.[19]

While global economic growth will likely remain the principal determinant of oil demand, major technological breakthroughs or changes in energy policies could have striking effects. Steady improvements in energy technology and energy efficiency, including increased use of alternative energy sources such as natural gas, are built into most demand forecasts. However, dramatic technical advances and sharp cost reductions in areas presently under development—such as hydrogen-based energy and fuel cells—could profoundly alter oil consumption patterns. Similarly, marked adjustments in government policies, including changes in energy taxation rates and/or new measures to curb dependence on imported energy products or enhance environmental protection, could also place global oil demand on a significantly different path. Even if the Kyoto Protocol on greenhouse gas emissions does not take effect during the medium term, some countries may well tighten environmental regulations to reduce emissions, possibly through higher energy taxes or a mandated switch to less carbon-intensive fuels.[20]

On the supply side, there is wide consensus among market analysts and energy agencies that global oil reserves are adequate to meet demand over the longer term (Table 1.12). The world reserve replacement rate is presently well above 100 percent, implying that new discoveries and expansion of existing oilfields are more than offsetting current oil consumption. Moreover, technological improvements are expected to further enhance the accessibility of existing reserves—including deep water oil wells and nonconventional oils such as Canadian oil sands—and bring down production costs further.[21] That said, massive investment, a large portion of which would be in developing countries, will be needed to raise production capacity to meet projected demand.[22]

Table 1.12. Oil Reserves and Production

	Proven Reserves[1] (billions of barrels)	2002 Production (millions of barrels a day)
Conventional oil	**1,048**	**73.1**
Saudi Arabia	262	7.6
Iraq	113	2.0
United Arab Emirates	98	2.0
Kuwait	97	1.9
Iran, Islamic Rep. of	90	3.5
Venezuela	78	2.3
Russia	60	7.7
United States	30	8.1
Libya	30	1.3
Nigeria	24	2.0
China	18	3.4
Qatar	15	0.6
Mexico	13	3.6
Norway	10	3.3
Algeria	9	0.9
Kazakhstan	9	0.9
Brazil	8	1.7
Indonesia	5	1.1
United Kingdom	5	2.5
Others	75	20.2
Undiscovered conventional resources	939	
Canadian oil and Venezuelan heavy bituminous crude oil	580	

Source: BP; International Energy Agency (IEA); and IMF staff estimates.

[1]Oil that has been discovered and is expected to be economically recoverable is called a proven reserve. Oil that is thought to exist and is expected to be economically recoverable is called an undiscovered resource. Data for Saudi Arabia and Kuwait include one-half of Neutral Zone reserves and production.

[19]See IEA (2002) pp. 58–69, 89–94, and 237–68.

[20]Okogu (1995) reports that gasoline taxation rates, based on IEA data, in most OECD countries were in the 60–80 percent range in 1993. An important exception was the United States, where the rate of gasoline taxation was about 30 percent.

[21]According to the IEA (2001), total production costs—which include lifting, production, and finding and development costs—for different Canadian oil sands production facilities are in the $5–16 a barrel range. By way of comparison, the IEA (2001) and Goldman Sachs (2002) estimate total production costs at $4–5 a barrel in the Middle East and Russia, and at $10–11 a barrel in Europe and the United States.

[22]Analysts project that cumulative global investment of $1 trillion could be required at various stages of the oil production chain during 2000–30 to meet demand. Of this amount, a substantial portion would need to be invested in developing countries.

Output shares of the major oil-producing regions of the world are expected to change over time, with some of the highest oil-consuming countries increasing their imports of petroleum and petroleum products. Natural decline rates of several mature oilfields in the OECD countries, especially in the North Sea and the United States, have picked up.[23] While higher oil prices and drilling rates in recent years may boost production in the near term, output from these fields is likely to start declining over the longer term. An exception to the projected declining trend among OECD countries may be Canada, where increased investment to exploit oil sands resources could well offset the decline in conventional oil production. According to the IEA's baseline forecast, net oil imports by OECD countries will rise from 23.6 mbd in 2000 to almost 30 mbd in 2010.[24]

Production is likely to rise in several non-OPEC countries. Oil production in Russia, which had fallen from over 11 mbd in 1987 (about 18 percent of world output) to 6 mbd in 1996, has recovered to over 8 mbd at present, mainly on account of investment in repairs and maintenance. Such investment could well boost output further, although Russia's oil transport network is beginning to constrain its ability to export oil. Indeed, oil exports are currently at their highest historical levels because domestic consumption, which also fell sharply in the early 1990s, has not rebounded significantly. To further enhance export potential, several major pipeline projects are at various stages of planning and implementation, including a pipeline link to China. These projects, together with prospective investment in large drilling projects, should yield further oil output and export growth over the longer term, although there is considerable variation in views among analysts over the extent and timing of the increase in Russia's oil production capacity. Outside Russia, other major pipelines and investment projects, such as the Baku-Tbilisi-Ceyhan pipeline, are expected to raise the oil production and export potential of countries in the Caspian region, especially Azerbaijan and Kazakhstan. Recent discoveries of major offshore oil reserves have boosted longer-term production prospects for Brazil and Angola, although successful deployment of advanced deep water technologies will be critical in realizing this output potential. Increases in output are also projected by analysts for other countries in west Africa and for nonconventional oil in Venezuela.

With the bulk of the world's oil reserves and the lowest production costs, OPEC members clearly have the potential to increase production capacity markedly over the long term. The extent of the actual increase, however, will depend on expectations for the "call on OPEC"—the difference between world oil demand and non-OPEC supply—and the availability of investment funds. In view of the high population growth rate and young demographic structure in many OPEC countries, pressures for increased social spending are likely to intensify. This may constrain investment to expand oil production capacity over the longer term, especially since the scope for foreign investment is limited by the prohibition of foreign participation in the upstream oil sector in several countries. There is also considerable uncertainty regarding the call on OPEC over the medium to long term, particularly in view of the wide range of world oil demand forecasts and the uncertainty surrounding the timing and extent of non-OPEC supply expansion. Some analysts believe OPEC will continue to face lower market share over the longer term, while others expect some increase in OPEC output to offset declining production from mature oilfields elsewhere.

[23]OECD countries accounted for about 29 percent of world oil output of 76.6 mbd in 2002. The natural decline rate refers to the rate of decline in production in the absence of new investment in drilling additional wells and enhanced recovery techniques.

[24]See IEA (2002), Tables 3.1 and 3.4. As a share of non-OECD oil output, the IEA projects OECD net oil imports to ease slightly from 44 percent in 2000 to 43 percent in 2010.

Another key uncertainty relates to Iraq. Given its vast oil reserves, an increase in production capacity from 2.5–3 mbd at present to 6 mbd in the long term appears achievable. However, views vary widely over how long this might take and how much investment would be required. Some analysts believe that with a reasonably quick improvement in the security situation, foreign investment could start to flow in and capacity could double in five years. Others note that even with improved security, it will take time to put in place a conducive investment climate, and a marked increase in capacity is unlikely to materialize this decade.

Implications for the Global Economy

The projected decline in oil prices in the near term should help solidify the global economic recovery, and the outlook for further softening of oil prices should support the outlook for the global economy over the longer term. Indeed, there may well be an upside risk to the global outlook if, as many analysts expect, oil prices decline faster than implied by futures prices, on which the global macroeconomic projections are based. At the same time, lower oil prices would weaken growth prospects in oil-exporting countries and, in some cases, affect fiscal sustainability.

Oil prices are likely to remain volatile, however, and future shocks could again affect economic prospects. The uncertainties surrounding the near- and longer-term outlook for world oil demand and supply suggest that oil prices could deviate significantly from the path implied by futures markets. If the trend decline in industry oil inventories continues, the impact of shocks on world oil prices may be magnified, resulting in higher volatility. A further reduction in spare production capacity would have a similar effect. Moreover, since investment projects in the oil sector tend to be lumpy, oil production responds to prices with a lag and in discrete steps. Such a pattern may explain why shocks have persistent effects on oil prices, and possibly also suggests that the eventual (sizable) adjustment of output may result in a sharp movement of prices in the opposite direction.

Increased cooperation efforts between oil-producing and oil-consuming countries may help reduce oil price volatility, thereby reducing the uncertainties surrounding the longer-term global growth outlook. To this end, the International Energy Forum (IEF) was formed in 1991 to promote dialogue between energy producers and consumers. Participation in the IEF's ministerial meetings has increased to 65 countries over the past decade, and a secretariat of the IEF is soon to be established in Riyadh. Important initiatives being undertaken by the IEF, in cooperation with various international organizations and forums, include the Joint Oil Data Exercise, which aims to assess and improve the quantity, quality, and timeliness of monthly oil data, and efforts to enhance transparent information flow on oil market developments.

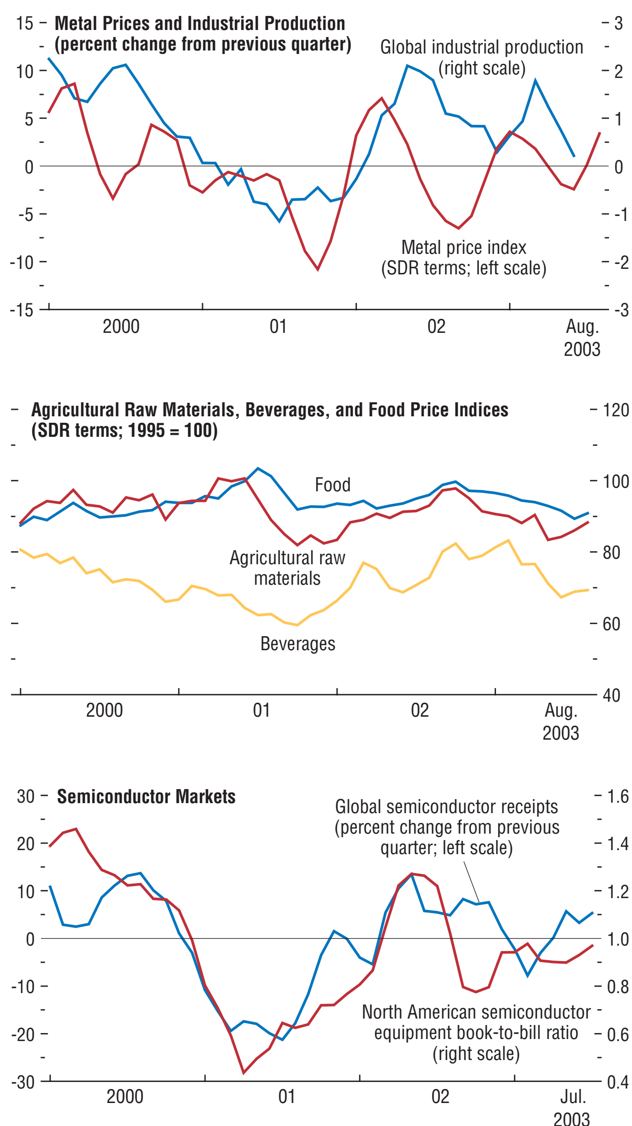
Appendix 1.2. Nonenergy Commodity Prices and Semiconductor Markets

The main authors of this appendix are Aasim Husain and Ximena Cheetham. Ivan Guerra and Paul Nicholson provided research assistance.

Nonenergy commodity prices were dampened in the first half of 2003 by weak demand due to war-related uncertainties, SARS-related concerns, and the slower-than-anticipated pace of economic activity. In addition, some unwinding of last year's supply shocks—principally weather-related—led to a reversal of part of the gains in prices during the latter part of 2002. As a result, the nonenergy commodity price index fell by 3.8 percent in Special Drawing Right (SDR) terms in the first half of the year. Owing to the depreciation of the U.S. dollar against other major currencies, however, nonenergy commodity prices rose in dollar terms by 1.6 percent during the first half of 2003.

Looking forward, stronger demand as the global recovery gains momentum is expected to lead to some firming of nonenergy commodity prices toward the end of this year and into next

Figure 1.23. Nonenergy Commodities and Semiconductors



Sources: World Semiconductor Trade Statistics; Semiconductor Equipment and Materials International; and IMF staff estimates.

year. In view of the softening of prices so far this year, however, the nonenergy price index is projected to ease by about 2½ percent in SDR terms (but increase by 5 percent in dollar terms) on an annual average basis in 2003, before recovering by 2 percent in 2004. Aside from the possibility of further weather-related or other supply shocks, nonenergy commodity price prospects will clearly be affected by the pace of the global economic recovery, particularly the more cyclically responsive commodity prices such as industrial metals.

Recent developments in industrial metals prices highlight their relationship with global industrial activity (Figure 1.23). Metals prices eased in SDR terms during the second and third quarters of last year as global economic prospects weakened, before picking up moderately toward the end of 2002 and the start of 2003 as overall economic indicators strengthened. However, prices of industrial metals softened once again in the second quarter of this year as the pace of the global recovery proved more tepid than previously expected.

Prices of agricultural raw materials and food and beverage commodities have also eased so far this year, although this appears mainly to be related to the dissipation of the major supply shocks last year. Among food items, cereals prices have fallen markedly from last year's drought-induced peaks and are now near average price levels (in SDR terms) prevailing in 2001. Vegetable oils and meals prices have also edged down this year, but have been supported by a sizable increase in imports by China. Among beverages, cocoa prices have eased markedly on account of stronger-than-expected production and as the anticipated disruptions to export deliveries owing to civil unrest in Côte d'Ivoire did not materialize. While the effects of last year's drought have begun to wear off, coffee prices have drawn support in recent months from crop destruction and increased export retention in some coffee-producing countries. Among agricultural raw materials, wool prices have declined markedly in recent months as wool imports to China slowed sharply amid

SARS concerns. Cotton prices, though well above year-ago levels, have also eased in recent months owing to weaker demand growth in the United States. Rubber prices, by contrast, have risen in the first half of 2003 on increased demand by tire producers, particularly in China.

Global semiconductor sales and other indicators of concurrent activity in the semiconductor sector have started to recover from setbacks in the first part of the year on account of the tepid pace of global economic activity and SARS-related concerns. However, forward-looking indicators such as orders for semiconductor equipment—which is used to produce semiconductors—and surveys of companies' IT-related investment spending plans remain sluggish. While equity prices for the tech sector have outperformed broader stock indices so far in 2003, the outlook for the sector remains tied to overall economic prospects.

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