

With the global recovery strengthening and broadening, the IMF staff's baseline forecast has been revised upward significantly, with global GDP growth in 2004 and 2005 now projected at about 4½ percent (Figure 1.1, Table 1.1). With global trade rising sharply, financial markets buoyant, and the U.S. economy rebounding, the balance of risks has significantly improved. In the short run it is possible that global growth may be higher than projected, although geopolitical risks—including terrorist attacks—and oil prices have become increasing concerns. But significant challenges and risks remain, including achieving an orderly resolution of global imbalances, notably the large U.S. current account deficit and surpluses elsewhere; addressing difficult medium-term fiscal situations in many industrial and emerging market economies; and managing the eventual transition to higher interest rates. While policymakers need to continue to ensure that the recovery is sustained, the focus increasingly needs to shift toward these issues, including through a credible and cooperative approach to addressing global imbalances, and to rebuilding room for policy maneuver to deal with unexpected shocks. In both advanced and developing countries it will be essential to take advantage of the recovery to press ahead with the structural reforms needed to improve growth potential, flexibility, and resilience, and to resist protectionist pressures.

Since the last *World Economic Outlook* in September 2003, the global recovery has strengthened and broadened. Industrial production has picked up sharply, accompanied by a strong rebound in global trade (Figure 1.2); business, and to a lesser extent consumer, confidence has strengthened; and investment growth—essential to sustain the recovery—has turned solidly positive in almost all regions. In the second half of 2003, global GDP growth averaged nearly 6 percent at an annualized rate, the highest since late 1999. While this was in part due to one-off factors—notably a surge in consumption in the United States due to the short-term impact of tax cuts and mortgage refinancing, and the rebound from the slowdown related to Severe Acute Respiratory Syndrome (SARS) in Asia—recent data suggest that global GDP growth has remained solid in early 2004.

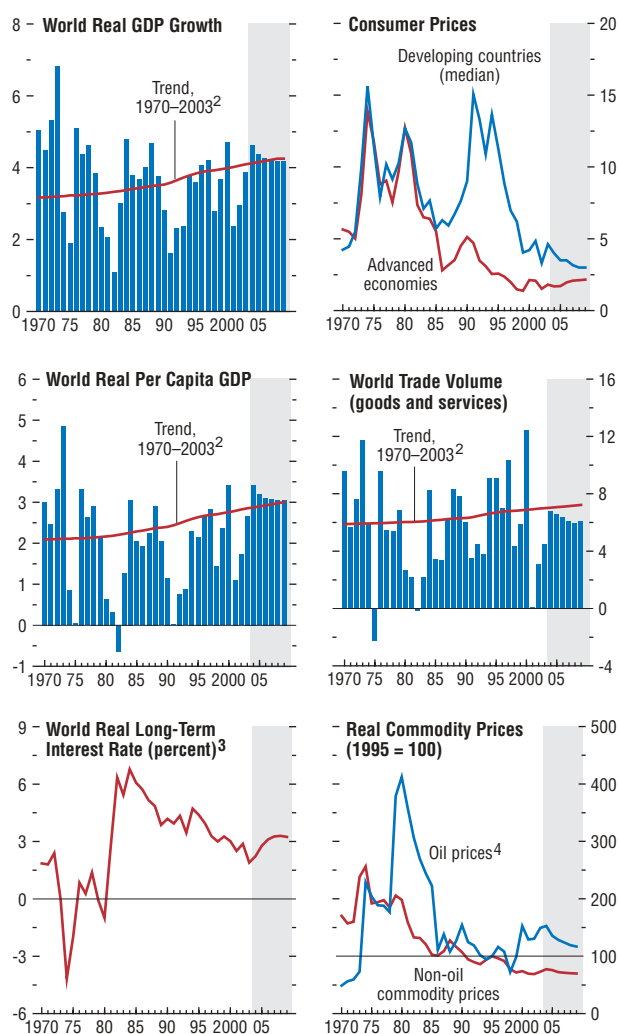
While a recovery now appears under way in all regions, its pace and nature vary significantly. To date, the upturn is most rapid in emerging

Asia, particularly China, and the United States; it is least well-established in the euro area, where consumption remains weak and some key forward-looking indicators have fallen back or moved sideways in recent months. Differences in the strength of domestic demand, with respect to both consumption and investment, are particularly noticeable. Among the industrial countries, domestic demand is generally strongest in those countries with the largest current account deficits, so that the recovery is tending to exacerbate underlying imbalances (Figure 1.3). And while domestic demand growth has picked up substantially in emerging Asia, the regional current account surplus remains very large, with exports supported by the rebound in the information technology (IT) sector as well as depreciating exchange rates.

Exchange market developments have been dominated by a further decline in the U.S. dollar, driven primarily by concerns over the sustainability of the U.S. current account

Figure 1.1. Global Indicators¹
(Annual percent change unless otherwise noted)

With the recovery increasingly established, global growth is expected to rise above trend in 2004, while inflation remains subdued.



¹Shaded areas indicate IMF staff projections. Aggregates are computed on the basis of purchasing-power-parity weights unless otherwise noted.
²Average 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.
³GDP-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.
⁴Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil.

deficit.¹ Notwithstanding some rebound since late February, the U.S. dollar has depreciated by 3¼ percent in trade-weighted terms since the Group of Seven (G-7) statement on exchange rate issues of September 19, 2003—a cumulative decline of 16½ percent from its peak in February 2002. To date, the adjustment has been relatively orderly, with little sign of stress in other financial markets, and volatility in currency markets is close to historical norms. However, the distribution of corresponding appreciations across countries and regions has remained uneven, focused primarily on the euro and a number of other industrial country currencies (Figure 1.4), including, increasingly, the yen—the latter despite substantial official intervention. Emerging market currencies, while generally appreciating somewhat against the U.S. dollar, have depreciated in trade-weighted terms. In Asia, this has been accompanied by substantial intervention and a further buildup in official reserves.

Elsewhere in financial markets, the broad-based rally has continued, with some consolidation since February, particularly following the terrorist attacks in Madrid and with rising geopolitical uncertainties elsewhere. Since the last *World Economic Outlook*, equity prices have risen strongly in both mature and emerging markets; bond spreads have dropped further, particularly for high-yield corporates and emerging markets; and financing flows to emerging markets have rebounded, with net private inflows rising to \$140 billion in 2003 (Figures 1.5 and 1.6; Table 1.2). This generalized shift toward riskier assets was partly due to actual (and perceived) improvements in fundamentals—notably, the strengthening recovery, rising corporate profitability, and improving credit quality in both corporate and emerging markets—but clearly also reflected more temporary factors, notably easy monetary conditions and abundant liquidity. Given concerns that markets were becoming

¹See the IMF’s April 2004 *Global Financial Stability Report* for a detailed discussion of financial market developments and issues.

Table 1.1. Overview of the World Economic Outlook Projections
(Annual percent change unless otherwise noted)

	2002	2003	Current Projections		Difference from September 2003 Projections ¹	
			2004	2005	2003	2004
World output	3.0	3.9	4.6	4.4	0.6	0.6
Advanced economies	1.7	2.1	3.5	3.1	0.3	0.6
United States	2.2	3.1	4.6	3.9	0.5	0.7
Euro area	0.9	0.4	1.7	2.3	—	-0.1
Germany	0.2	-0.1	1.6	1.9	-0.1	—
France	1.2	0.2	1.8	2.4	-0.3	-0.2
Italy	0.4	0.3	1.2	2.0	-0.1	-0.4
Spain	2.0	2.4	2.8	3.3	0.2	—
Japan	-0.3	2.7	3.4	1.9	0.7	1.9
United Kingdom	1.7	2.3	3.5	2.5	0.7	1.0
Canada	3.3	1.7	2.6	3.1	-0.2	-0.4
Other advanced economies	2.8	1.9	3.2	3.5	0.2	0.3
Newly industrialized Asian economies	5.1	3.0	5.3	5.0	0.7	1.1
Other emerging market and developing countries	4.6	6.1	6.0	5.9	1.0	0.6
Africa	3.5	4.1	4.2	5.4	0.4	-0.4
Sub-Saharan	3.5	3.5	4.2	5.7	0.4	-0.6
Central and eastern Europe	4.4	4.5	4.5	4.4	0.6	0.1
Commonwealth of Independent States	5.1	7.6	6.0	5.2	1.7	0.9
Russia	4.7	7.3	6.0	5.3	1.4	1.0
Excluding Russia	6.2	8.1	5.9	5.0	2.5	0.7
Developing Asia	6.4	7.8	7.4	7.0	1.4	0.9
China	8.0	9.1	8.5	8.0	1.6	1.0
India	4.7	7.4	6.8	6.0	1.8	0.9
ASEAN-4 ²	4.3	5.0	5.4	5.4	0.9	1.0
Middle East	4.2	5.4	4.1	5.0	0.5	-0.2
Western Hemisphere	-0.1	1.7	3.9	3.7	0.1	0.4
Brazil	1.9	-0.2	3.5	3.5	-1.7	0.5
Mexico	0.7	1.3	3.3	3.3	-0.1	-0.2
<i>Memorandum</i>						
World growth based on market exchange rates	1.8	2.7	3.8	3.5	0.5	0.6
World trade volume (goods and services)	3.1	4.5	6.8	6.6	1.6	1.3
Imports						
Advanced economies	2.3	3.5	5.7	5.4	0.6	1.0
Other emerging market and developing countries	6.2	8.9	10.2	9.4	3.5	2.3
Exports						
Advanced economies	1.9	2.7	6.3	6.1	1.1	1.2
Other emerging market and developing countries	6.5	8.7	8.1	8.7	4.1	1.4
Commodity prices (U.S. dollars)						
Oil ³	2.5	15.8	3.8	-10.0	1.6	14.4
Nonfuel (average based on world commodity export weights)	0.5	7.1	7.6	-0.8	2.0	5.2
Consumer prices						
Advanced economies	1.5	1.8	1.7	1.7	—	0.4
Other emerging market and developing countries	6.0	6.1	5.7	5.0	-0.1	0.5
Six-month London interbank offered rate (LIBOR, percent)						
On U.S. dollar deposits	1.9	1.2	1.3	3.5	—	-0.7
On euro deposits	3.3	2.3	2.1	2.6	0.1	-0.3
On Japanese yen deposits	0.1	0.1	0.1	0.4	—	-0.1

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during February 13–March 12, 2004.

¹Using updated purchasing-power-parity (PPP) weights, summarized in the Statistical Appendix, Table A.

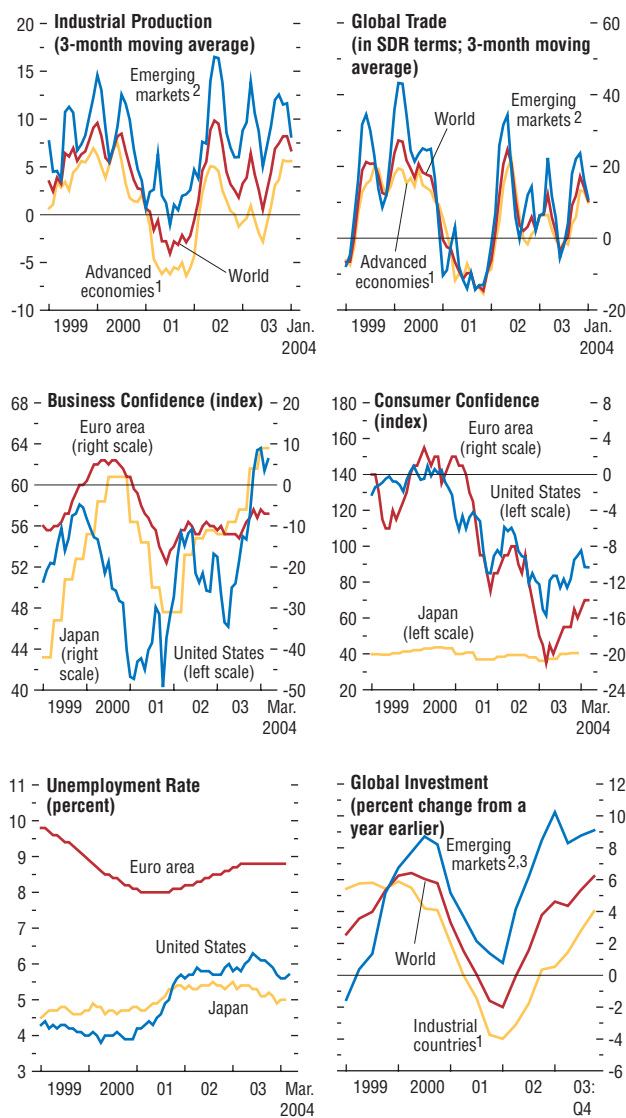
²Includes Indonesia, Malaysia, the Philippines, and Thailand.

³Simple 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 \$28.89 in 2003; the assumed price is \$30.00 in 2004, and \$27.00 in 2005.

Figure 1.2. Current and Forward-Looking Indicators

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

Industrial production and trade growth rebounded in the second half of 2003, accompanied by improvements in forward-looking indicators, particularly business confidence.



Sources: Business confidence for the United States, the Institute for Supply Management; 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, Bulgaria, Chile, China, Colombia, Czech Republic, Estonia, Hong Kong SAR, Hungary, India, Indonesia, Israel, Korea, Latvia, Lithuania, Malaysia, Mexico, Pakistan, Peru, the Philippines, Poland, Romania, Russia, Singapore, Slovak Republic, Slovenia, South Africa, Taiwan Province of China, Thailand, Turkey, Ukraine, and Venezuela.
³ Data for China, India, Pakistan, and Russia are interpolated.

richly valued, the recent consolidation is a welcome development, especially since it is being accompanied by signs of greater investor discrimination. Notwithstanding the deterioration in fiscal positions, long-run interest rates remain unusually low by historical standards, apparently partly reflecting expectations that monetary policy will remain accommodative for a significant period, but also due to cyclical factors (including the rebound in U.S. corporate profitability, which has so far allowed the pickup in investment to be financed without substantial recourse to borrowing).

The increasingly rapid global recovery, combined with currency developments, has also fed through to commodity prices (see Appendix 1.1). Oil prices have climbed markedly, with spot prices rising from \$26½ a barrel in September 2003 to \$34 a barrel in mid-April 2004. A significant portion of this increase appears to reflect the depreciation of the U.S. dollar (with a correspondingly limited impact on global growth). The remainder is due to higher-than-expected demand, particularly in the United States and China; relatively low inventories; earlier delays in restoring Iraq's oil production; OPEC announcements of prospective production cuts; and sizable speculative activity. Since late March, price swings have been especially pronounced; as of April 13, futures markets suggest that oil prices will average about \$32½ a barrel for 2004 as a whole, about 8 percent higher than assumed in the macroeconomic projections. Consequently, potential for considerable volatility remains, with much depending on the outlook for demand, geopolitical developments, the inventories situation, and the extent and pace at which speculative positions are unwound. Nonfuel commodity prices have also rallied, increasing by about 10 percent in SDR terms since mid-2003, with metals (traditionally the most cyclical commodity) and food and agricultural raw materials experiencing the largest gains. While nonfuel prices are expected to stay firm, they remain moderate by historical standards (Figure 1.1) and their average pace of increase is likely to slow in 2004 as earlier agricultural supply shocks unwind and

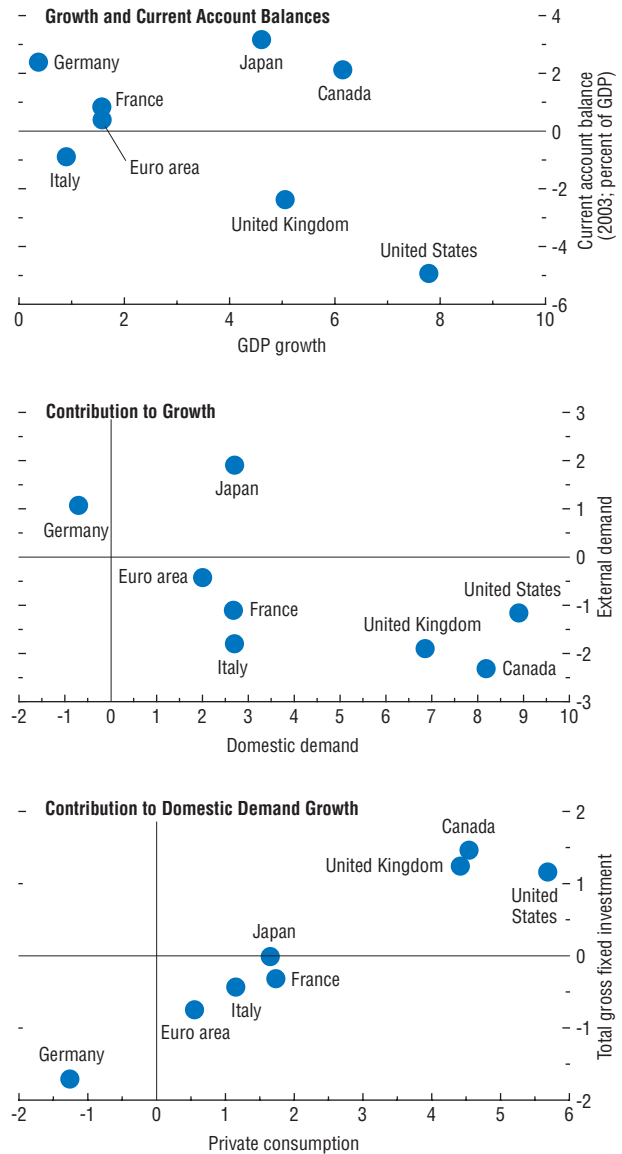
metals production responds to higher prices. Activity in the semiconductor market picked up strongly during 2003, and—despite some recent slackening—forward-looking indicators generally signal further strength ahead.

Inflation—with a very few exceptions—remains subdued (Table 1.3). Consumer price inflation in advanced countries averaged 1.8 percent in 2003, and—withstanding rising commodity prices—is projected to remain moderate in 2004, reflecting continued excess capacity, weak labor markets, and limited producer pricing power in the face of strong domestic and global competition. Inflation in other emerging market and developing countries is also now in (or very close to) the single digits in every major region. Even so, concerns about deflation have moderated, reflecting growing confidence that the recovery will be sustained, rising commodity prices, and commitments by several central banks to aggressively address deflationary pressures were they to arise. In emerging Asia, while inflation is still low, it is edging upward; and in China, concerns about falling prices have given way to worries about overheating and the risk of inflationary pressures.

With the global recovery proceeding more rapidly than anticipated at the time of the last *World Economic Outlook*, the IMF staff's baseline forecast has been revised upward markedly. Global growth in 2003 is now estimated at 3.9 percent, rising to 4.6 percent in 2004 (both 0.6 of a percentage point higher than expected last September) and slowing slightly to 4.4 percent in 2005. This is expected to be underpinned by continued policy stimulus already in the pipeline; the improving situation in the corporate sector, including a strong rebound in corporate profits, favorable financing conditions, and renewed strength in IT; wealth effects from the rise in equity markets over the past year; and a further pickup in inventories. The forecast assumes that monetary policy in the United States is tightened moderately with interest rates beginning to rise in the second half of 2004, that monetary policy in the euro area remains broadly unchanged this year, and

Figure 1.3. G-7: The Differing Nature of the Recovery
(Percent change from 2001Q3 to 2003Q4)

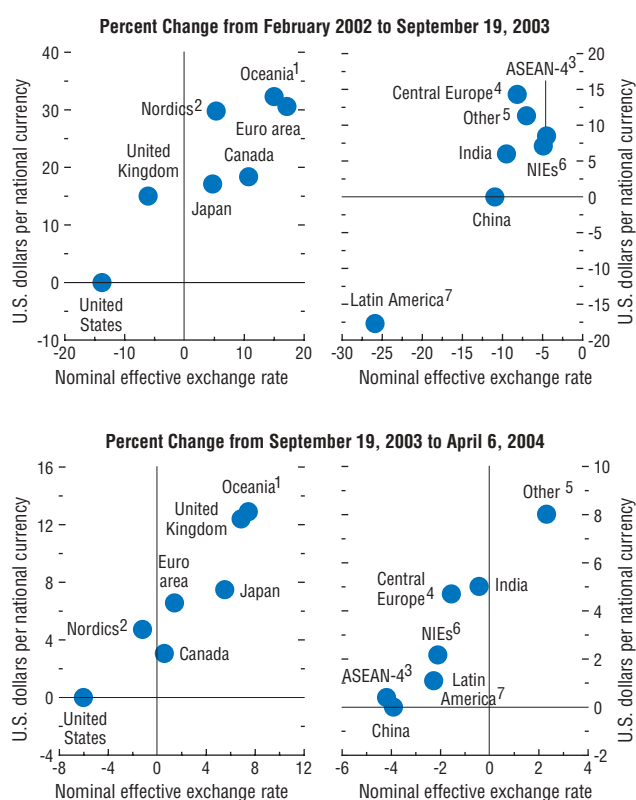
The strength and nature of the recovery has varied significantly across G-7 countries, with domestic demand—particularly consumption—being strongest in those countries with largest current account deficits.



Sources: Haver Analytics; and IMF staff calculations.

Figure 1.4. Global Exchange Rate Developments
(Percent)

Since the G-7 statement on exchange rate issues of September 19, 2003, the depreciation of the dollar has continued to be matched by appreciation of the euro, yen, and some other industrial country currencies; emerging market currencies have depreciated further in nominal effective terms.



Sources: Bloomberg Financial, LP; and IMF staff calculations.

¹Australia and New Zealand.

²Denmark, Norway, and Sweden.

³Indonesia, Malaysia, the Philippines, and Thailand.

⁴Czech Republic, Hungary, and Poland.

⁵Russia, Turkey, and South Africa.

⁶Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.

⁷Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

that quantitative easing in Japan continues. Fiscal policies vary widely; they are expected to be expansionary in the United States and Italy, and neutral or mildly contractionary elsewhere (Figure 1.7; Table 1.4; Box A1 in the Statistical Appendix). As usual, the *World Economic Outlook* projections are based on the assumption that real effective exchange rates remain unchanged over the forecast period.

The projected pace and nature of the recovery in individual countries and regions vary considerably, reflecting differing degrees of policy stimulus; exchange rate developments; progress in corporate restructuring; openness, and therefore ability to benefit from rising global trade, especially in IT; and region-specific developments (Figure 1.8):

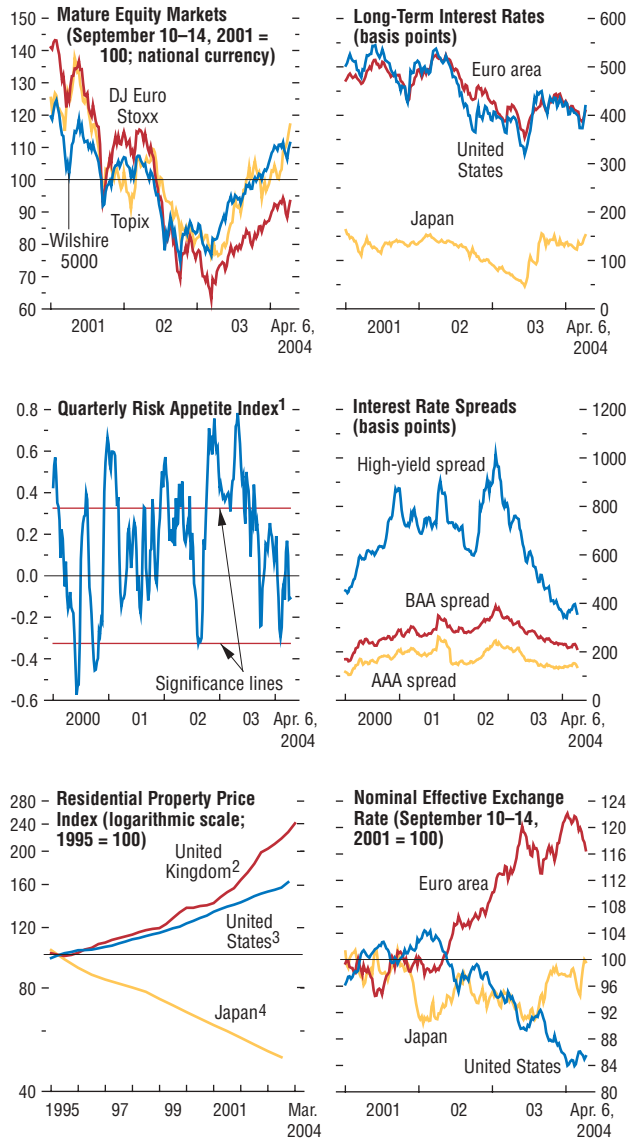
- In *industrial countries*, the recovery is again projected to be strongest in the United States, with GDP growth rebounding to 4.6 percent in 2004, accompanied by continued strong productivity growth. With the impact of past fiscal and monetary stimulus waning during 2004, much will depend on continued solid investment growth and a sustained pickup in employment (of which there are only tentative signs as yet). In the euro area, the recovery remains subdued; while there are signs of a pickup in fixed investment, household consumption remains weak. Solid household balance sheets and equity market gains are expected to support a gradual strengthening in domestic demand but, with relatively less policy stimulus in the pipeline and corporate restructuring apparently having some way to go, downside risks remain and much continues to depend on external demand, the traditional driver of European recoveries. In Japan, GDP growth has continued to exceed expectations, with strong external demand—notably from China—accompanied by rising investment and latterly a pickup in consumption. Looking forward, GDP growth is projected at 3.4 percent in 2004, the highest since 1996, moderating thereafter, with deflation and corporate and banking system weaknesses remaining concerns. In both Europe

and Japan, a further sharp currency appreciation would be a key short-term risk.

- Emerging market and developing countries* have also seen a rebound in activity, with GDP growth projections for 2004 marked up—to varying extents—in most major regions. The growth momentum has been particularly strong in *emerging Asia*, where GDP growth is projected to remain at 7.2 percent in 2004, the highest level since before the 1997/98 crisis, underpinned by accommodative macroeconomic policies, competitive exchange rates, and the recovery in the IT sector. Buoyant growth in China, underpinned by rapid increases in investment and exports, has provided important support to activity in countries within and outside the region; GDP growth in India has also exceeded expectations, aided by favorable rainfall and low domestic interest rates. With trade expanding rapidly, GDP growth and current account surpluses in Asia could both be higher than projected. In *Latin America*, while GDP growth—notably in Brazil—remained weak in 2003, the recovery is expected to consolidate in 2004, underpinned by strengthening domestic demand, higher commodity prices, and the global recovery. With many countries in the region facing substantial external financing requirements over the medium term, a reversal of the currently benign external financing conditions—for example, owing to higher interest rates in industrial countries—remains an important risk. In the *Middle East*, growth is expected to fall back from the relatively high levels of 2003, mainly owing to slower growth in oil production, but to remain robust; while oil prices are presently favorable, the medium-term outlook remains a key risk, especially given difficult fiscal situations in a number of countries. GDP growth in the *Commonwealth of Independent States* has also exceeded expectations, underpinned by robust upturns in Russia and Ukraine, including—encouragingly—some pickup in nonenergy sector investment. In *central and eastern Europe*, a more moderate upturn is pro-

Figure 1.5. Developments in Mature Financial Markets

The rebound in mature financial markets has continued, accompanied by a further decline in credit spreads. Long-run interest rates have stabilized, and remain relatively low by historical standards.

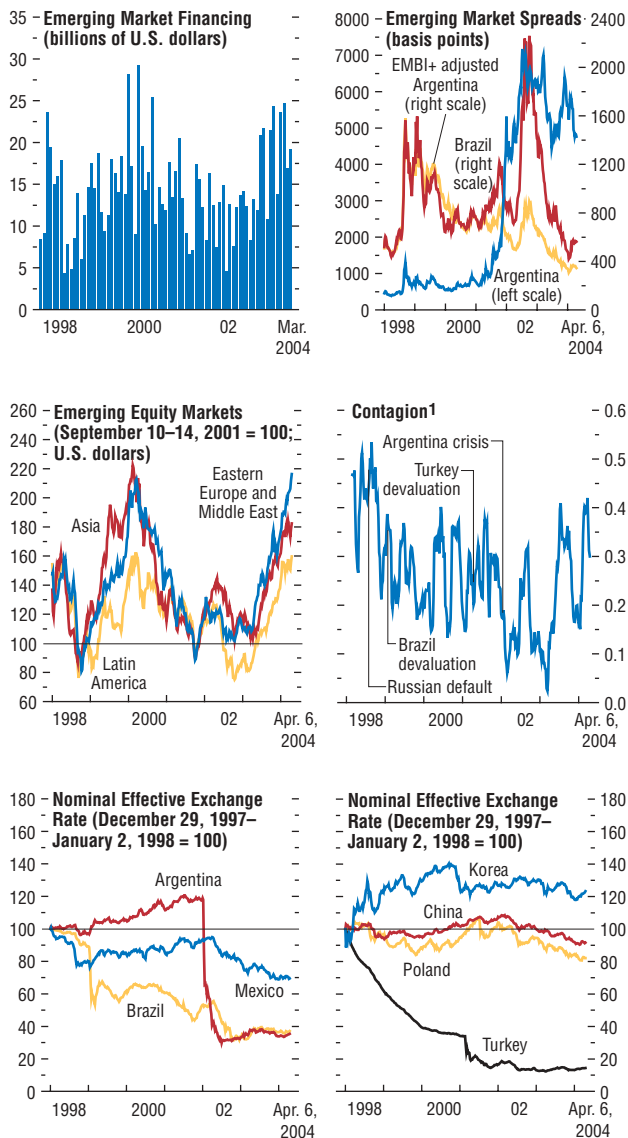


Sources: Bloomberg Financial Markets, LP; State Street Bank; HBOS Plc.; Office of Federal Housing Enterprise Oversight; Japan Real Estate Institute; and IMF staff calculations.

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 in the United States as a whole, in various regions of the country, and in the individual states and the District of Columbia.
⁴ Urban land price index: average of all categories in six large city areas.

Figure 1.6. Emerging Market Financial Conditions

Gross inflows to emerging markets have picked up sharply, while spreads remain very low by historical standards.



Sources: Bloomberg Financial Markets, LP; Capital Data; and IMF staff calculations.
¹Average of 30-day rolling cross-correlation of emerging debt market spreads.

jected, constrained by the relatively weak performance of the euro area and the need for fiscal consolidation in many countries.

- Among the *poorest countries*, GDP growth in sub-Saharan Africa (excluding South Africa) jumped to 4.4 percent in 2003, aided by surging oil production in Nigeria. GDP growth in the region is expected to strengthen further in 2004, reflecting a combination of improving macroeconomic fundamentals; higher commodity prices; better weather conditions (Ethiopia); and—last but not least—rising oil and gas production in several countries. While the projected increase in GDP growth is encouraging, *World Economic Outlook* projections of growth in Africa have consistently been overoptimistic in the past, in part reflecting unanticipated political instability—in this context, the recent deterioration in Côte d’Ivoire is cause for concern—or natural disasters.²

With the global recovery becoming increasingly well established, the balance of risks has significantly improved. Indeed, notwithstanding higher oil prices, a number of factors could generate a more robust short-term upturn in some regions, including the strong rebound in world trade; the generalized rebound in financial markets; and the continued strength of the U.S. economy, which is often a leading indicator of developments elsewhere. It is also relevant to note that, just as forecasters tend to be overoptimistic during downturns, they tend to be overly pessimistic during recoveries. That said, there are two important caveats. First, as recent events in Madrid and elsewhere underscore, geopolitical uncertainties remain an important—if difficult to quantify—risk; and further oil price volatility remains a concern. Second, looking forward, the global economy continues to face significant risks, some of which have been exac-

²In spring *World Economic Outlooks* since 1990, sub-Saharan African GDP growth for the current year has been overestimated on average by 1 percentage point, and GDP growth in the succeeding year, by 1.7 percentage points.

Table 1.2. Emerging Market and Developing Countries: Net Capital Flows¹*(Billions of U.S. dollars)*

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total²										
Private capital flows, net ³	217.8	177.6	77.4	86.6	42.2	20.6	47.0	131.2	162.9	100.9
Private direct investment, net	116.0	144.0	153.0	171.2	175.0	189.1	139.3	119.3	135.5	143.3
Private portfolio investment, net	85.0	62.8	38.4	66.0	6.1	-95.7	-98.6	-87.5	-43.9	-36.9
Other private capital flows, net	16.8	-29.2	-114.0	-150.6	-139.0	-72.8	6.3	99.3	71.2	-5.5
Official flows, net	-5.1	48.3	47.3	6.4	-14.5	25.8	3.3	-7.2	-20.0	-18.0
Change in reserves ⁴	-91.2	-104.1	-34.6	-92.7	-116.9	-113.5	-196.0	-363.9	-303.8	-175.7
Memorandum										
Current account ⁵	-95.4	-80.8	-51.4	38.8	128.9	88.1	145.8	207.3	162.5	111.0
Africa										
Private capital flows, net ³	9.1	4.0	9.1	11.8	1.1	6.5	7.2	9.5	13.2	16.8
Private direct investment, net	3.6	7.9	6.9	9.8	8.2	23.9	12.3	14.3	13.7	15.8
Private portfolio investment, net	2.8	7.0	3.7	8.3	-2.2	-8.8	-0.7	1.8	2.5	3.4
Other private capital flows, net	2.7	-10.9	-1.6	-6.3	-4.9	-8.5	-4.4	-6.6	-3.0	-2.4
Official flows, net	-3.0	3.3	4.7	3.5	3.1	1.9	4.2	4.1	4.2	2.7
Change in reserves ⁴	-6.7	-11.2	2.7	-3.4	-13.2	-12.5	-7.6	-14.4	-13.5	-11.4
Central and eastern Europe										
Private capital flows, net ³	25.6	21.8	27.3	34.5	33.4	-1.1	43.8	43.5	45.7	48.1
Private direct investment, net	10.4	11.6	18.0	21.3	22.9	22.7	23.1	13.2	18.2	20.9
Private portfolio investment, net	1.3	5.4	-2.4	4.3	3.6	-0.2	0.7	3.9	5.7	6.7
Other private capital flows, net	13.9	4.8	11.8	8.8	6.9	-23.6	20.0	26.4	21.7	20.5
Official flows, net	—	-2.8	1.1	-2.0	2.7	6.5	-7.2	-5.7	-6.1	-6.5
Change in reserves ⁴	-7.3	-10.1	-9.6	-11.0	-3.1	6.1	-13.6	-11.1	-5.5	-7.8
Commonwealth of Independent States⁶										
Private capital flows, net ³	-7.9	16.3	4.5	-7.6	-15.1	-5.6	-9.7	4.8	-0.5	4.4
Private direct investment, net	4.9	5.9	5.3	4.3	2.4	5.0	4.2	3.6	4.3	4.0
Private portfolio investment, net	-0.1	17.6	7.7	-3.0	-6.0	-9.2	-8.2	-13.3	-8.5	-8.8
Other private capital flows, net	-12.7	-7.2	-8.5	-8.9	-11.5	-1.3	-5.7	14.6	3.7	9.3
Official flows, net	10.9	8.5	9.4	0.1	-3.4	-3.7	-1.1	-4.2	-1.7	-1.3
Change in reserves ⁴	2.1	-3.8	7.5	-2.0	-17.2	-11.3	-11.8	-31.9	-32.4	-25.7
Emerging Asia⁷										
Private capital flows, net ³	118.6	34.0	-50.6	2.7	-4.2	10.1	24.8	84.3	116.8	19.5
Private direct investment, net	53.4	56.5	56.1	66.4	67.4	60.5	53.1	49.3	56.0	54.9
Private portfolio investment, net	32.0	6.3	8.4	56.6	20.1	-54.4	-57.6	-58.4	-18.1	-19.7
Other private capital flows, net	33.1	-28.8	-115.0	-120.2	-91.7	4.0	29.3	93.4	78.9	-15.7
Official flows, net	-13.2	25.2	17.5	1.8	4.0	-2.0	-1.9	-8.6	-3.5	-6.7
Change in reserves ⁴	-46.1	-35.9	-52.6	-87.1	-60.8	-90.7	-157.8	-245.3	-234.8	-118.0
Middle East⁸										
Private capital flows, net ³	2.0	9.6	8.4	-7.9	-24.9	-16.3	-27.6	-22.9	-30.1	-16.3
Private direct investment, net	4.1	5.2	5.1	3.9	7.7	8.1	6.9	8.9	8.9	11.8
Private portfolio investment, net	1.0	-2.7	-6.2	-4.5	-12.3	-15.8	-19.0	-24.3	-27.5	-23.2
Other private capital flows, net	-3.1	7.2	9.5	-7.3	-20.4	-8.6	-15.4	-7.4	-11.4	-4.9
Official flows, net	7.4	6.7	5.2	6.6	-11.0	-3.2	-5.4	-11.0	-7.3	-2.8
Change in reserves ⁴	-18.0	-16.6	10.3	-0.2	-27.4	-10.6	-3.1	-25.6	-11.5	-6.7
Western Hemisphere										
Private capital flows, net ³	70.4	91.9	78.6	53.2	51.9	26.9	8.5	11.8	17.9	28.4
Private direct investment, net	39.6	56.9	61.5	65.5	66.4	68.9	39.6	30.0	34.6	36.0
Private portfolio investment, net	47.9	29.2	27.2	4.4	2.9	-7.2	-13.7	2.9	2.1	4.8
Other private capital flows, net	-17.1	5.8	-10.1	-16.6	-17.4	-34.7	-17.4	-21.1	-18.8	-12.4
Official flows, net	-7.2	7.3	9.5	-3.4	-9.9	26.3	14.6	18.2	-5.6	-3.4
Change in reserves ⁴	-15.2	-26.5	7.2	11.1	4.8	5.4	-2.0	-35.5	-6.1	-6.2
Memorandum										
Fuel exporters										
Private capital flows, net ³	-21.9	28.0	5.1	-25.7	-54.8	-32.4	-50.9	-21.7	-35.0	-12.8
Nonfuel exporters										
Private capital flows, net ³	239.8	149.6	72.3	112.3	96.9	52.9	97.9	152.9	197.9	113.7

¹Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing. In this table, Hong Kong SAR, Israel, Korea, Singapore, and Taiwan Province of China are included.

²Beginning with this issue, Hong Kong SAR is included in these totals and in the emerging Asia group.

³Because of data limitations, "other private capital flows, net" may include some official flows.

⁴A minus sign indicates an increase.

⁵The 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 25 of the Statistical Appendix.

⁶Historical data have been revised, reflecting cumulative data revisions for Russia and the resolution of a number of data interpretation issues.

⁷Consists of developing Asia and the newly industrialized Asian economies.

⁸Includes Israel.

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

	Real GDP				Consumer Prices				Unemployment			
	2002	2003	2004	2005	2002	2003	2004	2005	2002	2003	2004	2005
Advanced economies	1.7	2.1	3.5	3.1	1.5	1.8	1.7	1.7	6.4	6.6	6.4	6.3
United States	2.2	3.1	4.6	3.9	1.6	2.3	2.3	2.2	5.8	6.0	5.5	5.4
Euro area ¹	0.9	0.4	1.7	2.3	2.3	2.1	1.7	1.6	8.4	8.8	9.1	8.9
Germany	0.2	-0.1	1.6	1.9	1.3	1.1	1.0	0.9	8.6	9.9	10.2	10.0
France	1.2	0.2	1.8	2.4	1.9	2.2	1.8	1.6	8.8	9.3	9.4	9.1
Italy	0.4	0.3	1.2	2.0	2.6	2.8	2.1	2.0	9.0	8.7	8.4	8.2
Spain	2.0	2.4	2.8	3.3	3.9	3.0	2.7	2.7	11.4	11.3	10.8	10.1
Netherlands	0.2	-0.8	1.0	2.0	3.9	2.2	1.3	1.0	2.5	4.2	5.3	5.6
Belgium	0.7	1.1	1.8	2.4	1.6	1.5	1.4	1.4	7.3	8.1	8.3	8.2
Austria	1.4	0.7	1.4	2.4	1.7	1.3	1.3	1.3	4.3	4.4	4.4	4.1
Finland	2.3	1.9	2.9	2.5	2.0	1.3	0.7	1.0	9.1	9.0	8.8	8.5
Greece	3.8	4.2	4.0	3.0	3.9	3.6	3.3	3.1	9.9	9.8	9.7	9.8
Portugal	0.5	-1.3	0.8	2.7	3.7	3.3	2.1	1.9	5.1	6.4	7.1	6.8
Ireland	6.9	1.4	3.6	4.7	4.7	4.0	2.6	2.4	4.2	4.9	5.0	4.9
Luxembourg	1.3	1.2	2.3	3.3	2.1	2.6	2.1	1.7	3.0	4.1	4.9	5.5
Japan	-0.3	2.7	3.4	1.9	-0.9	-0.2	-0.4	-0.1	5.4	5.3	4.9	4.9
United Kingdom ¹	1.7	2.3	3.5	2.5	1.3	1.4	1.6	1.8	5.2	5.0	4.9	4.9
Canada	3.3	1.7	2.6	3.1	2.3	2.7	1.4	1.9	7.7	7.6	7.4	7.1
Korea	7.0	3.1	5.5	5.3	2.8	3.5	3.7	3.4	3.1	3.4	3.3	3.2
Australia	3.8	3.0	3.5	3.6	3.0	2.8	2.6	2.5	6.3	5.9	6.0	5.9
Taiwan Province of China	3.6	3.2	4.9	4.9	-0.2	-0.3	0.7	1.5	5.2	5.0	5.0	4.7
Sweden	2.1	1.6	2.5	2.7	2.0	2.3	1.2	2.1	4.0	4.9	4.8	4.5
Switzerland	0.2	-0.5	1.7	2.2	0.6	0.6	0.3	0.4	2.5	3.5	3.2	2.9
Hong Kong SAR	2.3	3.3	5.5	4.5	-3.0	-2.6	-0.5	0.8	7.3	7.9	6.4	5.3
Denmark	1.0	0.2	1.8	2.6	2.3	2.1	1.7	1.8	4.9	6.0	6.0	5.6
Norway	1.0	0.2	2.5	2.0	1.3	2.5	1.2	1.9	3.9	4.6	4.6	4.5
Israel	-0.8	1.3	2.4	3.4	5.7	0.7	-0.3	1.6	10.3	10.7	10.7	10.1
Singapore	2.2	1.1	5.0	4.0	-0.4	0.5	1.2	1.5	4.4	4.7	4.2	3.8
New Zealand ²	4.3	3.5	3.0	2.5	2.7	1.8	2.3	2.4	5.2	4.7	4.9	5.2
Cyprus	2.0	2.0	3.0	3.5	2.8	4.1	1.2	3.7	3.5	3.5	3.4	3.2
Iceland	-0.6	4.0	3.5	4.6	4.8	2.0	2.1	3.3	2.5	3.3	3.0	2.5
<i>Memorandum</i>												
Major advanced economies	1.4	2.2	3.5	3.0	1.3	1.7	1.6	1.6	6.5	6.8	6.5	6.4
European Union	1.1	0.8	2.0	2.4	2.2	2.0	1.7	1.7	7.7	8.2	8.3	8.1
Newly industrialized Asian economies	5.1	3.0	5.3	5.0	0.9	1.4	2.1	2.4	4.1	4.3	4.1	3.8

¹Based on Eurostat's harmonized index of consumer prices.²Consumer prices excluding interest rate components.

erated by the proactive policy stance required in the last few years. As discussed below, it is not impossible that a number of these risks could have near-term consequences, for both financial markets and the real economy more generally.

- *As stressed in many past issues of the World Economic Outlook, the continued large current account deficit in the United States—matched by a fiscal deficit of similar size—and surpluses elsewhere, notably in Asia, remain a serious concern (Table 1.5).* In this regard, the depreciation of the U.S. dollar since early 2002 has been helpful, although corresponding appreciations

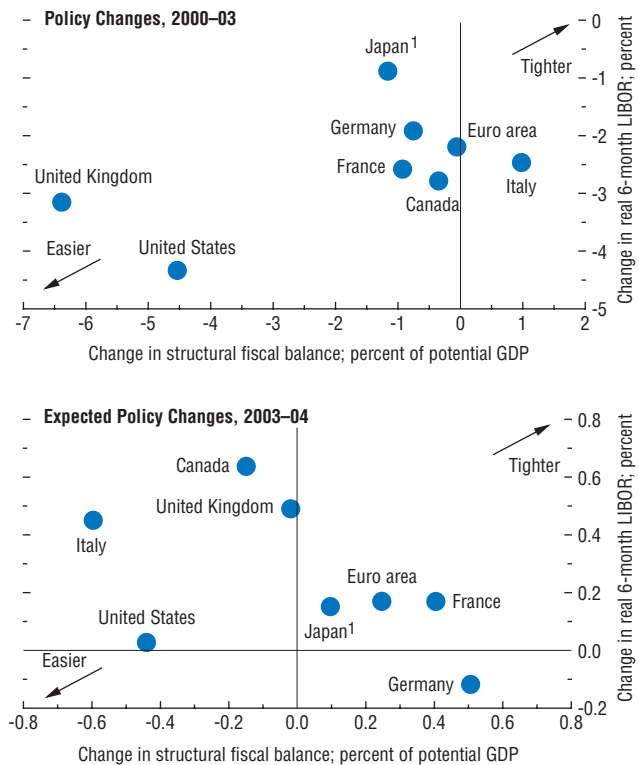
have so far been unduly concentrated on a number of industrial country currencies, many with weak cyclical positions. However, in part because domestic demand continues to increase more rapidly than in its major trading partners, the U.S. current account deficit is projected to fall only modestly to 4 percent by 2009, suggesting that further U.S. dollar depreciation over the medium term may well be needed. It is possible that this process could unfold benignly, especially if strong U.S. productivity growth is maintained. As Chairman Greenspan has noted, the relative flexi-

bility of the U.S. economy, and growing global financial integration, which should reduce the difficulties in financing deficits, are also positive factors. Even so, there are two clear concerns. First, as historical experience attests, even an orderly current account adjustment in the United States would likely be associated with a slowdown in GDP growth, as U.S. national saving rises and/or investment falls, especially if growth were not to pick up in the rest of the world.³ Second, a more disorderly adjustment—including abrupt movements in exchange rates—cannot be ruled out. This would have significantly more serious consequences, with potential spillovers into other financial markets, including through higher U.S. interest rates (see Box 1.1). The growing importance of official purchases of U.S. assets by Asian central banks may reduce risks of disorderly adjustment in the short run, but if sustained they could raise these risks in the longer term, given the domestic and international difficulties associated with rapidly rising external reserves.

- *Global interest rates are very low, and will eventually have to rise substantially, but the timing and speed of future moves remain subject to considerable uncertainty.* As stressed in the IMF’s *Global Financial Stability Report*, in a low-interest-rate environment there is a danger that asset prices, which have already rebounded substantially, could get ahead of fundamentals, and that future interest rate rises—especially if abrupt or unexpected—could lead to financial market volatility and possibly adversely affect the recovery. This is a particular concern in countries with buoyant property markets, including the United Kingdom, Australia, Ireland, and Spain, and to a lesser degree the United States and New Zealand (Box 1.2). In addition, while emerging market countries have taken advantage of benign financing conditions to improve the structure of their liabilities, the continued

Figure 1.7. Fiscal and Monetary Easing in the Major Advanced Countries
(Percent)

Real interest rates are projected to rise in major advanced countries in 2004, accompanied by a shift toward fiscal consolidation (except in the United States).



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

³See “How Worrisome Are External Imbalances?” Chapter III, *World Economic Outlook*, September 2002, for a detailed discussion.

Table 1.4. Major Advanced Economies: General Government Fiscal Balances and Debt¹
(Percent of GDP)

	1988–97	1998	1999	2000	2001	2002	2003	2004	2005	2009
Major advanced economies										
Actual balance	-3.6	-1.3	-1.0	—	-1.5	-3.7	-4.7	-4.5	-3.6	-2.8
Output gap ²	-0.2	0.1	0.5	1.3	-0.5	-1.7	-2.1	-1.2	-0.8	—
Structural balance	-3.4	-1.4	-1.3	-1.0	-1.5	-3.0	-3.7	-3.8	-3.2	-2.8
United States										
Actual balance	-3.6	0.4	0.9	1.6	-0.2	-3.3	-4.9	-4.8	-3.5	-3.0
Output gap ²	-0.9	0.9	1.9	2.2	-0.7	-1.9	-2.2	-1.0	-0.5	—
Structural balance	-3.3	—	—	0.6	—	-2.5	-3.9	-4.4	-3.3	-3.0
Net debt	61.5	57.6	53.8	48.9	47.1	48.2	49.7	50.5	51.6	54.5
Gross debt	67.2	66.1	62.2	57.7	55.8	56.8	58.5	59.6	61.3	64.0
Euro area										
Actual balance	...	-2.3	-1.3	-0.9	-1.7	-2.3	-2.8	-2.8	-2.4	-0.9
Output gap ²	...	-0.4	0.2	1.3	0.7	-0.5	-2.1	-2.4	-2.2	-0.1
Structural balance	...	-1.9	-1.3	-1.6	-2.1	-2.1	-1.6	-1.4	-1.2	-0.8
Net debt	...	61.8	61.6	59.1	58.8	58.7	60.0	60.2	60.1	55.2
Gross debt	...	73.6	72.2	69.7	69.4	69.2	70.4	70.6	70.3	64.7
Germany³										
Actual balance	-2.4	-2.2	-1.5	1.3	-2.8	-3.5	-4.0	-3.5	-3.1	-1.8
Output gap ²	0.6	-0.4	-0.1	0.9	0.3	-0.9	-2.5	-2.5	-2.2	—
Structural balance ⁴	-2.6	-1.7	-1.2	-1.6	-2.9	-2.9	-2.4	-1.9	-1.6	-1.8
Net debt	35.3	53.3	54.9	52.8	53.5	55.4	58.7	60.0	61.2	60.7
Gross debt	48.4	60.9	61.2	60.2	59.5	60.8	64.1	65.4	66.6	66.1
France										
Actual balance	-3.7	-2.7	-1.8	-1.4	-1.4	-3.2	-4.1	-3.9	-3.2	-0.5
Output gap ²	-0.9	-1.5	-0.6	1.2	1.0	—	-1.8	-2.3	-2.1	—
Structural balance ⁴	-3.0	-1.8	-1.4	-2.0	-2.1	-3.2	-2.9	-2.5	-1.9	-0.5
Net debt	35.2	49.8	48.8	47.5	48.2	49.1	53.5	55.3	55.9	51.4
Gross debt	44.2	59.5	58.5	57.1	56.8	58.7	63.2	64.9	65.6	61.0
Italy										
Actual balance	-9.2	-2.8	-1.7	-0.6	-2.6	-2.3	-2.4	-2.9	-2.8	-1.5
Output gap ²	0.1	-0.1	—	1.0	0.6	-1.0	-2.5	-3.0	-2.8	—
Structural balance ⁴	-9.0	-2.8	-1.8	-2.4	-3.1	-2.6	-1.4	-2.0	-1.8	-1.5
Net debt	104.4	110.1	108.4	104.5	103.9	101.4	99.8	98.8	97.6	90.1
Gross debt	110.3	116.4	114.6	111.2	110.6	108.0	106.2	105.2	103.9	95.9
Japan										
Actual balance	-1.2	-5.5	-7.2	-7.5	-6.1	-7.9	-8.2	-7.1	-6.6	-6.0
Excluding social security	-3.6	-6.9	-8.2	-8.0	-6.2	-7.6	-7.8	-6.6	-5.9	-5.2
Output gap ²	1.2	-1.3	-2.5	-1.2	-2.3	-3.9	-2.6	-0.6	—	0.1
Structural balance	-1.6	-5.1	-6.3	-7.0	-5.3	-6.4	-7.2	-6.9	-6.6	-6.1
Excluding social security	-3.8	-6.6	-7.7	-7.7	-5.7	-6.7	-7.2	-6.5	-5.9	-5.2
Net debt	20.2	45.8	53.5	59.1	65.2	71.4	79.6	85.9	92.2	110.7
Gross debt	81.0	117.9	131.0	139.3	148.9	158.5	166.1	171.2	176.4	186.8
United Kingdom										
Actual balance	-3.7	0.1	1.1	3.9	0.8	-1.5	-3.0	-3.0	-3.0	-2.7
Output gap ²	—	0.7	0.1	1.1	0.8	-0.4	-0.8	0.3	0.3	—
Structural balance ⁴	-3.6	-0.2	0.9	3.7	0.2	-1.7	-2.7	-2.8	-3.0	-2.7
Net debt	31.3	42.4	40.2	34.4	33.0	33.0	33.5	34.5	35.8	39.7
Gross debt	43.3	47.3	44.7	41.8	38.6	38.2	38.8	39.8	41.1	44.9
Canada										
Actual balance	-5.6	0.1	1.6	3.0	1.4	0.8	1.2	1.0	1.3	1.5
Output gap ²	—	-0.8	0.6	2.0	0.4	0.4	-1.1	-1.2	-0.8	—
Structural balance	-5.4	0.5	1.4	2.2	1.3	0.8	1.8	1.7	1.7	1.5
Net debt	76.8	83.1	74.8	64.7	59.1	56.1	51.1	48.1	44.5	31.5
Gross debt	108.7	116.2	110.8	101.8	99.6	96.0	90.8	86.3	80.8	61.5

Note: The methodology and specific assumptions for each country are discussed in Box A1 in the Statistical Appendix.

¹Debt 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.

²Percent of potential GDP.

³Data before 1990 refer to west Germany. 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.

⁴Excludes 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.

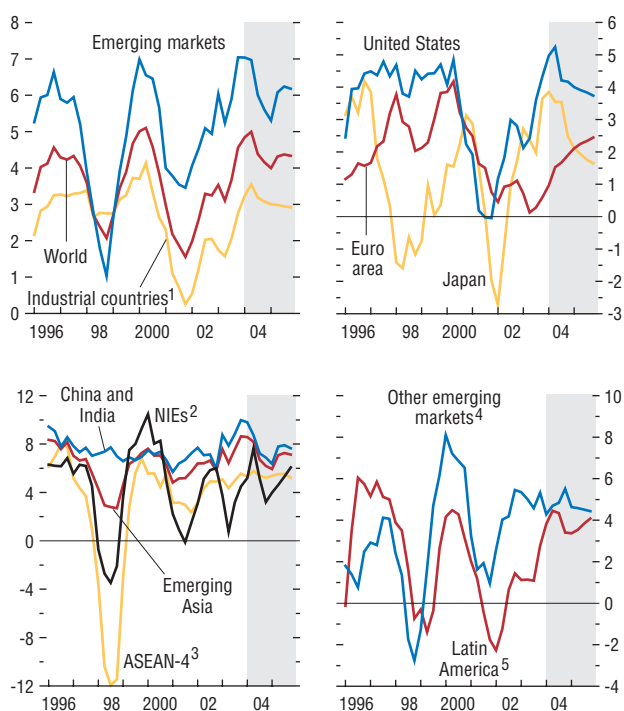
very strong inflows and historically low spreads raise concerns that markets may be somewhat complacent about the potential risks involved (see Chapter IV, “Are Credit Booms in Emerging Markets a Concern?”).

- *Medium-term fiscal positions across the globe remain very difficult.* Despite the fiscal consolidation during the 1990s, many industrial countries entered the new millennium with relatively high public debt and facing looming fiscal pressures from aging populations. Over the past three years, these concerns have significantly increased, reflecting the global downturn, fiscal easing, and—despite welcome recent measures in some countries in the euro area—rather limited progress in reforming pension and health systems. Beyond the potential risks for individual countries, if unaddressed this will likely put upward pressure on global interest rates over the medium term. In emerging markets, public debt rose steadily in the second half of the 1990s, and on average is even higher than in industrial countries, although servicing capacity is generally weaker.⁴ While current financing conditions remain benign, the historical evidence strongly suggests that without additional action there is a risk of widespread financing problems in the future.
- *While the Doha Round negotiations appear to be regaining some momentum, significant obstacles to achieving a meaningful agreement remain,* as illustrated by the setback at the Cancún Ministerial meeting of the World Trade Organization (WTO) in September 2003, and the recent flare-up of bilateral trade disputes (Box 1.3). With global imbalances adding to the potential for protectionist pressures, and geopolitical risks posing an additional threat to globalization, a successful completion of the round is particularly important, not least for developing countries, to which two-thirds of the potential gains would accrue. As recently noted by the IMF’s Acting Managing Director

Figure 1.8. Global Outlook

(Real GDP; percent change from four quarters earlier)

The global recovery has strengthened and broadened, led by the United States and Asia.



Sources: Haver Analytics; and IMF staff estimates.

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

²Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.

³Indonesia, Malaysia, the Philippines, and Thailand.

⁴Bulgaria, Czech Republic, Estonia, Hungary, Israel, Latvia, Lithuania, Pakistan, Poland, Romania, Russia, Slovak Republic, Slovenia, South Africa, Turkey, and Ukraine.

⁵Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

⁴See “Public Debt in Emerging Markets: Is It Too High?” Chapter III, *World Economic Outlook*, September 2003.

**Table 1.5. Selected Economies:
Current Account Positions**
(Percent of GDP)

	2002	2003	2004	2005
Advanced economies	-0.7	-0.8	-0.6	-0.6
United States	-4.6	-4.9	-4.2	-4.1
Euro area ¹	1.2	0.6	0.7	0.8
Germany	2.8	2.4	3.1	2.7
France	1.8	0.8	0.3	0.7
Italy	-0.6	-0.9	-0.8	-0.5
Spain	-2.4	-2.5	-2.9	-2.9
Netherlands	2.5	2.2	2.6	2.9
Belgium	5.4	4.5	4.6	4.5
Austria	0.3	-0.1	-0.2	-0.5
Finland	6.8	5.5	5.9	6.3
Greece	-6.1	-5.6	-5.0	-4.4
Portugal	-6.7	-5.1	-4.4	-4.0
Ireland	-0.7	-2.0	-2.4	-1.3
Luxembourg	8.2	5.9	6.9	8.0
Japan	2.8	3.2	3.1	3.2
United Kingdom	-1.7	-2.4	-2.2	-2.1
Canada	2.0	2.1	1.8	1.7
Korea	1.0	2.0	1.5	0.9
Australia	-4.3	-6.0	-5.4	-5.2
Taiwan Province of China	9.1	10.0	7.3	6.2
Sweden	4.8	6.6	5.9	6.0
Switzerland	9.6	9.5	10.1	10.1
Hong Kong SAR	8.5	11.0	10.3	9.8
Denmark	2.5	2.8	2.6	2.6
Norway	13.2	12.8	13.0	11.6
Israel	-1.3	-0.2	0.3	-0.4
Singapore	21.4	30.9	28.0	26.7
New Zealand	-3.7	-4.5	-5.0	-5.0
Cyprus	-5.4	-5.0	-4.4	-4.1
Iceland	-0.3	-5.6	-4.8	-6.1
<i>Memorandum</i>				
Major advanced economies	-1.4	-1.6	-1.2	-1.1
European Union ²	0.6	0.2	0.3	0.3
Euro area ²	0.9	0.4	0.2	0.2
Newly industrialized Asian economies	5.9	7.6	6.2	5.5

¹Calculated as the sum of the balances of individual euro area countries.

²Corrected for reporting discrepancies in intra-area transactions.

Anne Krueger, “A worldwide slide back to protectionism at this juncture would represent a setback nobody wants to contemplate. It would harm the prospects for future economic growth in all countries and could even undermine what has already been achieved.”⁵

Looking forward, while global policymakers need to continue to ensure that the recovery is

sustained, the focus increasingly needs to shift toward medium-term issues as well as broader developmental challenges. Beyond addressing the vulnerabilities listed above, in many countries there is a need to rebuild room for policy maneuver—which permitted an aggressive response to the downturn, as well as to the events of September 11, 2001, and lately SARS—to ensure the ability to respond appropriately to shocks. In addition, a clear medium-term policy framework provides confidence to markets that underlying problems are being addressed, thereby reducing the risk of short-term turbulence. Against this background, there appear four broad policy challenges.

- *Managing the monetary policy transition.* Interest rates in almost all countries will need to rise as the recovery continues, although the near-term situation varies significantly, depending importantly on the evolving pace and nature of the recovery. In some cases—notably in the United Kingdom and Australia—the tightening cycle is under way; in others, especially those that have experienced significant exchange rate appreciation, further easing could be required. A key challenge for central banks will be to communicate their intentions as clearly as possible to the markets, thereby reducing the risk of abrupt changes in expectations later on. During this transition, as emphasized in the *Global Financial Stability Report*, regulators will need to be particularly alert to possible mispricing of risk, excessive buildup of leverage, or concentrated position taking. In the United States, despite recent very rapid GDP growth and the depreciation of the U.S. dollar, inflation is low and labor markets remain sluggish. This has given the Federal Reserve leeway to maintain a very accommodative monetary stance. However, given the buoyant short-term outlook and the need to avoid financial market disruption both domestically and abroad, the time when the Federal Reserve will need to begin raising

⁵Address by Anne O. Krueger, then First Deputy Managing Director, International Monetary Fund, to the National Institute for Bank Management, Pune, India, January 21, 2004. Available via the Internet: <http://www.imf.org/external/np/speeches/2004/012104.htm>.

interest rates may be approaching, and the ground should continue to be prepared for future monetary tightening. In the euro area, while inflation has been surprisingly sticky, inflationary pressures are likely to be restrained by weak domestic demand, continued wage moderation, and the appreciating currency. The benign inflation outlook and deteriorating balance of risks to growth argue for shifting policy to an easing bias; if these developments persist, a cut in policy rates would be in order. In Japan, where moderate price declines continue, the challenge is to reverse entrenched deflationary expectations. Recent increases in the Bank of Japan's operating target to support the recovery and clarification of the conditions under which monetary tightening would take place are welcome steps, but could be more effective if supplemented by further quantitative easing and a medium-term inflation target to anchor inflationary expectations.

- *Facilitating an orderly resolution of global imbalances.* At present, the constellation of policies across the major countries and regions does not appear fully consistent with an orderly adjustment over the medium term. This underscores the need for a credible and cooperative strategy that both facilitates the necessary medium-term rebalancing of demand across countries and regions, and simultaneously supports global growth as that adjustment takes place. Key elements of such a strategy should include a credible plan by the United States to restore budgetary balance (excluding Social Security) over the medium term (see the first essay in Chapter II); stepping up the pace of structural reforms in the euro area; further banking and corporate sector reforms in Japan; and a gradual shift toward more exchange rate flexibility in most of emerging Asia, combined with additional structural reforms to support domestic demand. The monetary policy strategy

described above would generally be supportive of such an approach.

- *Using the recovery to address outstanding medium-term vulnerabilities.* With the recovery under way, the critical need in many countries is to make progress toward restoring sustainable medium-term fiscal positions. This is not just an issue of fiscal consolidation, although in most cases that is certainly needed. In most industrial countries, credible and high-quality measures to reform pension and health systems are even more important—and need to be taken into account in judging underlying progress—even if they do not have an immediate impact on the fiscal accounts. In emerging and developing countries, it is also essential to strengthen public debt sustainability through tax reforms to reduce revenue volatility, strengthen fiscal institutions to increase policy credibility, and take advantage of existing benign financing conditions to improve debt structure. The recovery also provides an opportunity to address other potential vulnerabilities, notably in the banking and corporate sectors, including through further progress in improving governance.
- *Reducing poverty.* While most major regions are expected to reach the target of halving poverty between 1990 and 2015 (Goal 1 of the Millennium Development Goals),⁶ most African countries are likely to fall significantly short. Despite much progress toward achieving macroeconomic stability, Africa remains highly vulnerable to exogenous shocks and continues to face a daunting range of development problems, many of which cannot be addressed without strengthening weak institutions. It is therefore welcome that the New Economic Partnership for Africa's Development and the African Union are taking steps to facilitate improved governance and lower corruption in the region. In this connection, it will be particularly important that the substantial oil resources coming on stream

⁶Progress toward other key goals, however, is less encouraging. See IMF and World Bank (2004), for a detailed discussion.

Box 1.1. The Effects of a Falling Dollar

Since its peak in early 2002, the value of the dollar has fallen by close to 20 percent in real effective terms. The largest depreciations have generally been against the currencies of other industrial countries, including the euro and the yen, while the performance against major emerging market regions has been more mixed, depreciating with respect to transition countries and (to a lesser extent) emerging Asia while appreciating against most currencies in Latin America (Figure 1.4). This box looks at the consequences of a depreciation of the U.S. dollar on the global economy, and the key issues on which it depends.

An important impact of a gradual fall in the dollar would be to reduce the U.S. current account deficit by switching external demand toward U.S. products. The depreciation of the currency makes local goods and services more competitive, increasing the demand from the rest of the world and reducing demand for foreign goods at home. This improves the external balance over time, although there can be a temporary worsening as prices of exports and imports respond more rapidly than quantities; over time, this reverses (this divergence between the short- and long-term effects is generally referred to as the J-curve, reflecting its shape). A rule of thumb is that a 10 percent depreciation in the real effective exchange rate of the dollar leads to a ½ percentage point of GDP improvement in the U.S. trade balance after two to three years. The counterpart reduction in demand and the external position in the rest of the world depends crucially, of course, on how the dollar has fared against individual currencies. For the depreciation since February 2002, the main impact is on other industrial countries.

A depreciation of the dollar also boosts the U.S. net foreign asset position and worsens positions elsewhere. Globalization has led to a rapid increase in U.S. holdings of foreign assets often denominated in other currencies and liabilities

generally issued in dollars.¹ As the value of other currencies rises in relation to the dollar, assets denominated in these currencies become more valuable. It has been estimated that a 25 percent depreciation in the dollar in real effective terms could improve the U.S. net foreign asset position by 7 percentage points of GDP, a sizable change given the overall net position is that the United States owes some 25 percent of its GDP to the rest of the world.² The loss to the rest of the world is somewhat larger, more like 10 percentage points of U.S. GDP, as U.S. liabilities to the rest of the world significantly exceed assets. Most of these losses will affect the private sector, although there will also be significant effects on central banks with large amounts of dollar reserves. That said, the direct impact on global demand will probably be extremely limited as in most industrial countries the vast majority of wealth is held in domestic, rather than foreign, assets (emerging markets are discussed below).

The macroeconomic consequences of a gradual depreciation of the dollar, while not benign, are probably limited. The increase in demand for U.S. products will temporarily boost U.S. output compared with its potential, raise inflationary pressures, and lead to some tightening of monetary policy. There is also a direct impact on inflation as foreign goods become more expensive, although estimates of the pass-through of the exchange rate onto inflation have been falling over time—a rule of thumb for the United States is that a 10 percent depreciation of the currency adds ½ percentage point to consumer price inflation, although some recent estimates are smaller, consistent with experience over the last two years. Overall, current account reversals appear to be associated with some slowing of growth in the short term, possibly reflecting the difficulty of rotating demand from domestic to external sources

¹See “Business Cycle Linkages Across the Major Advanced Economies,” in the October 2001 *World Economic Outlook*.

²See “How Worrisome Are External Imbalances?” in the September 2002 *World Economic Outlook*.

Note: The author of this box is Tamim Bayoumi.

smoothly.³ The gradual reduction in real demand and disinflationary impulse to the countries where currencies appreciate can be offset by a monetary (or fiscal) easing. Again, however, there may be short-term disruption from the switch in demand, which could be lessened by greater structural flexibility.

The situation could become significantly more difficult, however, if the depreciation is rapid and spills over into other financial markets. Turbulence in exchange rate markets will be disruptive to trade relations and could create greater protectionist pressures. It could also temporarily increase uncertainty about the future path of the economy, causing people to postpone decisions on investment and consumption, which can reduce activity in the short term. In addition, if the depreciation reflects market concerns about the financing of the U.S. current account deficit, it could increase the risk premium on U.S. assets, which may well have effects on premiums in foreign markets, weakening activity in the United States and abroad. It could also spark greater inflationary expectations in the United States, leading to further monetary tightening by the Federal Reserve. Elsewhere, a rapid appreciation of the currency against the dollar would be particularly difficult for countries with little room for

³See Figure 2.5 of “How Worrisome Are External Imbalances?” in the September 2002 *World Economic Outlook*.

macroeconomic maneuver. Japan is a good example, as interest rates are already at their floor and the difficult fiscal situation provides little room for expansionary policies, but other countries, including many heavily indebted emerging markets, may also feel seriously constrained.

Indeed, a rise in U.S. interest rates could be particularly problematic for heavily indebted emerging market countries by increasing financial fragility, although exchange rate changes may help offset this effect. Such countries pay a significant risk premium on borrowing owing to weak balance sheets and concerns about domestic policies. Increases in U.S. interest rates can create significant domestic difficulties by reducing international liquidity and dealing a blow to balance sheets by increasing costs of repayment, thereby raising the risk premium on borrowing, although these effects could be partly or fully offset if the dollar depreciates against local currencies, as borrowing is generally in dollars and the real burden of debt thus falls. Assessing the response of emerging market exchange rates to generalize a depreciation of the dollar is complicated by the fact that weak domestic activity can lead to downward pressure on local exchange rates (this “financial accelerator” effect is discussed further in Box 2.1). Indeed, it is notable that the recent period of dollar weakness has involved appreciations of the U.S. currency with respect to several emerging market countries with large external debt.

in the region are effectively used. Additional assistance from the international community is also critical, in the form of increased aid, continued debt relief, and—most importantly—greater access to industrial country markets. As is clear from the discussion above, structural reforms—the theme of this edition of the *World Economic Outlook*—are key to addressing many global challenges, including raising productivity growth; reducing economic vulnerabilities; improving economies’ ability to take advantage of rapid technological advances and

globalization, including China’s rapid emergence (see the second essay in Chapter II); and ensuring medium-term fiscal sustainability. While many countries have made progress in recent years, this has, unfortunately, often been relatively slow. This suggests the need for a closer look at the factors constraining the implementation of structural reforms in individual countries. Chapter III of this *World Economic Outlook* takes an initial look at this issue, focusing on the experience of industrial countries over the past thirty years. The chapter finds, perhaps unsurprisingly, that

Box 1.2. Housing Markets in Industrial Countries

The dramatic rise in residential property prices in recent years, especially in Australia, Ireland, the Netherlands, Spain, and the United Kingdom (where real house prices have risen by 50 percent or more during the last five years), has heightened concerns of an asset price bubble and thus the likelihood of a sharp price correction.¹ A sharp decline in house prices can be costly for the economy—evidence presented in the April 2003 *World Economic Outlook* suggests that housing price declines tend to be protracted and are often associated with declines in economic activity and financial instability. The macroeconomic effects can be magnified when falling house prices are triggered by rising real interest rates and households or financial institutions are vulnerable to such changes.

High house prices can be explained by a number of macroeconomic factors that have raised demand for housing. Real interest rates have declined significantly—even, at times, turning negative in some of the countries (Ireland, the Netherlands, and Spain). In addition, disposable income has grown rapidly during the past five years, especially in Ireland and the United States (see the figure). Arguably, another demand factor has been the relaxation of liquidity constraints, originating not only from lower interest rates but also from further financial market deregulation in some countries and increased competition among financial institutions in the provision of mortgages. Finally, country-specific factors—strong first-time buyer demand,² a weak supply response of new housing (Netherlands, United Kingdom), purchase of vacation homes by foreigners (Spain), and tax incentives (Netherlands, Spain)—have also contributed to boost prices.

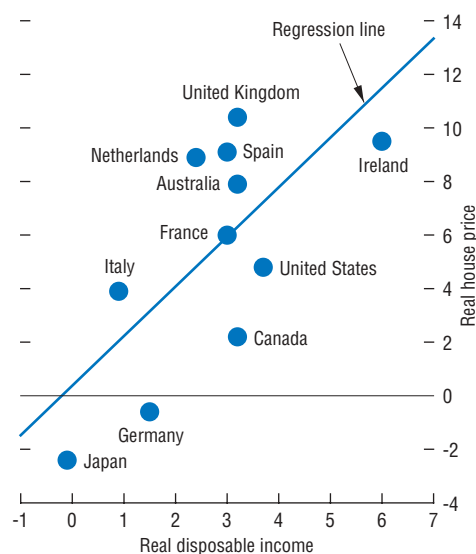
Note: The main authors of this box are Gian Maria Milesi-Ferretti and Laura Kodres.

¹Commercial property price increases have been much less pronounced, but still very significant in a few countries (Ireland and the Netherlands). See Zhu (2002) for a discussion.

²Due to high population growth in the 25–35 age segment (Ireland, Spain) and government-introduced incentive schemes (Australia).

Real House Prices and Disposable Income

(Average growth rate, 1997–2002; correlation coefficient = 0.68)



Sources: OECD, *Analytical database*; national sources; Office of Federal Housing Enterprise Oversight; HBOS plc; Japan Real Estate Institute; and Bundesbank calculations based on Bulwein data.

While these factors help explain the rise in demand for housing, concerns have been raised about the size of housing price increases in some countries, such as the United Kingdom and Australia. Indeed, even if the run-up in prices is justifiable on the basis of current and expected future fundamentals, a house price reversal could still be caused by deteriorating fundamentals—for example, higher interest rates, a significant rise in unemployment, and slower growth in disposable income. Were a sharp decline in housing prices to occur, there are several channels through which macroeconomic effects could be felt. House price declines can lead to falls in *residential property investment*, which has been as high as 1 percent of GDP in Australia, the Netherlands, Spain, and, particularly, Ireland. And by reducing the value of household assets, lower house prices

can lead to a decline in *private consumption* through a wealth effect. Equity withdrawal, a manifestation of higher housing wealth, has been a significant support to private consumption growth in the Netherlands, the United Kingdom, and the United States, and to a lesser extent in Australia. Estimates presented in the April 2002 *World Economic Outlook* suggest that a 10 percent decline in house prices is on average associated with a 0.5 percent decline in consumption in advanced economies.

The wealth effects on consumption can be amplified if households are financially vulnerable when a housing bust occurs, particularly when mortgage debt service is sensitive to higher interest rates (a proximate cause of house price declines), as would be the case in countries where variable-rate mortgages are predominant (such as Australia, Ireland, Spain, and the United Kingdom) and the stock of household debt is high.³ Household debt has increased substantially as a share of disposable income (albeit not as a share of wealth) in all the countries, and is particularly high in Australia, the Netherlands, the United Kingdom, and the United States. However, the decline in interest rates has so far offset or moderated the impact of rising debt stocks on debt service.⁴

Higher interest rates together with declining house prices can also pose risks for financial stability and can feed through to investment. Such risks emanate from financial institutions' direct holdings of mortgage loans as well as from their indirect holdings through mortgage-backed securities. Despite rapidly growing securitization of mortgages, banks in countries with booming housing markets are still the predominant holders of mortgage risk, and thus face both interest rate risk and credit risk.⁵ As interest rates rise,

³Evidence shows that the volatility of house prices is higher in countries where variable-rate mortgages are common.

⁴While the low inflation environment may increase households' ability to borrow, the associated real burden of mortgage debt service declines more slowly.

⁵Mortgage-backed securities comprise about 12 percent of residential mortgage lending in Ireland;

the market value of mortgage loans declines and the probability of defaults rises—with the relative effects depending on the degree to which interest payments are adjusted to the higher prevailing rates.⁶ Credit risks can also arise for other reasons, such as an inability to pay owing to the household borrower becoming unemployed. If a loan becomes impaired, the property collateral underlying the loan can be used for repayment—hence, lower loan-to-value ratios provide a larger cushion to lenders in such cases.⁷

In countries with booming housing markets, banking systems are generally considered healthy: they have relatively high capital ratios, low nonperforming loan ratios (especially on mortgages), and stable profitability. Moreover, average loan-to-value ratios across the stock of mortgage loans are relatively low—below 80 percent in all countries. However, the number of loans with higher loan-to-value ratios has been growing in Ireland and the United Kingdom, and particularly in the Netherlands. The number of buy-to-let mortgages has also increased in Australia, Ireland, Spain, and the United Kingdom, suggesting a more speculative component to house purchases. Moreover, in all of these countries, variable-rate or short-term fixed-rate mortgages predominate, carrying higher default risks from interest rate rises than fixed-rate products. Although asset quality typically deteriorates slowly, financial supervisors should remain vigilant, in light of the relatively large mortgage exposures of banks, still-rising house prices, and the recent moves toward more speculative mortgage transactions.

8 percent in the United Kingdom; 4 percent in the Netherlands; 6 percent in Spain; and 18 percent in Australia. In contrast, in the United States, mortgage-backed securities comprise 57 percent of home mortgages.

⁶Loans are not typically marked-to-market on banks' balance sheets—hence, interest rate risk on existing loans is not recognized as accounting gains or losses unless the loan is sold.

⁷Impaired loans may also require banks to increase loan provisioning and raise regulatory capital.

Box 1.3. Risks to the Multilateral Trading System

Developments over the past year have raised some concern over the health and future direction of the multilateral trading system. The most visible setback was the disappointing outcome to the World Trade Organization (WTO) Cancún Ministerial in September 2003, where trade ministers failed to agree on modalities for negotiations that were to conclude by end-2004. It was the second WTO ministerial to collapse after the 1999 failure in Seattle, and some observers have suggested that Cancún may bode ill for the multilateral trading system. The proliferation of regional and bilateral trade agreements and a number of highly visible and contentious trade disputes have added to the perception that the architecture of the world trading system is under stress. Recent events notwithstanding, a closer look suggests that risks to the system may be overstated, but that the costs of not pushing ahead with a suitably ambitious framework for multilateral trade liberalization could be sizable, particularly for developing countries.

While the Doha Round has experienced setbacks, it has fared no worse than previous rounds. No recent trade round has proceeded without discord, and each has at some point been perceived to be in danger of collapse. The Uruguay Round, for example, which was signed in 1994, took eight years to complete, and the Tokyo Round took six years (1973–79). The agenda for the Doha Round is broader and more complex than those of previous rounds. Early GATT rounds focused primarily on tariff reductions. The agenda was significantly widened during the Uruguay Round, both in terms of sectors (agriculture, services) and rules (e.g., subsidies, intellectual property rights). The Doha Round added a number of contentious regulatory areas (e.g., investment and competition rules) and seeks to tighten commitments in the new sectors. The multilateral trading system thus increasingly touches upon societal preferences well beyond the organization of manufac-

turing, requiring the negotiations to be sensitive to a wide range of political and social interests.

Perhaps as important, the membership of the WTO (and its predecessor, the GATT) has undergone a significant transformation—rising from 81 countries at the beginning of the Tokyo Round to some 142 members at the beginning of the Doha Round. The heavy concentration of developing countries acceding to the WTO in recent years implies an underlying shift in priorities, while the essential mechanics of the institution have remained unchanged. Added to this is the unique character of the Doha Development Agenda, whose emphasis on the interests of developing countries sits uneasily with the concept of reciprocity—the traditional engine of WTO negotiations. Some setbacks and difficulties in achieving an ambitious and far-reaching agenda of trade reforms may therefore be understandable.

Some observers have highlighted the growing number of regional trade agreements as a potential threat to the multilateral trading system.¹ Such agreements cannot be condemned out of hand, as they can potentially promote trade creation and even establish the framework for later multilateral liberalization. But they are clearly a second-best alternative to broad-based reduction of trade barriers on a most-favored nation basis and, if poorly designed, can lead to trade diversion, administrative complexities, and a set of trade rules that compete with those under the WTO framework. The perception that they are simpler to negotiate and can bring more immediate gains also risks drawing attention and support away from multilateral negotiations, particularly for countries with limited administrative capacity.

The danger that regional and bilateral agreements pose to the world trading system is likely

¹Over 170 regional trade agreements are currently in force; an additional 70 are estimated to be operational but not yet notified. By end-2005, if the regional trade agreements planned or already under negotiation are concluded, the total number of regional trade agreements in force might well approach 300.

Note: The main authors of this box are Hans Peter Lankes and Todd Schneider. The box was prepared in consultation with the IMF's Office in Geneva.

overstated, however. Although such agreements are indeed proliferating, they have encountered many of the same problems found at the multilateral level, as well as some of their own. Agriculture and other sensitive products, for example, remain difficult in virtually all trade negotiations. Indeed, tackling agricultural subsidies may only be realistic at the multilateral level since their reduction cannot be targeted to subsets of trade partners. This reduces the scope for negotiating trade-offs in regional agreements. Regulatory issues such as investment or government procurement rules can be contentious at the regional level as well—an important reason for the limited progress and declining ambition of the Free Trade Area of the Americas (FTAA) initiative. Implementation and enforcement have also proved challenging in the context of several of the east Asian initiatives.

While there have been increasingly contentious trade disputes, the continued use of WTO mechanisms seems to indicate trust in the rules-based multilateral trading system. The WTO's dispute settlement process, for example, continues to be widely used by the membership, although like many other institutional features it has come under close scrutiny. Its value has been confirmed, for instance, by the referral of trade disputes among members of the North American Free Trade Agreement (NAFTA), despite NAFTA having its own arbitration mechanism. Countries have also continued to demonstrate a practical recognition of the costs associated with trade disagreements, as evidenced by the U.S. decision to withdraw safeguard duties on steel imports ahead of schedule, avoiding a potentially costly trade conflict with a host of major trading partners.

reforms have generally progressed fastest in those areas that yielded most immediate benefits with the least uncertainty and less in others, notably tax and labor market reform. It also identifies a number of factors that tend to improve (or reduce) the chances of successfully implementing reforms. At the current juncture, the combination of a period of weak growth in

Dire predictions for the world trading system are thus premature. Despite wide-ranging complaints regarding deficiencies in the WTO, there is no evidence that members are eager to abandon it. Following the setback at Cancún, there has been a crescendo of rhetoric in support of restarting the Round, together with hints at—albeit limited—substantive concessions. Nevertheless, concerns over the prospects for the Doha Round are not unfounded and call for a more serious political commitment to translate rhetoric into action.

The success of the multilateral architecture hinges not so much on the rules of the system or its institutions, but on the willingness of members to cooperate toward common objectives. The Doha Round has exposed rifts between developed and developing countries, and some frailties in the WTO's decision-making framework. In these circumstances, there is a risk that the search for agreement will yield the lowest common denominator—a watered-down agreement that would satisfy defensive interests at the cost of substantive progress on the Doha Development Agenda. The result might be disillusionment with the WTO as a mechanism for tackling the opportunities and challenges of globalization, and the increasingly active pursuit of alternative routes that risk damaging the multilateral fabric of the system. The exponential growth of bilateral and regional arrangements is, indeed, partly driven by impatience with the slow pace of the multilateral machinery. A weak result would jeopardize a critical opportunity to achieve market access goals and the reform of trade rules so as to spread the gains to those countries most in need.

some countries, followed now by a generalized recovery, should be propitious for advancing reforms, although the need for fiscal consolidation in many countries is a retarding factor. External factors—both external competition and international agreements, such as the European Single Market—can also be a useful spur to action.

Finally, the recent boom and bust in equity markets once again underscores the potential cost of asset price shocks in modern economies. These costs are often very large; over the past three decades, equity price busts have typically resulted in a cumulative loss of GDP of about 4 percent, while housing busts have been twice as severe. Looking forward, as financial markets become more efficient, and asset stocks continue to rise, asset price shocks may become even more important;⁷ moreover—perhaps paradoxically—the achievement of sustained low inflation may increase the potential risks.⁸ There is a widespread view—especially among central bankers—that monetary policy is not well suited to addressing asset bubbles, but there is little consensus on what can or should be done instead. Looking forward, this issue should be high on the agenda for policymakers and policy-oriented academic researchers. One possible approach could be a systematic review of the institutional infrastructure of asset markets, both across and within countries, to see whether specific features—for instance, constraints on housing supply, lending practices, or corporate accounting and auditing regulations—have been associated with or exacerbated bubbles in the past, to help design reforms to reduce the risk that they recur in the future.

North America: Growth in the United States Surges; In Canada It Slows

Following a year of uncertainty and tentative recovery, the U.S. economy moved ahead strongly in the second half of 2003 as geopolitical uncertainties eased, monetary and fiscal policies remained highly stimulative, and the aftereffects of the bursting of the equity price bubble waned.⁹ Real GDP grew by an exception-

ally strong 8¼ percent (annual rate) in the third quarter, and by a further 4 percent in the fourth quarter. Growth was led by private consumption—which was spurred by tax cuts that boosted disposable incomes and low interest rates and the associated home refinancing boom—and a rebound in business investment as profits rose, the pressures from corporate balance sheet restructuring eased, and financing conditions improved (Figure 1.9). The employment response in this current recovery, however, has been weak by historic standards, raising fears in some quarters that the U.S. economy is in the midst of a “jobless” recovery. Nonfarm payrolls—the most commonly watched indicator of employment conditions—have until recently been very subdued, while the household survey—which has painted a somewhat stronger employment picture—remains weak relative to most other recovery periods.

Forward-looking indicators generally point to a continued robust expansion ahead, and the IMF staff has raised its growth forecast for 2004 to 4½ percent (¾ of a percentage point higher than in the September 2003 *World Economic Outlook*), and expects 4 percent growth in 2005. This forecast is predicated on further strong business investment growth and only a modest slowing in private consumption during 2004 as improving employment conditions and the rebound in equity prices largely offset the fading impact of tax cuts and home equity withdrawals.

Despite this positive economic outlook, there are still a number of uncertainties about how the recovery will develop. These include the following.

- *Will employment growth pick up as expected?*
Relatively weak employment growth during this upturn may be attributable to a number of factors: the recession has encouraged firms

⁷See, for example, “Is Wealth Increasingly Driving Consumption?” in Chapter II, *World Economic Outlook*, April 2002.

⁸When inflation is high, nominal wages tend to rise rapidly as well, so that the ratio of interest payments to income drops sharply over time. When inflation is low, debt service ratios decline more slowly, so that borrowers are much more exposed to shocks.

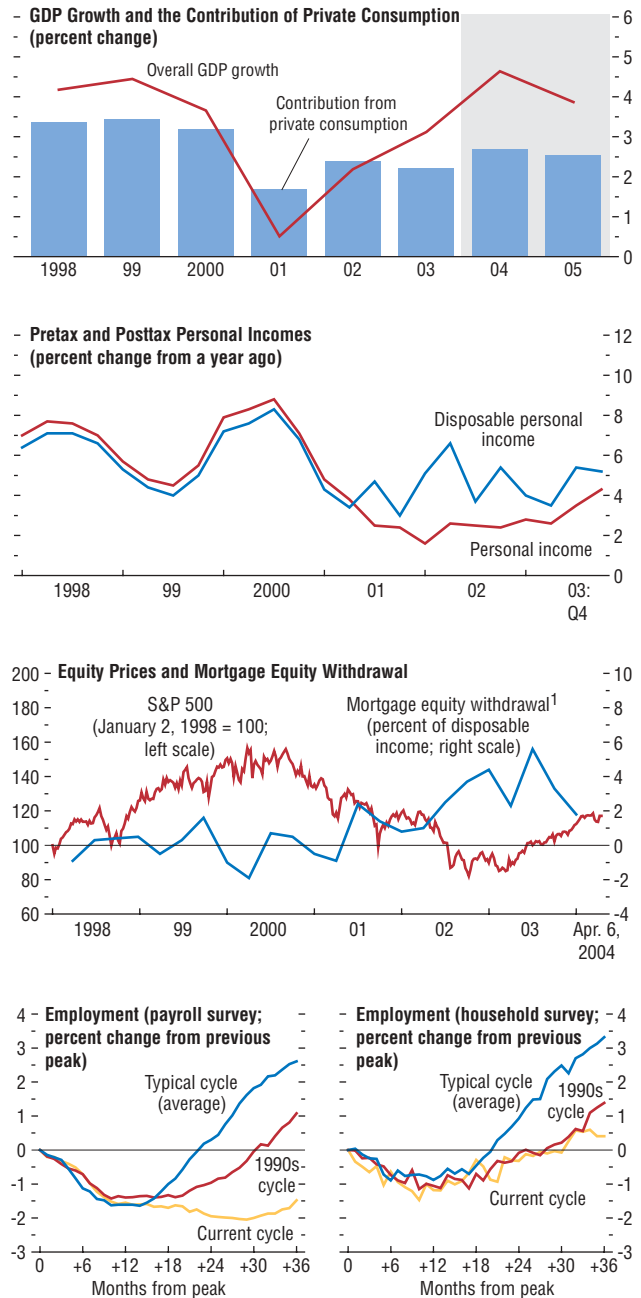
⁹Evidence suggests that the bursting of a typical equity price bubble shaves about 4 percentage points off growth over a two- to three-year period following the peak (see Chapter II, *World Economic Outlook*, April 2003).

to implement changes in the way they utilize labor to improve productivity and lower costs, and they have therefore required less labor to meet increased demand; uncertainty about the timing and strength of the economic rebound—particularly against the backdrop of geopolitical uncertainties and terrorist threats—has meant that firms have delayed hiring until the recovery is firmly established; and structural change has compelled workers in declining industries to find new jobs elsewhere in the economy, rather than simply being rehired back into their old jobs as the recession ends, and this takes time.¹⁰ These factors, however, are likely to have delayed rather than negated the usual cyclical recovery in the labor market, and with the corporate profit share currently close to record levels and unit labor costs having declined over the past two years, a pickup in employment (and wages) is likely, providing support to private consumption. Indeed, the employment sub-index in the Institute for Supply Management (ISM) survey is now at levels consistent with strong payroll growth, and recent payroll data have been encouraging. If employment does not pick up as expected, however, this would have significant implications for the sustainability of the recovery.

- *How will higher interest rates affect consumer spending?* The gradual increase in interest rates that is generally expected is unlikely to have significant implications for households. While refinancing and home equity withdrawals would likely decline, leading to some reduction in consumer spending, and debt-servicing costs would rise, household balance sheets remain in relatively good shape and the reliance on fixed-rate mortgages will mitigate the impact to some extent. However, if mortgage rates were to rise more abruptly than expected, the impact on debt servicing would be more pronounced, and the housing market

Figure 1.9. United States: Growth, Consumption, and Personal Incomes

Private consumption has been the lynchpin of the U.S. economy as it has been boosted by tax cuts and the withdrawal of housing equity. As the impact of these factors wanes, a strong labor market will be the key to sustaining consumption in the period ahead.



Sources: Haver Analytics; Global Insight; Bloomberg Financial, LP; and IMF staff estimates.

¹Defined as mortgage borrowing less nominal residential investment.

¹⁰See, for example, Groshen and Potter (2003); and Schreft and Singh (2003).

could also be adversely affected, particularly in regions that have seen strong price appreciation. A more sluggish housing market could have a negative impact on household wealth and consumption.

- *How will the current account deficit adjust?* The current account deficit has widened in recent years—reaching 5 percent of GDP in 2003—and it has increasingly been financed by the purchase of debt securities by central banks and official agencies, rather than by equity and direct investment flows. As discussed earlier, the adjustment of this current account deficit may result in a period of weaker growth, particularly if accompanied by an abrupt and disorderly adjustment of the U.S. dollar.

Despite the strong pickup in GDP growth, the output gap remains sizable, and despite higher-than-expected March CPI inflation, inflationary pressures are muted. Against this background, the Federal Reserve has maintained a very accommodative monetary policy stance, judging that the upside and downside risks to sustainable growth and inflation are broadly balanced at present. Nevertheless, if the recovery proceeds as expected, the time when the Federal Reserve will need to begin raising interest rates may be approaching, and it will need to continue to lay the groundwork for starting the move toward a more neutral monetary policy stance. Regarding the financial and corporate sector, continued progress is needed to strengthen corporate governance and accounting standards to ensure that investor confidence is maintained.

The very expansionary fiscal policy that has been pursued by the U.S. authorities in recent years has provided valuable support to the recovery, but it has contributed to a significant deterioration in the U.S. budget position, which may impose considerable costs on both the U.S. and global economies over the medium term (see Chapter II). Restoring a sustainable fiscal position is therefore a priority, and in this regard the U.S. Administration's commitment to halve the federal government deficit over the next five years is an important first step, although credible measures to achieve this reduction have yet to be

put in place. There are good reasons, however, to believe that a more ambitious fiscal consolidation is warranted. First, by consolidating more aggressively during this cyclical upswing, the fiscal accounts will be in better shape to respond to the next downturn when it occurs. Second, the retirement of the baby boom generation, which will begin later this decade, will put significant pressure on the Social Security and Medicare systems, and it is important that the authorities undertake early reform of these programs to accommodate the pressures. Third, an increase in public saving would help in the needed adjustment of the current account deficit.

In Canada, growth slowed to 1¼ percent in 2003. Although domestic demand remained relatively robust, the sharp appreciation of the Canadian dollar, the SARS outbreak, and the discovery of one case of BSE (also known as mad cow disease) severely affected net exports, which detracted 2½ percentage points from GDP growth. A pickup in growth is expected during 2004—to 2½ percent—as the drag from the external sector wanes with the strengthening of the U.S. economy and higher commodity prices, and consumption and investment benefit from low interest rates and recent tax cuts. As the output gap has widened with the slowing of the economy, inflation has returned to the Bank of Canada's 1–3 percent target range, and after tightening monetary policy in early 2003, the central bank has subsequently reversed course and reduced the target for the overnight interest rate by 125 basis points to 2 percent since mid-2003. The slowing economy and increased outlays in support of the public health care system have reduced the federal budget surplus, but the fiscal situation in Canada remains relatively favorable, and the authorities are committed to maintaining the federal debt ratio on a downward track.

Euro Area: Subdued Recovery, With Domestic Demand Still Uneven

In the euro area, the recovery is subdued and has initially relied mainly on external demand.

After stagnating in the first half of 2003, real GDP grew by 1½ percent (annual rate) in the third quarter and 1¼ percent in the fourth quarter. The sharp pickup in global trade has boosted exports, despite the stronger euro. Investment rebounded in the fourth quarter, though it continues to be dampened by uncertainties related to exchange rate appreciation and ongoing balance sheet restructuring. Consumption growth has been weak, even though employment has held up well compared with previous downturns, reflecting wage moderation. Across countries in the euro area, growth divergences reflect mainly differences in domestic demand—weakest in Germany and strongest in Greece, Ireland, and Spain—in part reflecting persistent real interest differentials (Figure 1.10).

Growth is projected to increase to 1¾ percent in 2004 and 2¼ percent in 2005, but—with recent economic indicators failing to improve—the robustness of the recovery is uncertain. Strong external demand, rising profitability, high equity prices, low corporate bond spreads, and solid household balance sheets are expected to underpin a gradual pickup in growth.

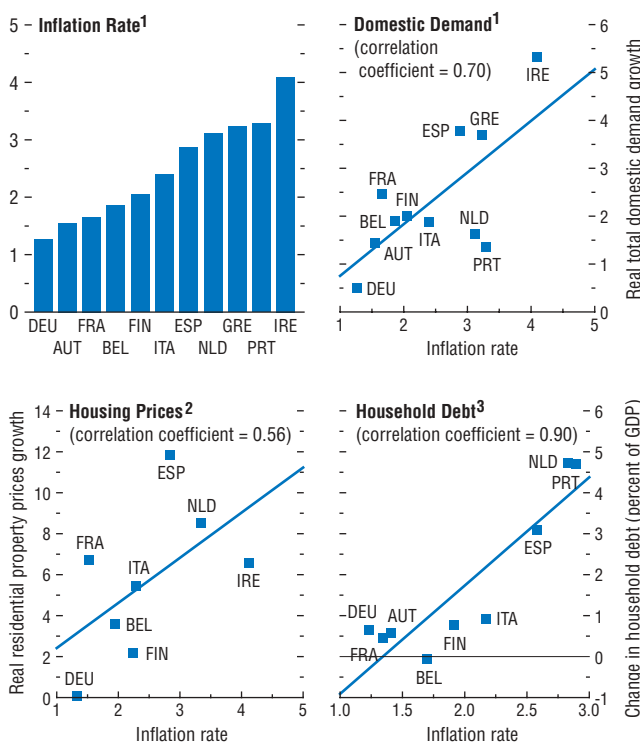
However, subdued consumer sentiment and high unemployment may continue to weaken consumption growth, continued high levels of leverage raise questions about whether balance sheet restructuring has advanced sufficiently to sustain business investment, and a further sharp appreciation of the euro could dampen external demand. In addition, while the direct effect of the Madrid bombings on growth is likely to be small, the bombings could weaken confidence or increase security measures that slow trade.

Core consumer price inflation has been surprisingly sticky at just below 2 percent, but is expected to slow over the next two years. Several factors point to a further decline in inflation during 2004–05, including the progressive deceleration of wage claims in the face of continued slack, improving labor productivity as the recovery gathers momentum, and the stronger euro. Given the benign outlook for inflation, the downside risks to growth argue for shifting to an easing bias in monetary policy. If economic indi-

Figure 1.10. Euro Area: Implications of Persistent Inflation Differentials

(Average annual percent change unless otherwise noted)

Persistent inflation differentials across euro area countries have implied persistent differences in real interest rates, which in turn have been associated with divergent domestic demand, housing prices, and household debt.



Sources: European Commission; national sources; Bundesbank calculations based on Bulweim data; and IMF staff calculations.

¹Average, 1999–2003.

²Average, 1999–2002.

³Average, 1997–2002.

cators continue to suggest that the already subdued pace of the recovery has weakened further, and the inflation outlook remains benign, a cut in interest rates would be in order.

Since the adoption of the single currency in 1999, inflation differentials across euro area countries have been substantial and persistent. While the magnitudes of the inflation differentials are not dissimilar from those in other currency areas, their persistence is unusual (European Central Bank, 2003). Given the common nominal interest rate across the euro area, this has led to sustained differences in real interest rates, accompanied by cross-country divergences in real domestic demand and real housing prices, which are both booming in Spain but stagnating in Germany (Figure 1.10). While the inflation differentials likely reflect a combination of temporary and longer-term structural factors, further progress toward the realization of the Single Market will help to reduce their magnitude and persistence. In the meantime, the inflation differentials and their associated macroeconomic divergences underline the key stabilization role of the national fiscal policies, as well as the importance of improving structural flexibility, especially in product and factor markets.

Fiscal deficits on average continued to widen in 2003, with improvements in structural balances more than offset by automatic stabilizers. General government deficits in France and Germany exceeded the ceiling under the Stability and Growth Pact for the second year running, despite an improvement in Germany's structural balance of about ½ percent of GDP. In Italy, the general government deficit was held below the ceiling, but this largely reflected one-off measures. In France, long-term fiscal sustainability improved because of important pension reforms. Looking ahead, fiscal deficits in France and Germany are projected to remain above the Stability and Growth Pact ceiling through 2005. In the immediate future, for countries with weak budgetary positions, underlying fiscal adjustment of at least ½ percent of GDP based on high-quality measures strikes the right balance between the short-term need to avoid undercut-

ting the incipient recovery and the medium-term need for further consolidation. Over the medium term, countries that decide to implement credible structural reforms could be given limited leeway to meet underlying budgetary targets in a cumulative fashion rather than on a year-by-year basis. Following the procedural impasse under the Stability and Growth Pact in late 2003, it is essential to strengthen some aspects of the implementation of the Pact, not least because the Pact is instrumental to the pursuit of sound policies, having underpinned the shift to a largely appropriate euro area fiscal policy stance in a challenging cyclical environment. Specifically, more attention could be given to public debt and issues of longer-term fiscal sustainability, including how to take account of unfunded liabilities, how to encourage fiscal consolidation in good times, and how to measure the quality of adjustment.

Increased attention to structural reforms is welcome, but more could be done to increase sustainable long-term growth and improve the euro area's ability to adjust to shocks. Progress has been made recently, including the Agenda 2010 reforms in Germany and pension reforms in France, but the pace of product market reforms has generally slowed and the number of internal market infringement cases is on the rise. Looking forward, projected demographic changes over the long term underline the importance of increasing labor force participation and productivity growth. Many countries need to reform their tax-benefit systems (including through pension and health care reforms) to improve work incentives, ease employment protection legislation to reduce hiring-and-firing costs, and reduce regulatory and administrative burdens to improve the business environment. The current recovery provides a favorable environment for accelerating reforms, as improving prospects for employment and income could mitigate the inevitable short-term costs. Moreover, countries could also take advantage of having committed to reforms under the Lisbon Strategy, as supranational cooperation agreements have proven useful in overcoming obstacles to reforms

(see Chapter III on “Fostering Structural Reforms in Industrial Countries”). As regards financial integration, the legislative phase at the European Union (EU) level on the Financial Services Action Plan is essentially complete, the Lamfalussy process has been extended to banking and insurance, and attention is being given to financial crisis prevention and management. It is now important to focus on the implementation of framework directives in national legislation.

As in the euro area, growth rates are projected to rise in Denmark, Norway, Sweden, and Switzerland, partly reflecting the pickup in global demand. In Norway, the recovery is underpinned by strengthening household consumption, reflecting increasing employment and house prices, and firming business investment intentions. Domestic demand is less robust in the other countries, reflecting weaker employment situations, lower capacity utilization rates, and ongoing balance sheet adjustment. As these recoveries are still largely dependent on external demand, they are vulnerable to effective exchange rate appreciations or a faltering of the recovery in the euro area (their major trading partner). With still-large output gaps continuing to put downward pressure on inflation, central banks in Norway and Sweden have cut interest rates in recent months and further reductions could be considered if the recoveries fail to gain traction. In Switzerland, with interest rates already close to zero, it will be important to keep monetary policy very accommodative until the recovery is secured.

In contrast to the euro area, macroeconomic performance in the United Kingdom remains strong and the main risk to the outlook is the possibility of an abrupt correction in the housing market. Strong performance is due not only to an appropriately countercyclical monetary policy and an expansionary fiscal stance, but also to structural flexibility, reflecting the deep reforms of labor, product, and financial markets over the past twenty years. Support for the cyclical upturn is expected to shift gradually to external demand from consumption, as the impact of higher interest rates feeds through. While banks' high prof-

itability and capitalization should allow them to absorb shocks stemming from a sharp decline in housing prices, some highly indebted households could be vulnerable to increases in interest rates or unemployment. Against this background, monetary policy should continue to tighten gradually; indeed, financial markets expect small and steady rate hikes. Given the recent widening of the structural fiscal deficit, gradual fiscal consolidation is also appropriate to meet the government's fiscal rules, strengthen fiscal fundamentals, and support monetary policy during the cyclical upswing. Moderating the ongoing steep escalation in government spending would limit the risk of inefficiencies and help fiscal consolidation. As a key challenge is to ensure the adequate provision of pensions as the population ages, the recent establishment of a Pension Commission—charged with monitoring whether people are saving enough and recommending corrective actions if needed—is welcome.

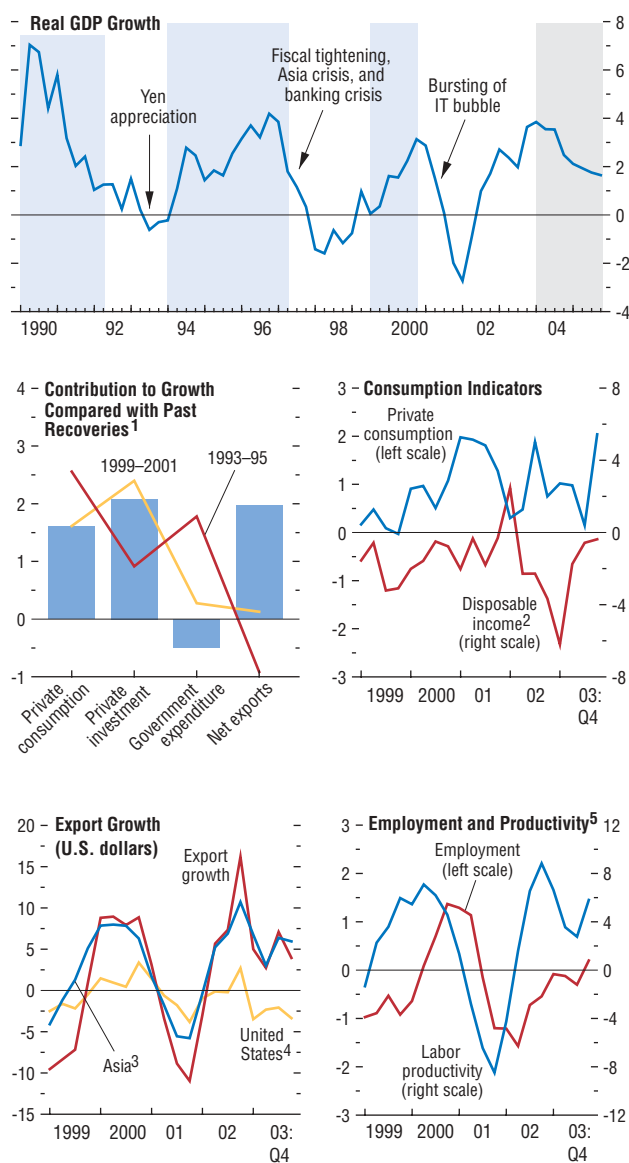
Japan: Is a Sustained Recovery Finally Under Way?

In Japan, the recovery has continued to substantially exceed expectations, with GDP growth in 2003 estimated at 2.7 percent, 0.7 percentage point higher than projected last September, and an even larger upward revision to the forecast for 2004. Despite the appreciation of the yen—withstanding record official foreign exchange intervention—the recovery has been driven by exports, particularly to Asia, and by a rebound in private investment, aided by rising corporate profitability and the recovery in equity markets (Figure 1.11). Private consumption has grown moderately—although there are increasing signs of a pickup—while government expenditure, particularly investment, has subtracted from demand. While official data may overstate both GDP and private investment growth owing to statistical problems, the pickup can also increasingly be seen in other indicators, including the all-industry index, the Tankan survey of business conditions, capital goods production, and machinery orders.

Figure 1.11. Japan: How Does the Current Recovery Compare With the Past?

(Percent change from a year ago)

Japan's recent recovery has been unusually dependent on exports, particularly to Asia; consumption remains weak, reflecting falling disposable income and sluggish employment growth.



Sources: Haver Analytics; CEIC Data Company Limited; and IMF staff estimates.
 1 Contribution to growth between 2001Q4 and 2003Q4; compared with 1999Q1 and 2001Q1, and 1993Q4 and 1995Q4.
 2 Deflated by consumer price index.
 3 Contribution of Asia exports to total export growth.
 4 Contribution of U.S. exports to total export growth.
 5 Total employment in the nonagricultural industries, and labor productivity in the manufacturing sector.

At the current juncture, a key question is whether Japan's recovery can be sustained or whether, as with earlier recoveries in the post-bubble period, it will prove to be another false dawn (Figure 1.11). In this connection, recent progress in addressing Japan's underlying problems—which should help raise potential growth from its present anemic level of about 1 percent, and reduce vulnerability to shocks—is encouraging, although much still remains to be done.

- Corporate sector performance has improved, reflected in rising profitability and some decline in debt ratios. However, these improvements have been concentrated in large export-oriented enterprises; the situation of small firms, which account for a substantial share of total debt, while improving, remains difficult.
- Banking system health is improving—reflected among other things in a sharp rise in bank stock prices—although significant weaknesses remain. Recent difficulties in Resona and Ashikaga banks have been effectively contained, and major banks strengthened their balance sheets in the first half of FY2003, notably through reducing nonperforming loans and reducing the share of deferred tax assets in capital. However, both ratios remain relatively high and problems in regional banks—not covered by the Program for Financial Revival—need to be addressed more aggressively. The low level of core profitability remains a key concern, with recent improvements partly reflecting one-off factors, including equity market gains.
- Deflationary pressures have eased recently, with core consumer price index (CPI) inflation rising to close to zero in recent months, although this is in part due to one-off factors; excluding these, deflation is about ½ percent. Survey data provide tentative evidence that deflationary expectations are easing, with the Tankan suggesting that the percentage of firms expecting price declines fell in March 2004. Against this background, the IMF staff expects a continued but moderate recovery, with GDP growth projected at 3.4 percent in 2004, slowing to 1.9 percent during 2005. In the short run, the

risks appear broadly balanced. It is possible that the recovery may be somewhat stronger than projected, especially if growth and demand in the United States and Asia exceed expectations; the rebound in corporate profitability continues, and rising bonuses feed through into consumption; or the upturn in labor market conditions is sustained. The key downside risk is a further sharp appreciation of the yen. Over the medium term, the central concerns remain the vulnerabilities created by the weaknesses described above; the very difficult fiscal outlook and, associated with that, the risk of higher long-term interest rates; and the relatively limited room for policy maneuver in response to unexpected shocks.

Turning to macroeconomic policies, a key issue remains to decisively end deflation; as recent research has emphasized, the key to this is to end deflationary expectations.¹¹ Over the past year, the Bank of Japan has become more proactive, raising its operating target four times, on the latest two occasions to support the recovery. In October 2003, it clarified that monetary policy would not be tightened until core CPI inflation is zero or above for several months and a majority of Policy Board members forecasts that core CPI inflation will remain positive over the forecasting period. While these steps are welcome, they do not yet appear sufficient to bring about a timely end to deflation and influence deflationary expectations; this could be aided by additional quantitative easing, combined with a medium-term inflation target to anchor inflationary expectations.

On the fiscal side, the structural budget deficit (excluding bank support) is expected to remain at about 6¾ percent in FY2003 and FY2004. As experience in 1997 underscores, an abrupt fiscal tightening would risk choking off the recovery; that said, the upturn provides an opportunity to begin the consolidation process, in the context of a well-defined medium-term fiscal plan. In

this connection, the authorities aim to achieve a primary surplus of the general government (excluding social security) in the early 2010s, through a combination of expenditure restraint and—over the medium term—tax changes; they have also put forward a plan to begin to address looming pension problems through a combination of increased government and private contributions and modestly reduced benefits. While these are welcome initiatives, gross and net public debt are expected to remain on a sharply rising trend, suggesting that additional efforts will be needed to assure medium-term sustainability.

As has been discussed in the *World Economic Outlook* on many occasions, an acceleration of structural reforms of the financial and corporate sector remains the key to a return to sustainable growth in Japan. As recent research has shown, since the productivity of the most highly indebted firms in Japan is very low, there can be large medium-term gains from a well-designed corporate restructuring, which substantially outweigh the short-term costs.¹² While the obstacles to progress remain significant, the analysis of Chapter III suggests that from a political economy perspective, the combination of earlier economic weakness—increasing awareness of the costs of delaying reform—and the current recovery may be conducive to accelerating reform, especially before substantial fiscal consolidation gets under way.

Latin America: Is There a Tension Between Tackling Social Issues and Reducing High Public Debt?

Economic growth in Latin America has rebounded following the deep recession during 2001–02 (Table 1.6). The recovery was initially led by external demand, as exports responded to the substantial exchange rate depreciations in the region, but more recently domestic demand has begun to pick up as interest rates have

¹¹See Eggertsson and Woodford (2003).

¹²See Kim (2003).

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			
	2002	2003	2004	2005	2002	2003	2004	2005	2002	2003	2004	2005
Western Hemisphere	-0.1	1.7	3.9	3.7	8.9	10.6	6.2	5.6	-0.9	0.2	-0.4	-1.0
Mercosur³	-1.2	1.9	4.0	3.7	12.0	14.4	6.1	5.8	0.4	1.8	0.6	-0.4
Argentina	-10.9	8.7	5.5	4.0	25.9	13.4	6.7	9.5	10.5	5.7	4.6	1.6
Brazil	1.9	-0.2	3.5	3.5	8.4	14.8	5.9	4.7	-1.7	0.8	-0.4	-0.9
Chile	2.2	3.3	4.6	5.5	2.5	2.8	1.3	2.9	-1.3	-0.8	-0.2	-0.6
Uruguay	-11.0	2.5	7.0	4.0	14.0	19.4	8.3	7.7	1.6	0.4	0.5	1.0
Andean region	0.2	1.2	5.1	3.5	9.1	10.2	8.9	9.3	1.4	2.7	2.3	1.3
Colombia	1.8	3.6	4.0	4.0	6.3	7.1	5.7	5.0	-1.9	-1.8	-2.3	-2.1
Ecuador	3.3	2.6	5.9	3.6	12.6	7.9	3.2	2.7	-4.9	-1.7	1.4	1.5
Peru	4.9	4.0	4.0	4.5	1.5	2.5	2.5	2.5	-2.1	-1.8	-0.7	-0.8
Venezuela	-8.9	-9.2	8.8	1.1	22.4	31.1	29.3	35.0	7.9	11.3	9.3	6.4
Mexico, Central America, and Caribbean	1.1	1.5	3.0	3.5	5.1	5.9	5.6	3.8	-2.6	-1.8	-2.2	-2.4
Dominican Republic	4.7	-1.3	-1.0	4.5	5.2	27.4	28.8	10.6	-3.8	5.6	4.5	2.9
Guatemala	2.2	2.1	2.6	3.5	6.3	5.9	5.0	4.5	-5.1	-4.4	-4.2	-4.3
Mexico	0.7	1.3	3.3	3.3	5.0	4.5	4.3	3.2	-2.2	-1.5	-2.0	-2.2

¹In 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.

²Percent of GDP.

³Includes Argentina, Brazil, Paraguay, and Uruguay, together with Bolivia and Chile (associate members of Mercosur).

declined and confidence has returned. Export growth has also underpinned an improvement in the current account position, which moved into a small surplus in 2003—the first in at least 35 years—while inflation has generally been well contained. Looking ahead, growth is expected to strengthen during 2004 as the recovery in domestic demand takes further hold, although the outlook remains vulnerable to a deterioration in the global financial market environment or domestic policy slippages that undermine investor confidence.

Despite the improvement in economic conditions, unemployment remains high, and together with wide income inequalities and pervasive poverty (Figure 1.12), this has contributed to an increase in social tensions in a number of countries. Indeed, public opinion surveys show that Latin Americans view unemployment as the most important problem facing their countries (poverty is also high on the list), while a large majority of people view the current income distribution as unfair (Latinobarometer, 2003). These social pressures pose a considerable challenge for policymakers, not only because they

have undermined government stability in a number of countries—making policy implementation more difficult—but also because they need to be addressed against the backdrop of high existing public debt levels.

Is there a tension between working to improve social conditions and reducing public debt? While the need to maintain a tight fiscal policy in the face of high public debt levels and fragile financial market sentiment certainly constrains governments from trying to improve the social situation in the short term through higher spending, efforts to lower public debt ratios would have a number of benefits for social conditions over the longer run. Lower public debt would reduce vulnerabilities—the experience in Argentina clearly shows that financial crises can have a devastating impact on social conditions—and increase the scope for countercyclical fiscal policies, thereby helping cushion the impact of future economic downturns. In addition, it would also help create additional room within the budget for spending on infrastructure, health, education, and the social safety net (although improving the effectiveness of the

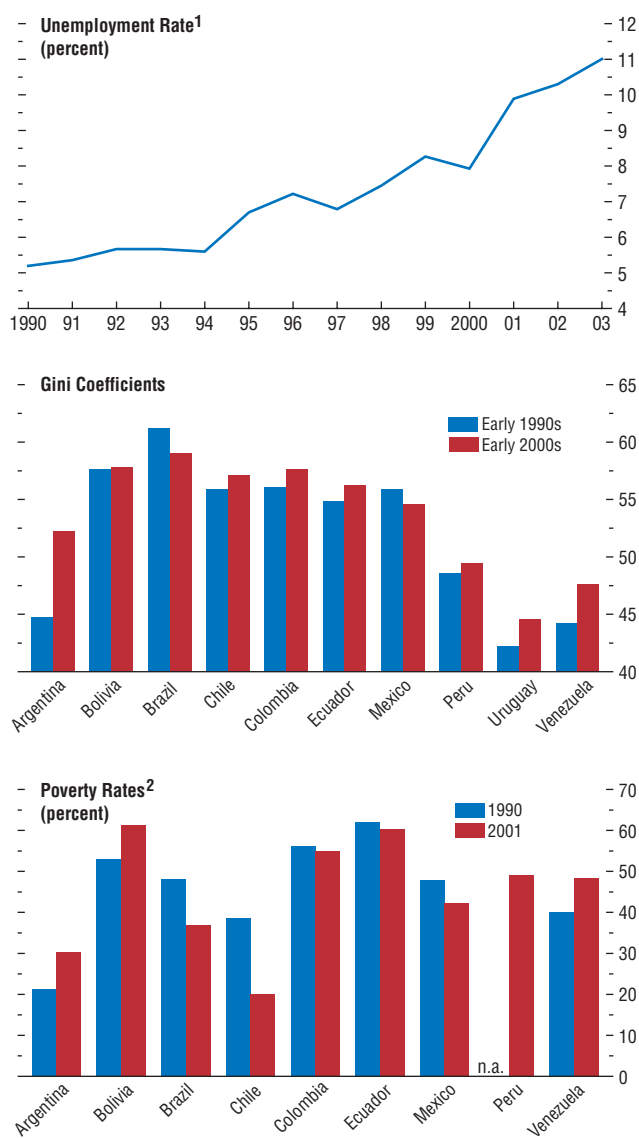
delivery of social services and ensuring the social safety net is well targeted will be as critical to efforts to reduce poverty and inequality as additional spending).

There are no quick or easy solutions to either the social or public debt problems in Latin America, and the policy response in each country will need to be tailored to individual circumstances. A broad-based structural reform program, however, will be central to achieving both of these goals, as strong and sustained economic growth—and the wide dispersion of the benefits from this growth—would not only help improve social conditions but would also constitute a crucial component of the efforts to put public debt on a firm and lasting downward path (see the September 2003 *World Economic Outlook*). Fiscal reforms will also be needed to improve the sustainability of public debt, including steps to strengthen the tax base—so that governments have access to more stable, and in some cases higher, revenues—and reduce tax distortions, improve the control of expenditures and reduce unproductive spending, increase the credibility of fiscal policy (including by strengthening fiscal institutions), address the risks from contingent and implicit liabilities, and reduce the reliance on foreign currency and short-term debt to limit the risks from exchange rate and interest rate movements.

Turning to individual countries, in Argentina there has been a marked rebound in confidence and output, with real GDP estimated to have grown by 8¾ percent in 2003 as consumption and construction investment strengthened (although output still remains 11 percent below its precrisis peak). At the same time, inflation has declined substantially, the current account has remained in sizable surplus, and strong tax revenues have contributed to an estimated public sector primary surplus of 3 percent of GDP. The economy is expected to expand by a further 5½ percent in 2004, although the sustainability of the recovery will depend on progress on the policy front, where the priorities are an increase in the primary budget surplus and the restructuring of sovereign debt to restore fiscal sustain-

Figure 1.12. Unemployment, Income Inequality, and Poverty in Latin America

High unemployment, wide income inequalities, and pervasive poverty have all contributed to rising social tensions in a number of Latin American countries.



Sources: World Bank; ECLAC; and IMF staff estimates.

¹Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, and Venezuela.

²In percent of population. Data for 2001 are estimates.

ability; strengthening the banking system; and an improved environment for private business, including the development of a balanced regulatory framework for utility concessionaires and a more predictable legal environment.

In Uruguay, the economic situation has improved considerably since the May 2003 debt exchange, and real GDP growth in 2003 was positive for the first time since 1998. Risks, however, remain high, and to maintain the confidence of the financial markets the authorities will need to push ahead with bank restructuring and fiscal consolidation.

Strong macroeconomic policies and progress with structural reforms have contributed to improved confidence and signs of recovery in Brazil, including a resumption of output growth in the fourth quarter of 2003. The economy is expected to expand by 3½ percent in 2004, following a small decline in 2003, as domestic demand responds to lower interest rates—official rates have been cut by 10¼ percentage points since June 2003 in response to the decline in inflation and inflation expectations. Prudent fiscal policies—which resulted in a primary surplus of more than 4¼ percent of GDP in 2003—and steps to improve the structure of public debt have helped ease concerns about the stability of public sector debt dynamics, although high public debt (over 80 percent of GDP in gross terms) remains a significant vulnerability going forward, particularly in the event of a deterioration in financial market conditions or policy slippages that undermine investor confidence. The Chilean economy has continued to perform well, and growth is expected to accelerate to 4½ percent in 2004, boosted by the improved terms of trade—due to higher copper prices—and increased investment in infrastructure and in the natural resources industry. The central bank has reduced interest rates as inflation has fallen, while fiscal policy remains consistent with the target of a structural budget surplus of 1 percent of GDP.

In the Andean region, a pickup in growth is anticipated in 2004, although in most countries the outlook is clouded by political uncertainties.

In Venezuela, the projected rebound in activity is critically dependent on an orderly resolution of the political crisis and a corresponding recovery in consumer and business confidence. Corrective measures are urgently needed to restore fiscal sustainability as the sharp deterioration in the budget position has significantly increased vulnerabilities to a decline in oil prices or a deterioration in external financing conditions. To varying degrees, political uncertainties also present risks to the outlook in Peru, where growth is expected to remain at about 4 percent in 2004, but public debt in foreign currency remains high and fiscal reforms need to be accelerated; in Ecuador, where the economy is benefiting from higher oil prices and the opening of a new oil pipeline, but the difficult political situation is delaying necessary fiscal and structural reforms and the budget position is vulnerable to a decline in oil prices; and in Bolivia, where social unrest and political instability have had a negative impact on growth and the fiscal position. In Colombia, the improved security situation and sound macroeconomic policies have boosted confidence and growth has accelerated, but further fiscal consolidation to reduce public debt and create room for private sector growth is needed to maintain this momentum going forward.

Turning to Mexico, growth is expected to accelerate this year—following three years of disappointing performance—as exports benefit from stronger industrial growth in the United States and lower domestic interest rates support consumption and investment spending. Prudent monetary policy has underpinned declining inflation toward the Bank of Mexico's longer-term objective of 3 percent, but the pace of reduction in broad measures of the fiscal deficit has fallen short of earlier expectations, and public debt remains at a higher-than-desirable level. The limited progress with reforms in critical areas—including the energy sector, labor market, and tax system—has also dampened private investment and led to increasing concerns about Mexico's medium-term competitiveness.

In Central America, growth prospects for 2004 have been positively influenced by the free trade

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			
	2002	2003	2004	2005	2002	2003	2004	2005	2002	2003	2004	2005
Emerging Asia³	6.2	7.2	7.2	6.8	1.9	2.5	3.8	3.4	3.8	3.8	3.0	2.7
China	8.0	9.1	8.5	8.0	-0.8	1.2	3.5	3.0	2.8	2.1	1.6	1.9
South Asia⁴	4.6	7.0	6.5	6.0	4.2	3.9	4.4	4.1	1.2	0.7	0.1	0.1
India	4.7	7.4	6.8	6.0	4.3	3.8	4.3	4.1	1.0	0.5	0.2	0.3
Pakistan	4.4	5.5	5.4	5.7	2.9	3.6	4.0	4.0	4.1	3.3	1.0	0.5
Bangladesh	4.9	5.4	5.8	6.3	3.8	4.9	5.1	3.5	0.6	-0.3	-1.2	-1.2
ASEAN-4	4.3	5.0	5.4	5.4	5.8	3.9	3.7	3.3	5.6	5.5	4.6	3.4
Indonesia	3.7	4.1	4.8	5.0	11.9	6.6	5.0	4.5	4.5	3.9	2.9	2.2
Thailand	5.4	6.7	7.0	6.7	0.6	1.8	2.2	1.3	5.5	5.6	4.4	2.3
Philippines	4.4	4.5	4.5	4.2	3.1	3.1	3.9	4.0	5.5	2.1	1.6	0.8
Malaysia	4.1	5.2	5.7	6.0	1.8	1.1	2.2	2.5	7.6	11.1	10.9	9.7
Newly industrialized Asian economies	5.1	3.0	5.3	5.0	0.9	1.4	2.1	2.4	5.9	7.6	6.2	5.5
Korea	7.0	3.1	5.5	5.3	2.8	3.5	3.7	3.4	1.0	2.0	1.5	0.9
Taiwan Province of China	3.6	3.2	4.9	4.9	-0.2	-0.3	0.7	1.5	9.1	10.0	7.3	6.2
Hong Kong SAR	2.3	3.3	5.5	4.5	-3.0	-2.6	-0.5	0.8	8.5	11.0	10.3	9.8
Singapore	2.2	1.1	5.0	4.0	-0.4	0.5	1.2	1.5	21.4	30.9	28.0	26.7

¹In 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.

²Percent of GDP.

³Consists of developing Asia, the newly industrialized Asian economies, and Mongolia.

⁴Includes Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka.

agreement with the United States (CAFTA). The situation in a number of Caribbean countries, however, remains a concern. Conditions in the Dominican Republic have deteriorated in the wake of the banking crisis, and the economy is expected to contract by 1 percent in 2004. In Jamaica, very high public debt poses a significant risk to the outlook, and a comprehensive strategy to address the debt problem is needed. The countries of the Eastern Caribbean Currency Union (ECCU) also face serious difficulties, including weak fiscal positions, high debt burdens, and fragile financial sectors. Given the currency board arrangement, strong fiscal consolidation is now needed to reduce the risk of crisis.

Emerging Asia: With Recovery Taking Hold, Scope for Greater Exchange Rate Flexibility

In emerging Asia, GDP growth accelerated to 7 percent in 2003, accounting for about 50 percent of world growth (Box 1.4 and Table 1.7). Economic activity surged in the second half of

the year, reflecting both domestic demand and export growth. Consumption and tourism rebounded, especially in those economies that had been affected by SARS, supported by accommodative monetary policies and increased consumer credit. Investment grew briskly in China, but elsewhere it was held back by lingering balance sheet problems and, in some countries, political uncertainties related to upcoming elections. Exports were boosted by the pickup in global growth, the upturn in global demand for technology goods, and effective exchange rate depreciations, as most countries continued to intervene substantially to limit appreciations versus the U.S. dollar. Imports were robust as well, reflecting both the strength of exports and the rebound in domestic demand, so the region's current account surplus was broadly unchanged. Reflecting increasing capacity utilization rates and rising global commodity prices, inflation picked up modestly in most countries, although it remains very low.

Looking forward, growth is expected to remain high in 2004, based on the continued

Box 1.4. Is Emerging Asia Becoming an Engine of World Growth?

The economies in emerging Asia have grown at an extraordinary pace over the past three decades.¹ The average annual GDP growth rate in emerging Asia was about 7 percent during 1970–2002, compared with an average of 3 percent in OECD countries. As a result, emerging Asia's share in world GDP has increased from 9 percent in 1970 to 25 percent in 2003, compared with 21 percent for the U.S. economy.² An important characteristic of the rapid economic development of emerging Asia has been the emphasis on outward-oriented growth strategies. This has been reflected in high trade growth and a steady increase of emerging Asia's share in global trade, which more than doubled from 8 percent in 1978 to 19 percent in 2002.

A key question arising from emerging Asia's rapid growth is whether the region has become a locomotive for world growth. The region's strong growth performance in 2002 and 2003 has been in the face of a weak global environment. Emerging Asia accounted for 44 percent of world GDP growth in 2002 and for 24 percent of export growth in the rest of the world.³ However, exports continue to play an important role in growth in emerging Asia. Exports of goods and services remained close to 40 percent of GDP, while they accounted for 78 percent of total demand growth in 1999–2002, up from 66 percent in 1990–96.⁴

Note: The author of this box is Harm Zebregs.

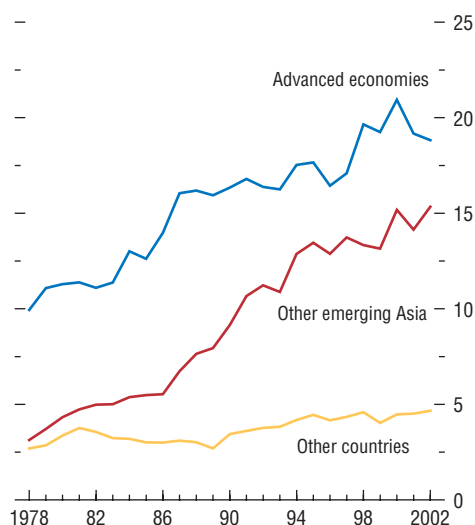
¹Emerging Asia is defined here to include China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, and Thailand.

²When measured at market exchange rates, emerging Asia's share in world GDP increased from 6 percent in 1970 to 10 percent in 2003.

³Emerging Asia's contribution to world GDP growth in market exchange rates was about 20 percent in 2002.

⁴Total demand is defined here as demand from residents and nonresidents for domestically produced output (equivalent to GDP less the change in inventories). Excludes China, for which no data are available on exports of goods and services in constant prices.

Emerging Asia: Exports
(Percent of emerging Asia GDP)



Sources: IMF, *Direction of Trade Statistics*; and IMF staff calculations.

The sharp rise in intraregional trade suggests that the region as a whole is becoming less dependent on the rest of the world and more of an autonomous engine of growth (see the first figure). Increased trade integration has clearly resulted in closer links between economies in the region and greater business cycle correlation across countries. Exports between countries in the region have risen steadily from about 20 percent of total exports in the late 1970s to 40 percent in 2002. The share of imports from the rest of the world in total imports declined from 82 percent to 58 percent over the same period. Moreover, the rise in intraregional exports accounted for more than half of export growth in emerging Asia in 1998–2002. China is an important factor in the rise in intraregional trade. Together with Hong Kong SAR, China absorbed 17 percent of exports of other countries in emerging Asia in 2002, and accounted for 35 percent of export

growth of other countries in the region in 1998–2002.⁵

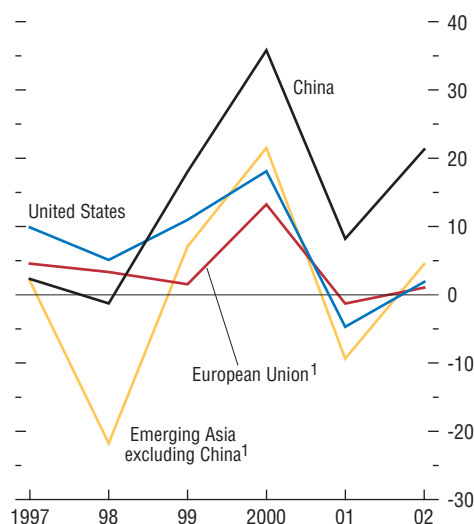
Advanced economies remain the largest export market for final goods of emerging Asia. This is because a key factor in the rise in intraregional trade in emerging Asia is vertical integration and geographical dispersion of production processes within the region. The share of intraregional trade in exports of intermediate goods in emerging Asia has increased from 25 percent in the late 1970s to 47 percent in 2002, while the shares of the European Union, Japan, and the United States declined over the same period. A rough estimate suggests that about 50 percent of intraregional intermediate exports end up in products that are exported to the rest of the world.⁶

Nevertheless, emerging Asia, especially China, is becoming an important source of demand for the world economy. With the recovery following the Asian financial crisis, emerging Asia's imports from the rest of the world now account for almost 2.5 percent of GDP of the rest of the world, compared with 4 percent for the European Union and 5.5 percent for the United States. Moreover, with China's increasing integration, and its dual role as a production hub and emerging consumer of final goods, its imports are increasing rapidly from all trading partners. In 2003, China's imports from the Asian region rose by 43 percent, the European Union by 31 percent, the United States by 24 percent, Latin America by 81 percent, and Africa by 54 percent. China is now the third-largest importer in the world.

⁵China and Hong Kong SAR are combined to eliminate bilateral trade between these two economies, which tends to distort China's contribution to regional export growth.

⁶This estimate is based on the 1995 Asia Input-Output table adjusted with 2001 export data (Monetary Authority of Singapore, 2003). It implies that roughly 40 percent of intraregional exports are ultimately consumed outside the region.

Import Value Growth
(Percent)



Sources: IMF, *Direction of Trade Statistics*; and IMF staff calculations.

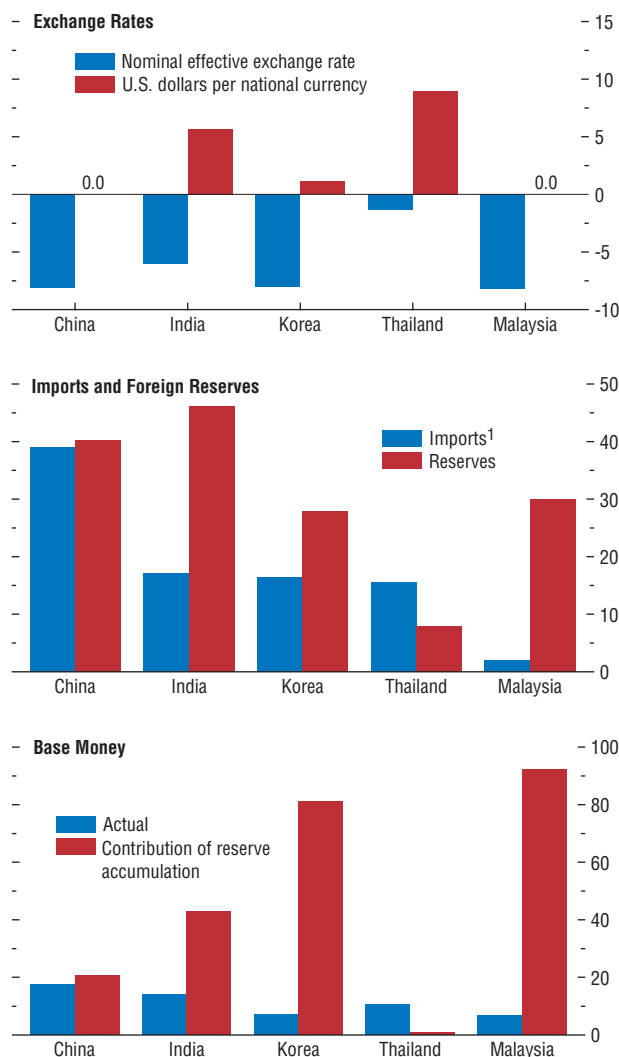
¹Excludes intraregional trade.

Emerging Asia has grown very rapidly over the past three decades and is an increasingly dynamic force in the global economy. In particular, China is becoming an important consumer of final goods, contributing to growth in the rest of the world, especially Japan. However, emerging Asia's growth remains heavily reliant on exports to advanced countries. For emerging Asia to expand its contribution to world growth, the region will need to further nurture domestic demand growth. In particular, structural reforms will be required to strengthen and deepen financial markets, improve public and private sector governance, and increase competition, as well as raise the labor productivity of the large rural populations in China and India. These measures would not only help balance emerging Asia's economic growth and make it more resilient, but would also help turn the region into a major engine of the global economy.

Figure 1.13. Emerging Asia: Foreign Reserve Accumulation

(Percent change from a year ago; end-2003 unless otherwise indicated)

To limit appreciations against the U.S. dollar, many countries continue to intervene substantially in the foreign exchange market. The resulting rapid buildup in foreign reserves is generally in excess of import growth. The monetary impact of foreign reserve accumulation has largely been sterilized, so actual base money growth has been much lower.



Sources: Bloomberg Financial, LP; IMF, *International Financial Statistics*; and IMF staff calculations.

¹Total imports for 2003.

momentum of domestic demand and the strong outlook for the global economy. The balance of risks in the short run is on the upside, with the possibility of favorable surprises to exports and capital inflows. Indeed, there is the risk that credit growth—driven in part by rapid reserve accumulation—may exacerbate financial imbalances in the countries with the strongest cyclical upturns. Foreign exchange intervention increased reserves by about \$250 billion in 2003, the counterpart of which was the region’s current account surplus and capital inflows.¹³ The monetary impact of foreign reserve accumulation has largely been sterilized, so base money growth has been much lower than the contribution of foreign reserve accumulation (Figure 1.13).

With growth accelerating and some financial imbalances emerging, many countries may need to gradually tighten macroeconomic policies in the coming year. While inflation is still generally low, it is turning up, so policies may need to be adjusted preemptively, given the lags before policy changes have their full effects. In countries where a tightening of monetary conditions is necessary, it would be desirable to achieve this in part through nominal effective exchange rate appreciation. As discussed in the September 2003 *World Economic Outlook*, greater exchange rate flexibility in most countries with strong external positions would allow monetary policy to be geared more toward domestic stabilization, reduce susceptibility to external shocks, lower the risks of future financial crises, cut the costs of holding foreign reserves, and improve consumption and investment opportunities, while also helping to resolve global imbalances. In addition, accelerated fiscal consolidation may be warranted in a number of countries, and it will be important to maintain fiscal discipline in the run-up to elections. Strengthened prudential oversight of the banking system will be crucial to

¹³The increase in reserves in 2003 is understated because China used about \$45 billion to recapitalize state banks. Looking forward, Korea has announced plans to use reserves to fund an investment corporation.

ensure that lenders appropriately evaluate and manage risks. At the same time, further progress on structural reforms is essential to support sustained, domestic-demand-led growth in the medium term.

Turning to individual countries, surging growth in China has helped to boost intra-regional trade and support regional growth, but signs of incipient overheating suggest that a further tightening of macroeconomic policies is now warranted. While strong fixed investment has helped to underpin real GDP growth, there are growing concerns about overinvestment in several sectors where output is booming and input prices have increased sharply. Despite measures to rein in money and credit growth—including open market operations and an increase in reserve requirements—and tighter prudential oversight of bank lending, credit growth remains strong. To mitigate the risk of overheating and avoid the buildup of sectoral imbalances, additional tightening of policies is needed in the period ahead to slow GDP growth to a more sustainable rate. Given the strength of the external position, the desirability of improving the effectiveness of monetary policy, and the need to facilitate adjustment to structural changes over the medium term, it remains in China's interest to move gradually to greater exchange rate flexibility. Fiscal consolidation is a key objective for the medium term, given pension reform costs, the sizable contingent liabilities associated with banking weaknesses, and the need to improve the social safety net and health care. Also, while the central bank recently recapitalized two of the four large state-owned banks and further liberalized lending rates, it will be important to implement concrete restructuring plans in the banking system, accelerate asset disposals by asset management companies, and restructure and diversify ownership of state-owned enterprises.

In India, growth has accelerated, reflecting both cyclical and structural factors. The structural factors include the lagged impact of economic liberalization during the 1990s on manufacturing production, the recent further

opening up of the external sector, the effect of investment in infrastructure (especially in roads and telecommunications), the corporate restructuring undertaken in recent years, and the impact of the global outsourcing of customer support services on exports. Cyclical and temporary factors include the effect of good monsoon rains on agricultural production, the impact of low interest rates on consumer and real estate credit, and the global recovery. Against this background, further progress in addressing India's large fiscal imbalances is urgent, because the recovery will increase the private sector's demand for financing, putting upward pressure on interest rates. The way forward is set out in the recent Fiscal Responsibility and Budget Management Act, which aims to balance the current budget by 2008, an adjustment of about 1 percent of GDP a year. Given India's low revenue-to-GDP ratio, the bulk of the adjustment will need to come from revenue-enhancing measures, including improving tax administration, broadening the tax base, and simplifying the tax regime. The appreciation of the rupee against the U.S. dollar under the managed float is welcome, and even greater flexibility would be desirable. While progress has been made in strengthening the financial system, vigilance over credit quality will continue to be necessary to limit risks from rapid credit growth.

Elsewhere in south Asia, strengthening growth in Pakistan provides the opportunity for fiscal consolidation, accelerating structural reforms, and improving institutions, which are essential to achieving sustained growth and reducing poverty. The priorities are to strengthen the tax effort, strictly control expenditures, and improve governance and transparency. In Bangladesh, fundamental improvements in tax administration are necessary to allow for increased spending on infrastructure and social priorities. Given the likely adverse impact on export earnings of the phasing out of quotas under the Multifibre Agreement in 2005, it is also crucial to improve competitiveness, including by pushing ahead with bank reform and improving governance.

In the ASEAN-4, Thailand's expansion has strong momentum and inflation remains low. With a closing output gap, the Bank of Thailand is shifting its focus from supporting activity to safeguarding stability, consistent with its inflation-targeting framework. Emerging pressures in some areas, notably the foreign exchange, equity, and housing markets, have been addressed through limits on short-term capital inflows and prudential regulations. Cyclical considerations and a still-high level of public debt argue for fiscal prudence. In Malaysia, economic activity is also recovering strongly and inflation and unemployment remain low. The key policy priority is to implement the announced fiscal consolidation geared to achieve a balanced budget by 2006, which will require further elaboration of a comprehensive set of policies. The fixed exchange rate system continues to be supported by strong fundamentals, but greater exchange rate flexibility supported by suitable macroeconomic policies would broaden Malaysia's policy options to address shocks. In Indonesia, modest growth continues to be driven by private consumption, inflation has declined, and the planned fiscal consolidation is appropriate. Looking ahead, it will be critical to sustain progress on banking, legal, and judicial reforms to help enhance the investment climate and put the economy on a higher growth path. In the Philippines, vulnerabilities remain, so it is important—especially in the run-up to the presidential elections in May—to stay the fiscal course and stand ready to tighten monetary policy should exchange rate depreciation pose a threat to the attainment of the inflation target. Thereafter, the priorities are to act forcefully and without delay to increase tax revenue, restructure the power sector, strengthen the banking system, and improve the business environment.

In the Asian newly industrialized economies (NIEs), which were hardest hit by SARS, the recoveries have relied more heavily on net exports, so it is appropriate to maintain supportive macroeconomic policies until domestic demand gains traction. To help rebalance

growth from external to domestic sources, greater exchange rate flexibility would be desirable, and monetary policy could be used to support domestic demand if necessary. In Korea, where domestic demand has been held back by high household debt and industrial relations problems, supportive monetary and fiscal policies need to be sustained. Further efforts are needed to strengthen the financial system, including stepped-up supervision of consumer lending; improve corporate governance; and enhance labor market flexibility. In Singapore, supportive macroeconomic policies have assisted the recovery, while a deepening and acceleration of reforms, including further divestment of government-linked companies, would help to enhance medium-term competitiveness and growth prospects. In Hong Kong SAR, where robust private consumption is driving a stronger recovery, deflation is abating and the key policy priority is fiscal consolidation.

In contrast to the Asian NIEs, the surge in growth in Australia and New Zealand has been driven primarily by domestic demand, so external current account deficits have widened significantly. Household spending is being underpinned by immigration, declining unemployment rates, buoyant housing prices, and rapid growth of consumer credit. Looking forward, growth prospects are strong, especially in Australia, where productivity growth has been robust. Although currency appreciations in both countries are dampening inflation in traded good prices, low unemployment and high capacity utilization are contributing to upward pressure on the prices of nontraded goods. As a result, policy interest rates have been raised over the past six months in both countries (by $\frac{1}{2}$ percentage point in Australia and $\frac{1}{4}$ percentage point in New Zealand), and further increases may be necessary. Fiscal positions in both countries are strong, and bank, corporate, and household balance sheets remain generally sound. While medium-term prospects are favorable, reforms to the pension and health systems will be necessary to contain fiscal pressures arising from aging populations.

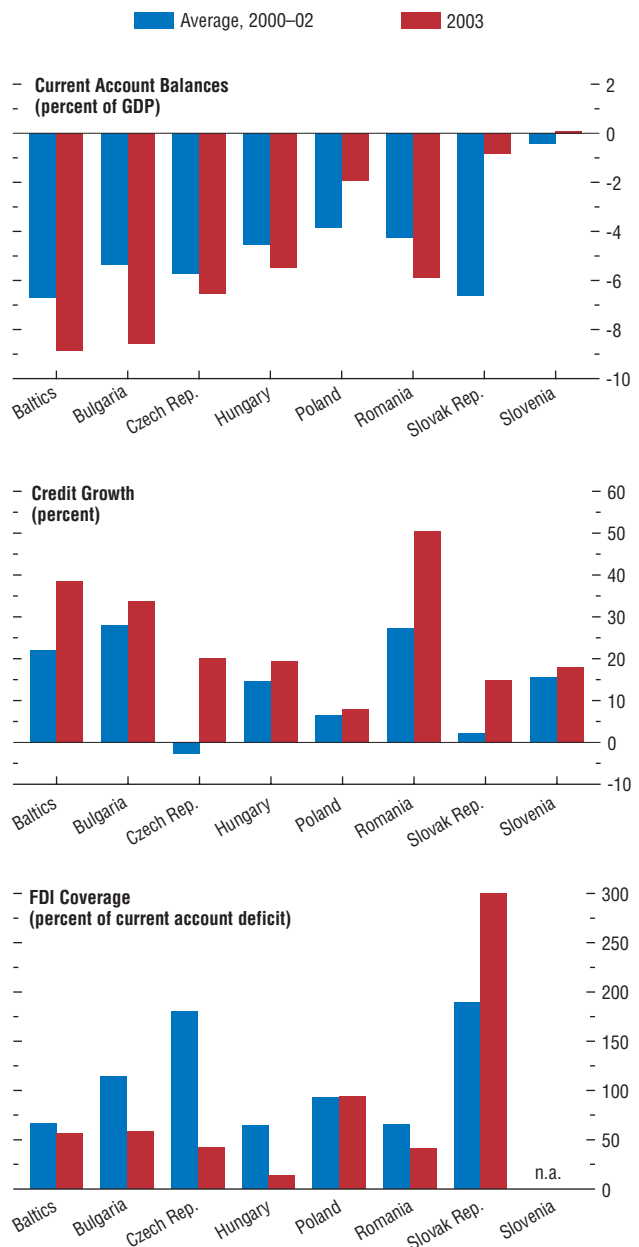
EU Accession Countries: External Imbalances Need to Be Addressed

Following their remarkable economic transformation over the past decade, 10 accession countries will join the European Union in May 2004 (Bulgaria and Romania hope to follow in 2007). Attention will then turn to the next stage of the integration process with Europe, adopting the euro, and the prior requirement of meeting the Maastricht criteria, including membership of the Exchange Rate Mechanism (ERM2) for at least two years. In moving forward with this process, a high premium will need to be placed on ensuring that the macroeconomic framework is fully consistent with announced policy objectives as shifts in market expectations about macroeconomic convergence will be a continuing potential source of pressure on exchange and interest rates. Against this background, the sharp widening in the current account deficits in a number of countries in 2003—as rapid credit growth and/or expansionary fiscal policies fueled a surge in imports—and the decline in net foreign direct investment (FDI) inflows (and the FDI coverage of the current account deficits) have raised questions about external sustainability and competitiveness, and the consistency of policies with announced convergence objectives (Figure 1.14). Indeed, with growth expected to accelerate during 2004–05—and to be well above the rate in western Europe—current account deficits in most of the EU accession countries are expected to remain high (Table 1.8).

Are existing current account imbalances a cause for concern? While near-term vulnerabilities are certainly cushioned by the low levels of external debt, adequate international reserves, and—despite the decline last year—still generally high FDI coverage of the deficits, current account imbalances of this size will certainly not be sustainable over the medium term, and do increase the risks of financial market volatility. As countries move ahead with their strategies for adopting the euro, it will therefore be important that policies focus on reducing existing imbalances to minimize such risks. In partic-

Figure 1.14. EU Accession Countries: Current Account Balance and Foreign Direct Investment

Current account deficits are large and widened in a number of the accession countries in 2003 as lax fiscal policy and strong domestic credit growth fueled imports. At the same time, FDI flows have financed a smaller share of the current account deficit than in earlier years.



Sources: Haver Analytics; IMF, *International Financial Statistics*; and IMF staff calculations.

Table 1.8. EU Accession Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices ¹				Current Account Balance ²			
	2002	2003	2004	2005	2002	2003	2004	2005	2002	2003	2004	2005
EU accession countries	4.4	4.4	4.5	4.4	15.3	9.5	7.1	5.6	-3.0	-3.8	-3.8	-3.5
Turkey	7.9	5.8	5.0	5.0	45.0	25.3	12.0	10.6	-0.8	-2.9	-3.0	-2.4
Excluding Turkey	3.0	3.9	4.3	4.2	5.3	3.8	5.1	3.6	-3.9	-4.1	-4.1	-4.0
Baltics	6.4	7.4	6.2	5.9	1.5	0.5	2.1	2.6	-7.3	-8.9	-8.5	-7.2
Estonia	6.0	4.7	5.5	5.0	3.6	1.3	3.0	2.5	-12.2	-13.7	-11.0	-7.5
Latvia	6.1	6.7	6.0	6.0	1.9	2.9	3.0	3.0	-7.2	-9.1	-9.9	-8.1
Lithuania	6.8	9.0	6.7	6.3	0.3	-1.2	1.1	2.5	-5.2	-6.5	-6.7	-6.7
Central Europe	2.2	3.4	4.0	3.8	2.8	2.2	4.2	3.1	-3.6	-3.3	-3.4	-3.5
Czech Republic	2.0	2.9	3.0	3.4	1.8	0.1	3.5	3.0	-6.1	-6.5	-5.4	-4.8
Hungary	3.5	2.9	3.2	3.4	5.3	4.7	7.1	4.4	-4.1	-5.5	-5.3	-4.3
Poland	1.4	3.7	4.7	4.0	1.9	0.8	3.0	2.4	-2.6	-2.0	-2.3	-2.9
Slovak Republic	4.4	4.2	3.9	4.1	3.3	8.5	7.8	4.2	-8.0	-0.9	-2.9	-3.5
Slovenia	2.9	2.3	3.5	4.1	7.5	5.6	3.7	3.4	1.4	0.1	-0.6	-1.0
Southern and south-eastern Europe	4.6	4.5	4.8	4.9	16.1	10.7	9.4	5.9	-3.8	-6.2	-5.6	-5.4
Bulgaria	4.8	4.3	5.0	5.2	5.8	2.3	6.0	3.6	-4.3	-8.6	-8.4	-7.7
Cyprus	2.0	2.0	3.0	3.5	2.8	4.1	1.2	3.7	-5.4	-5.0	-4.4	-4.1
Malta	1.2	1.3	2.6	3.2	2.2	1.3	2.1	2.0	-2.1	-4.3	-3.5	-3.1
Romania	5.0	4.9	5.0	5.0	22.5	15.3	12.0	7.2	-3.4	-5.9	-5.2	-5.2

¹In 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.

²Percent of GDP.

ular, firm action is needed to reestablish budgetary discipline in a number of countries to put fiscal policy on a course to meet the Maastricht criteria (and this will need to be achieved while making room for additional spending associated with membership in the European Union and the North Atlantic Treaty Organization (NATO)). The rapid expansion of domestic credit will also need to be carefully monitored. While the ongoing process of financial deepening is clearly welcome, monetary policy will need to stand ready to slow credit growth if necessary, while strong supervisory and prudential oversight of the banking system is required to guard against the possible disruptive effects of excessive credit growth (see Chapter IV).

Turning to individual countries, a recovery is under way in Poland, led by exports—which are benefiting from the significant depreciation of the exchange rate over the past 18 months—and fiscal stimulus. While the economy is expected to strengthen further in the near term, the serious deterioration in the fiscal position must be addressed to maintain investor confidence and

reinforce the durability of the recovery. The 2004 budget—which envisaged a sharp widening in the fiscal deficit—is therefore a step in the wrong direction, and the Hausner Plan to contain fiscal outlays must be fully implemented to retain the confidence of financial markets. Interest rates have been on hold since mid-2003, and with inflation now rising and expected to move above the midpoint of the central bank's target range by year-end, the room for further monetary easing has disappeared.

In Hungary, the economy slowed in 2003 despite strong consumption growth, which was fueled by fiscal expansion and associated large wage increases. Imports grew strongly, exports slowed, and tourism receipts fell, resulting in a widening of the current account deficit to 5½ percent of GDP, which was largely financed by debt as net FDI flows declined. Concerns about fiscal and external imbalances put downward pressure on the forint in late 2003, and the central bank raised its main policy rate by 600 basis points during June–November 2003, although a recent easing of these pressures has subse-

quently allowed a modest reduction in interest rates. While growth is anticipated to pick up in 2004 to 3¼ percent, the outlook critically depends on the authorities taking measures—particularly on the fiscal side—to restore market confidence and allow risk premia and interest rates to come down.

Growth of 3 percent is expected in the Czech Republic this year as stronger investment and exports—which will benefit from the recovery in western Europe—offset some slowing in consumption. Inflation fell to low levels in 2003—hovering around zero for much of the year—and the central bank kept interest rates at euro area levels. Fiscal developments, however, have been disappointing, with the general government deficit widening in 2003. To keep public debt low, it will be important that the authorities' medium-term fiscal adjustment plans are implemented in full. In the Slovak Republic, strong export performance has underpinned growth and a significant reduction in the current account deficit, while progress is being made toward needed fiscal consolidation.

Buoyant domestic demand in the lead-up to EU membership has underpinned strong growth in the Baltic countries, but current account deficits have widened sharply from already high levels and are a key concern, particularly against the background of lower FDI coverage. While fiscal policy has generally been prudent and public debt remains low, an increase in public saving is needed to help reduce external imbalances. Ongoing efforts to strengthen the financial sector are welcome, although the authorities will need to remain vigilant for any problems that may arise as a result of current strong credit growth.

Growth in Bulgaria and Romania has been buoyed by strong credit growth, and while inflation is still relatively subdued, current account deficits have widened sharply. Vulnerabilities are mitigated by the relatively comfortable international reserves position (and low external debt in Romania), but nevertheless steps—particularly to tighten fiscal policy—are needed to reduce external imbalances. To slow

credit growth, interest rates have been raised by 300 basis points since August in Romania and prudential rules have been tightened in both Romania and Bulgaria, but the authorities need to remain watchful as further action may be required. In Slovenia, domestic demand has strengthened, but a weak external sector performance held back real GDP growth in 2003. Fiscal policy has remained prudent, but monetary policy needs to more resolutely focus on reducing inflation (which remains well above the euro area average).

In southeastern Europe, economic performance in Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, and Serbia and Montenegro has generally been favorable, and growth is expected to strengthen further in 2004, boosted by the anticipated recovery in western Europe. Significant economic challenges remain, however, including the need to foster an environment more conducive to private sector-led growth—which will require less government involvement in the economy, deregulation, a reduction in corruption, and a continuation of ongoing efforts to increase political stability—and to address large current account deficits to reduce external vulnerabilities.

In Turkey, improved financial markets conditions have had a positive impact on economic activity. Real GDP expanded by 5¼ percent in 2003, boosted by private investment and to a lesser extent private consumption, and growth is expected to average 5 percent during 2004–05. Inflation pressures have eased considerably, aided by the appreciation of the exchange rate, and the external position remains manageable, although higher oil prices and the impact on tourism of terrorist-related uncertainties could affect the current account deficit this year. There are, however, significant risks to this outlook. Public debt dynamics are vulnerable to any loss of confidence in the financial markets, and it is therefore important that the 6½ percent of GNP primary surplus target be achieved. The acceleration of legislative reforms aimed at EU accession has helped financial market confidence, but

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			
	2002	2003	2004	2005	2002	2003	2004	2005	2002	2003	2004	2005
Commonwealth of Independent States³	5.1	7.6	6.0	5.2	13.8	12.1	10.3	8.8	6.9	7.0	6.1	3.8
Russia	4.7	7.3	6.0	5.3	15.8	13.7	11.2	9.9	8.9	8.9	7.9	5.1
Ukraine	5.2	9.3	6.0	4.0	0.8	5.2	6.9	4.6	7.5	6.0	3.6	2.6
Kazakhstan	9.5	9.5	8.0	7.5	5.9	6.4	6.5	5.8	-2.8	2.4	2.3	-0.5
Belarus	5.0	6.8	4.8	3.5	42.6	28.4	22.7	13.6	-2.6	-2.6	-3.5	-3.8
CIS-7	6.4	6.2	5.1	6.2	17.7	8.5	6.4	5.6	-4.2	-7.3	-9.5	-6.4
Armenia	12.9	12.0	7.0	6.0	1.1	4.8	3.0	3.0	-6.6	-7.7	-6.9	-6.2
Azerbaijan	10.6	11.2	8.1	13.2	2.8	2.2	4.0	2.5	-12.3	-25.8	-32.2	-16.3
Georgia	5.5	8.6	6.0	5.0	5.6	4.8	5.8	5.0	-6.0	-7.9	-9.4	-9.5
Kyrgyz Republic	—	5.2	4.1	4.5	2.1	2.7	3.7	3.8	-3.9	-3.5	-4.2	-5.3
Moldova	7.8	6.3	5.0	4.0	5.3	11.7	9.5	6.9	-6.0	-7.9	-7.0	-7.5
Tajikistan	9.1	10.2	8.0	4.0	12.2	16.4	8.5	5.0	-2.7	-1.3	-2.2	-4.7
Uzbekistan	3.2	0.3	2.0	2.0	44.3	14.8	8.9	9.3	2.5	7.0	6.7	4.4
<i>Memorandum</i>												
Net energy exporters ⁴	5.1	7.5	6.1	5.5	14.8	12.9	10.7	9.5	7.7	7.8	7.0	4.4
Net energy importers ⁵	5.2	7.9	5.4	3.8	10.7	9.5	9.1	6.3	3.2	2.7	1.0	0.1

¹In 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.

²Percent of GDP.

³Excludes Mongolia. Updated data for Turkmenistan not available.

⁴Includes Azerbaijan, Kazakhstan, Russia, and Turkmenistan.

⁵Includes Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Tajikistan, Ukraine, and Uzbekistan.

measures to expedite reforms in the financial sector to strengthen the supervisory and legal framework are still needed.

Commonwealth of Independent States: Managing the Challenges of Remonetization

GDP growth in the CIS countries again exceeded expectations in 2003 and is now estimated at 7.6 percent, 1.7 percent higher than projected last September (Table 1.9). Within this, almost all countries experienced solid growth, underpinned to differing extents by higher-than-expected oil prices; buoyant consumption and wage growth; highly competitive exchange rates; and, in some cases, unexpectedly strong growth in investment. Looking forward, GDP growth is expected to moderate in 2004 and 2005 as consumption and investment growth return to more sustainable levels and oil prices ease, but it should nonetheless remain relatively strong by historical standards.

Over the past five years, the growth performance in the CIS has been surprisingly resilient, aided by Russia's successful recovery from the 1998 crisis and improved macroeconomic stability—particularly lower inflation—in many countries in the region. However, recent growth has depended heavily on the energy sector; to be sustained, it will need to be generated increasingly by new investment in other sectors. While there are encouraging signs that this may now be occurring in some countries, sustained progress will require further measures to strengthen the investment environment, particularly by developing the institutions and structures needed to support a market-based economy, which remains the Achilles' heel of the region (particularly, but not only, in Belarus, Tajikistan, Turkmenistan, and Uzbekistan). In this connection, as the 2003 *EBRD Transition Report* underscores, it is disturbing that the pace of reform in the CIS has recently lagged that in southern Europe, raising concern that some CIS countries could fall permanently behind. In a number of cases, more

rapid progress may require political reforms to reduce the power of vested interests that benefit from a situation of partial reform. As the experience of the accession countries shows, external anchors—including the WTO—can, if observed, potentially play a helpful role in developing a domestic consensus for reform.

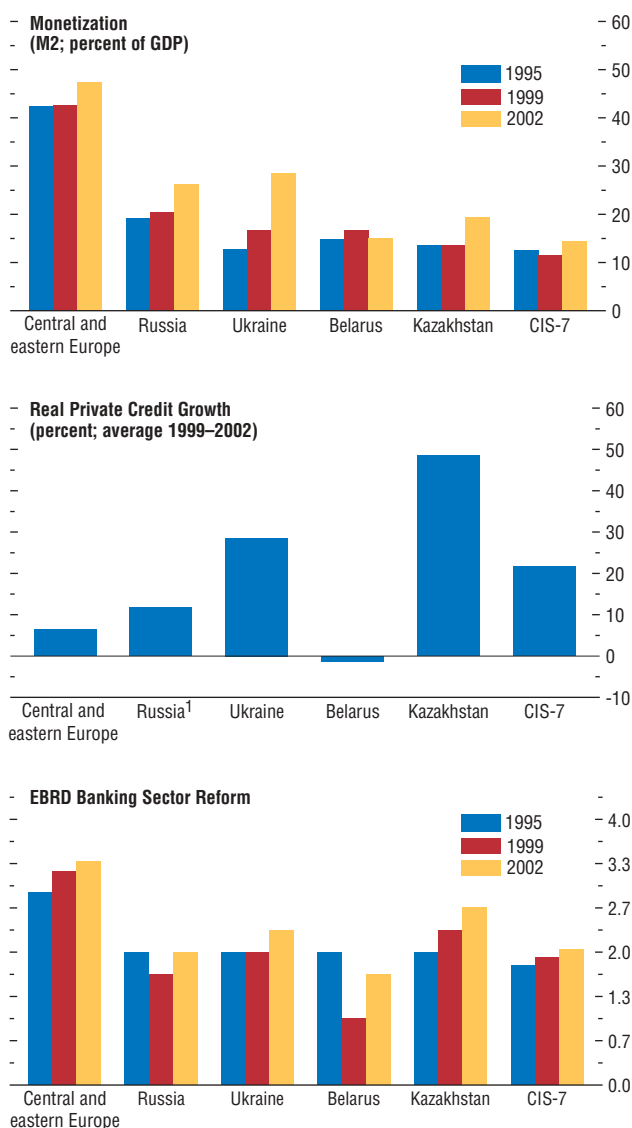
An improved investment environment needs to be accompanied by stronger banking systems—the main source of investment finance—which remain generally weak and underdeveloped, and an improved judicial framework. In this connection, the recent rapid growth in bank deposits—remonetization—in many CIS countries (Figure 1.15) is welcome, but poses new macroeconomic and prudential challenges:¹⁴

- Given banks' generally weak abilities to assess loans and creditworthiness, rapid credit expansion poses risks to financial stability (see Chapter IV). While progress has been made in bank reform, it significantly lags that in other transition economies (Figure 1.15); without additional progress, underdeveloped banking systems may increasingly place a speed limit on sustainable growth.
- To date, rising money demand has made it possible to combine rapid monetary growth with relatively low inflation, and—particularly in the energy-exporting countries and Ukraine—to maintain relatively stable exchange rates in the face of large foreign exchange inflows. But remonetization is unpredictable and must eventually slow, at which time rapid money growth would pose an inflationary threat (already a concern in some countries). In such circumstances, the authorities will need to be ready to tighten monetary policy, including by allowing exchange rates to appreciate.

¹⁴See “The Next Ten Years of Transition: The Challenges Ahead,” remarks by John Odling-Smee to the International Seminar dedicated to the 110th Anniversary of the Establishment of the State Bank in Armenia and the 10th Anniversary of the Introduction of the National Currency of the Republic of Armenia, Yerevan, November 23, 2003. (Available via the Internet: <http://www.imf.org/external/np/speeches/2003/112303.htm>.)

Figure 1.15. Commonwealth of Independent States: Remonetization and Credit Growth

Money stocks are rising markedly in a number of CIS countries, accompanied by rapid credit growth; banking reforms have moved ahead, but are less advanced than in central and eastern Europe.



Sources: IMF, *International Financial Statistics*; and European Bank for Reconstruction and Development, *Transition Report 2002*.

¹Since private credit fell sharply in 1999 following the 1998 crisis, real private credit growth in 2000–02 is significantly higher.

Turning to individual countries, Russia's economic performance has remained impressive, with Moody's revision of its external debt rating to investment grade in October 2003, underlining the progress made since the 1998 crisis. But while the economy is growing strongly, the pace of disinflation remains slow, and a tighter monetary policy is needed to achieve the 8–10 percent inflation target in 2004, including greater upward exchange rate flexibility and active sterilization of foreign exchange intervention. A somewhat more restrictive fiscal stance would help achieve the inflation objective and reduce appreciation pressures, while providing insurance against lower-than-expected oil prices (in this respect, the establishment of an oil stabilization fund is welcome). On the structural side, further progress is needed with respect to the financial sector, natural monopolies, and the civil service and public administration to achieve the goal of doubling real GDP in the next decade, and to help reduce excessive dependence on oil.

In Ukraine, despite a poor harvest, GDP growth accelerated to 9.3 percent in 2003, underpinned by surprisingly strong growth in domestic demand, as well as strong exports, including to China. While the impact of these factors is expected to decline in 2004 and 2005, GDP is nonetheless projected to remain solid by historical standards, with risks potentially on the upside. Rising real money demand has allowed the authorities to maintain the de facto peg of the hryvnia to the U.S. dollar in the face of a very strong external position, and the fiscal stance is prudent, but more flexible exchange rate management eventually will be needed to reduce inflationary risks. On the structural side, progress has been made in approving pension legislation and corporate and personal tax reform. However, the tax environment remains distorted by governance problems, and strengthening the financial sector, addressing high quasi-fiscal deficits and debt in the energy sector, and improving corporate governance remain key priorities.

In Belarus, macroeconomic performance has been mixed. The proposed currency union with

Russia in 2005 could be used as an external anchor, but would need to be supported by tighter macroeconomic policies and much greater political commitment to the reform process.

The CIS-7 countries have also generally experienced solid economic growth since 2001, aided by the strong performances of the larger countries in the region. As set out in the CIS-7 Initiative, implementation of reform programs in nationally developed Poverty Reduction Strategy Papers is key to addressing their pressing poverty and debt sustainability problems, supported by additional assistance from the international community. Over the past year, debt indicators have improved in three of the five heavily indebted countries, most notably Armenia, although further progress is needed to ensure sustainability; in Georgia and Moldova policy slippages have set back possible debt rescheduling and restructuring operations. Addressing intraregional trade and transit barriers, which seriously dilute the benefits of generally liberal de jure trade regimes and appear especially costly for the poorest CIS-7 countries (Kyrgyz Republic and Tajikistan), could also play an important role.

Middle East: Improved Prospects, but Much Depends on Geopolitical Uncertainties and Security Situation

In the Middle East, real GDP growth strengthened in 2003, reflecting higher oil production and—in the second half of the year—the reduction in uncertainties following the Iraq war (Table 1.10). Although the war disrupted trade, investment, and tourism flows in the first half of 2003, economic activity recovered in the second half of the year, with firms in several countries winning reconstruction contracts and trade and tourism rebounding (Figure 1.16). Improved prospects for non-oil sectors were reflected in surges in equity prices. Oil-exporting countries benefited from both higher world oil prices and increased export volumes, as they raised oil output to replace the loss of Iraqi production and

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			
	2002	2003	2004	2005	2002	2003	2004	2005	2002	2003	2004	2005
Middle East	4.2	5.4	4.1	5.0	7.5	8.6	8.9	8.1	4.6	7.3	6.0	3.4
Oil exporters³	4.6	6.3	4.2	5.2	9.4	10.4	10.4	9.8	5.7	8.8	6.9	4.1
Iran, I.R. of	7.2	5.9	5.9	5.8	15.8	17.0	16.0	15.0	3.3	0.1	-1.4	-2.2
Saudi Arabia	1.0	6.4	0.7	3.2	-0.6	0.5	1.0	0.9	6.3	12.9	9.9	5.5
United Arab Emirates	1.9	7.0	2.4	4.6	3.1	2.8	2.6	2.4	4.9	8.5	8.4	7.0
Kuwait	-0.4	9.9	0.7	2.7	1.4	1.2	2.0	2.0	11.9	16.9	15.5	12.2
Mashreq	3.2	3.0	3.7	4.4	2.0	3.2	4.7	3.4	0.1	1.4	1.7	0.8
Egypt	3.2	3.1	3.7	4.5	2.4	3.2	5.2	3.5	0.7	2.4	4.3	3.1
Syrian Arab Republic	3.2	2.5	3.6	4.0	0.6	4.3	4.0	4.0	7.1	5.0	2.8	1.7
Jordan	5.0	3.2	5.0	5.5	1.8	2.3	3.0	1.8	4.5	11.1	5.3	1.6
Lebanon	2.0	3.0	3.0	3.0	1.8	1.4	2.0	2.0	-13.2	-12.6	-10.9	-9.0
<i>Memorandum</i>												
Israel	-0.8	1.3	2.4	3.4	5.7	0.7	-0.3	1.6	-1.3	-0.2	0.3	-0.4

¹In 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.

²Percent of GDP.

³Includes Bahrain, Iran, I.R. of, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, United Arab Emirates, and Yemen.

the demand for oil picked up as the global economy gained momentum. In these countries, the external current account and fiscal balances also improved.

Accelerating global growth is expected to underpin non-oil activity in 2004–05, but the growth of oil production in most oil exporters is projected to slow sharply as Iraqi oil output comes back on stream. Geopolitical uncertainties and the unsettled security situation in some countries constitute important downside risks. At the same time, unemployment rates across the region remain high, and, in some countries, fiscal imbalances are still large or are likely to reemerge as oil revenues decline. Thus, medium-term growth prospects depend crucially on structural reforms and, in some countries, fiscal consolidation to address vulnerabilities. In light of the projected rapid growth of the working-age population, there is a special need to spur employment growth and improve skill matches through labor market reform.

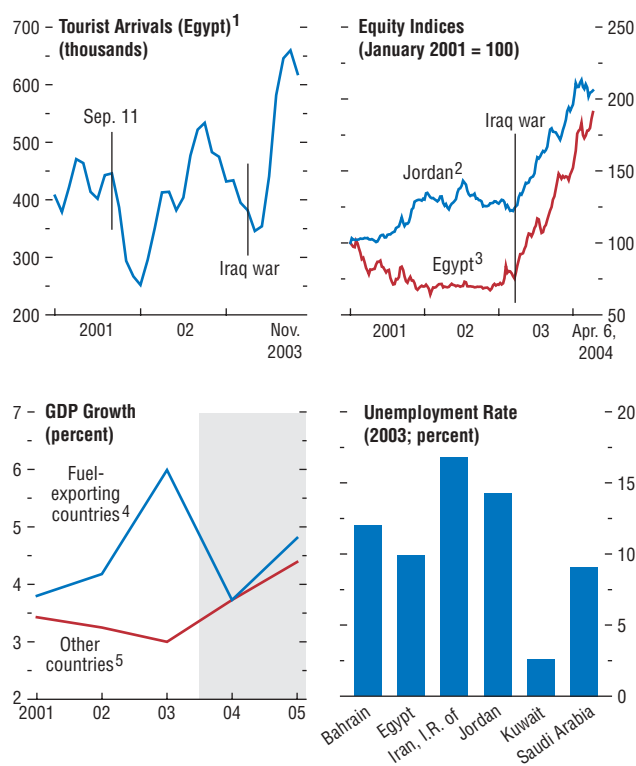
In Iraq, oil production has returned to its pre-war level, but security conditions have deteriorated significantly, and the modalities for the transfer of power to a provisional Iraqi government by mid-2004 are not yet settled. Informa-

tion on recent economic developments is scarce, with a long lag in the processing of inflation statistics and no data on conjunctural economic activity, budget outcomes, monetary developments, or the balance of payments. Anecdotal evidence suggests that industrial capacity is significantly underutilized and unemployment is high. In this environment, external support—including debt relief—is essential, and policies need to focus on capacity building, reconstruction, and macroeconomic stability. Once the new government is in place, it will be important to focus on strengthening institutions, which are essential for high-quality, sustainable growth in the medium term, as emphasized in Chapter III of the April 2003 *World Economic Outlook*.

Among the oil-exporting countries, economic growth in Iran continues to be strong and broad based, driven by robust oil exports, fiscal stimulus, rapid credit expansion, and business optimism, which in turn reflects the easing of international tensions over Iran's nuclear energy program and expectations of further structural reforms. However, high government spending out of oil resources is causing domestic liquidity and inflation to grow at high rates—and the recent devastating earthquake that destroyed the

Figure 1.16. Middle East: Reduction in Uncertainties Boosts Prospects

Non-oil activity and short-term prospects recovered in the second half of 2003, with tourism rebounding and equity prices surging. However, the projected leveling off of oil production will dampen growth in oil-exporting countries. Unemployment rates remain high throughout the region, underlining the importance of reforms to boost medium-term growth.



Sources: Bloomberg Financial, LP; Haver Analytics; and IMF staff estimates.

¹ Three-month moving average.

² Jordan stock market general price index.

³ The Hermes financial index.

⁴ Bahrain, Iran, I.R. of, Kuwait, Libya, Oman, Qatar, Saudi Arabia, United Arab Emirates, and Yemen.

⁵ Egypt, Jordan, Lebanon, and Syrian Arab Republic.

city of Bam is requiring additional government spending. Thus, fiscal consolidation and monetary tightening are needed to help contain broad money growth and inflation. On the structural side, trade and financial sector reforms have advanced and foreign direct investment has been liberalized, but further progress needs to be made in improving the business environment, reducing labor market rigidities, and privatizing public enterprises, to boost medium-term growth and bring down the still-high unemployment rate.

In other oil exporters, higher world oil prices and increased oil production in 2003 led to surges in real GDP growth, stronger external current account surpluses, and sharp improvements in government budget balances. Looking ahead, growth rates are expected to slow, current account surpluses to decline, and fiscal balances to weaken, as oil production quotas fall in 2004 and world oil prices ease in 2005. Thus, in most countries, fiscal consolidation is essential to reduce vulnerability to oil price fluctuations, including steps to broaden the non-oil revenue base, strengthen expenditure management, and reduce current outlays. In all countries, it is crucial to invigorate growth in the non-oil sector and generate employment opportunities by making further progress in labor market reforms and in reforming the legal, regulatory, and institutional framework to encourage foreign investment and enhance the role of the private sector.

In Egypt, growth picked up during the course of 2003, reflecting in part the favorable impact of earlier exchange rate depreciation on manufactured exports and a recovery of tourism after the Iraq war. While the stock market is clearly signaling an improvement in the short-term outlook, broad-based measures are needed to increase medium-term growth to the level required to absorb the rapidly rising labor force and improve living standards. Fiscal consolidation is essential to strengthen the government budget and improve debt sustainability; monetary tightening is needed to dampen inflationary pressures; coordinated reforms are crucial to increase exchange market flexibility; weaknesses

in the banking system need to be addressed; and structural reforms are necessary to create a more business-friendly environment.

Elsewhere in the Mashreq, macroeconomic conditions are also strengthening following the disruption of the Iraq war, but further reforms are needed to sustain growth in the medium term.¹⁵ In Syria, growth is projected to pick up in 2004, based on a rebound of exports to Iraq and some private sector response to the reforms undertaken in 2003 and expected in 2004, including recent interest rate reductions and the opening of private banks. However, additional reforms—including further exchange rate and trade liberalization, introduction of a value-added tax, and the liberalization of interest rates—will be needed to lift economic growth sufficiently to bring down high unemployment rates. In Lebanon, exports have picked up and tourism has increased, helped by the substantial real exchange rate depreciation in 2002–03. However, public debt dynamics remain very difficult, underlining the importance of accelerating fiscal adjustment, including fundamental expenditure and revenue reforms. In Jordan, exports grew and domestic demand rebounded—supported by strong fiscal stimulus—in the second half of 2003. However, fiscal measures are required—including a multiyear strategy to eliminate remaining subsidies on petroleum products—to meet the government deficit target in 2004 of 3.9 percent of GDP, and the reform of the pension system needs to be completed.

In Israel, an incipient recovery appears to be taking hold, led by external demand. The reduction in regional uncertainties and the upturn in global technology spending have spurred exports, including tourism, and boosted financial markets, with a rise in stock prices, an appreciation of the exchange rate, and a reduction in the risk premium on external debt. To foster the recovery, while maintaining macroeconomic stability, it is important to rebalance the policy mix

toward tighter fiscal policy and looser monetary policy. As inflationary pressures are subdued, reflecting the still-large output gap and exchange rate appreciation, the recent cuts in the policy interest rate are welcome. The targeted reduction in the government budget deficit to 4 percent of GDP in 2004 is appropriate, and the planned adoption of expenditure ceilings will help to support a gradual reduction in spending over the medium term.

Following two years of steep decline, the Palestinian economy recovered slightly in 2003, reflecting an increase in residential construction driven by pent-up demand, improved access to the Israeli labor market, and the return of revenues by the government of Israel. However, real GDP was still some 30 percent below its level in 1999, and the outlook depends crucially on the security situation, the associated curfews and closures, and the economic impact of the separation fence. As a result, the fiscal situation continues to be difficult, and budget support from external donors remains essential. While the revenue and expenditure system has been made stronger and more transparent, further reforms are needed, including a new income tax law based on international best practice and improved control over the hiring of government employees.

Africa: The Struggle to Reduce Poverty

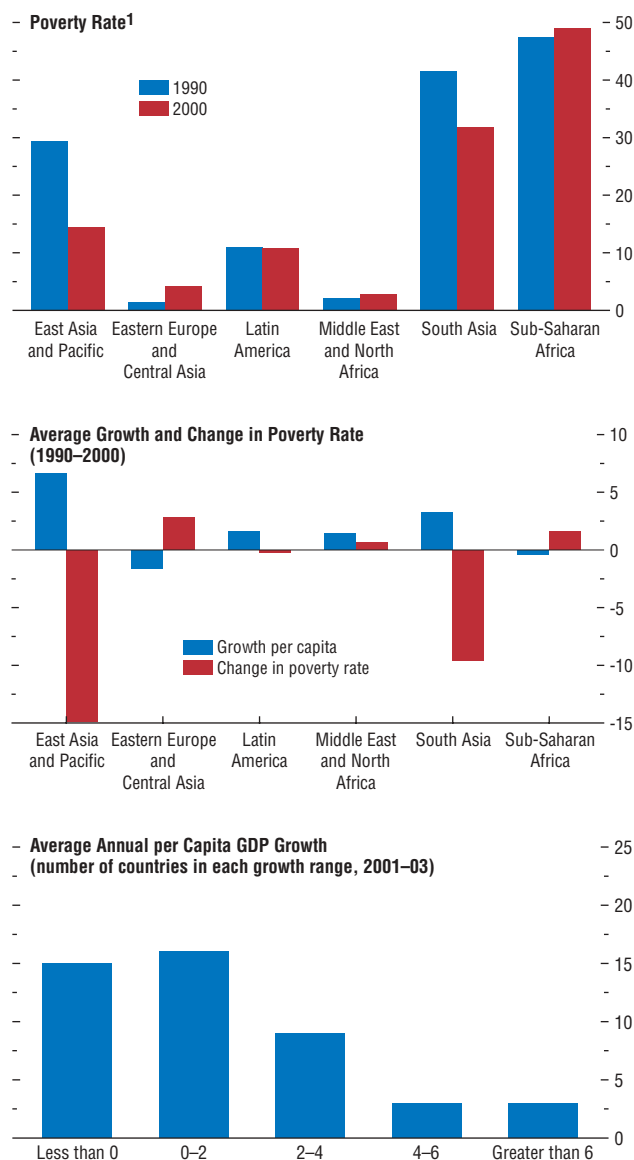
At the global level, important progress is being made in reducing poverty, with the latest estimates indicating that just under 22 percent of the world's population is living in extreme poverty, compared with 28 percent in 1990.¹⁶ Much of this improvement, however, has been in east and south Asia, particularly China and India (Figure 1.17). In sub-Saharan Africa, extreme poverty is actually estimated to have increased, and nearly one-half of the population is living below the poverty line (the actual number of people in extreme poverty is estimated to have

¹⁵The Mashreq consists of Egypt, Jordan, Lebanon, and the Syrian Arab Republic.

¹⁶Data taken from World Bank, *Global Poverty Monitoring* (available via the Internet: <http://www.worldbank.org/research/povmonitor/>). Extreme poverty is defined as living on less than \$1.08 a day. The latest data available are for 2000.

Figure 1.17. Sub-Saharan Africa: Growth and Poverty
(Percent unless otherwise indicated)

Poverty in sub-Saharan Africa is estimated to have increased as per capita GDP growth has stagnated. Unless growth is accelerated, the goal of halving poverty by 2015 will not be achieved. Within sub-Saharan Africa, some countries have achieved robust growth, but per capita GDP has fallen in many others.



Sources: World Bank; and IMF staff calculations.

¹Poverty defined as living on less than \$1.08 a day. This definition is different from that in Figure 1.12, where the poverty line is higher.

risen by 60 million). The relative success of different regions in reducing poverty appears closely related to their growth performance, with annual real per capita GDP rising by an average of 7 percent in east Asia, but stagnating in sub-Saharan Africa.

To achieve the Millennium Development Goal (MDG) of halving extreme poverty by 2015, growth in sub-Saharan Africa will need to accelerate markedly, perhaps to about 7 percent a year (4½ percent in per capita terms given population growth of 2½ percent).¹⁷ It is therefore encouraging that progress is being made toward establishing a policy environment that is more conducive to fostering strong economic growth. In particular, many countries have strengthened their macroeconomic policy framework in recent years—inflation has generally been brought down to relatively low levels and fiscal deficits reduced—external debt burdens have been eased through the Heavily Indebted Poor Countries (HIPC) Initiative, and some steps have been taken to improve governance. And this progress is paying dividends. Economic activity in sub-Saharan Africa has been quite resilient over the past three years despite the global economic slowdown, and growth is now projected to pick up strongly to 4¼ percent in 2004 and 5¾ percent in 2005—a rate of growth not seen since the early 1970s—as the improved policy environment, the global recovery, higher commodity prices (in 2004), more favorable weather conditions in some countries, and large expansions in oil production (in Angola, Chad, and Equatorial Guinea) all boost activity (Table 1.11). As previously noted, however, the *World Economic Outlook* has systematically overestimated growth in sub-Saharan Africa—largely because of the susceptibility of the region to natural disas-

¹⁷The estimate of the growth rate that will be needed to meet the MDG for poverty reduction depends on the size of assumed impact of growth on poverty. There continues to be a debate on the size of this coefficient, and also on the relative importance of growth and other policies—such as those that may reduce income inequality—on poverty (see Besley and Burgess, 2003; Dollar and Kraay, 2002; and Collier and Dollar, 2001).

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			
	2002	2003	2004	2005	2002	2003	2004	2005	2002	2003	2004	2005
Africa	3.5	4.1	4.2	5.4	9.6	10.3	8.6	6.7	-1.7	-0.7	-1.3	-2.0
Maghreb	3.4	6.2	4.2	4.5	2.1	2.2	3.0	3.1	4.5	6.0	4.5	3.3
Algeria	4.1	6.7	4.4	4.3	1.4	2.6	3.8	4.0	7.8	11.3	8.8	7.1
Morocco	3.2	5.5	3.0	4.0	2.8	1.2	2.0	2.0	4.1	3.1	2.3	1.6
Tunisia	1.7	6.1	5.6	6.0	2.8	2.7	2.7	2.5	-3.5	-2.9	-3.0	-3.0
Sub-Sahara³	3.4	4.4	5.1	7.0	14.0	17.4	14.8	9.2	-5.6	-4.0	-4.3	-5.0
Horn of Africa	3.9	1.9	6.4	6.4	1.3	10.5	6.1	4.7	-8.5	-7.3	-7.0	-7.3
Ethiopia	1.2	-3.8	6.7	6.4	-7.2	15.1	5.5	3.0	-5.7	-4.7	-7.9	-7.4
Sudan	6.0	5.8	6.2	6.5	8.3	7.7	6.5	6.0	-9.7	-8.3	-6.5	-7.0
Great Lakes	4.6	3.7	5.1	5.8	8.8	7.7	3.8	3.9	-3.0	-3.3	-6.6	-8.0
Congo, Dem. Rep. of	3.5	5.0	6.0	7.0	27.7	9.1	6.0	5.0	-2.7	-2.0	-6.0	-7.6
Kenya	1.0	1.5	2.6	3.6	2.0	9.7	-0.2	3.4	—	-2.3	-8.1	-11.2
Tanzania	6.3	5.5	6.3	6.5	4.6	5.0	4.7	3.8	-4.0	-2.6	-6.0	-4.5
Uganda	6.7	4.9	5.5	6.2	5.7	5.9	3.5	3.5	-6.3	-6.0	-3.9	-6.0
Southern Africa	2.3	2.4	4.7	6.3	44.3	54.3	50.9	26.2	-3.5	-3.7	-3.6	-4.6
Angola	15.3	4.5	12.8	11.2	108.9	98.3	40.2	15.9	-5.8	-6.2	-4.4	-7.1
Zimbabwe	-12.8	-13.2	-9.2	5.2	140.0	431.7	640.0	200.0	-2.2	-4.5	-8.8	-12.3
West and Central Africa	3.4	6.4	4.9	8.0	8.4	9.7	8.4	5.7	-7.0	-3.6	-3.5	-3.9
Ghana	4.5	4.7	5.0	5.0	14.8	26.4	8.6	6.0	0.5	-0.4	-1.0	-1.6
Nigeria	1.5	10.6	0.9	5.9	13.7	14.4	16.5	10.1	-10.7	-2.8	-3.0	-5.7
CFA franc zone	4.4	4.1	7.9	10.8	3.8	2.0	2.7	2.9	-4.7	-4.1	-3.5	-2.2
Cameroon ⁴	6.5	4.2	4.7	5.1	6.3	1.2	2.0	2.0	-7.2	-3.1	-3.2	-3.8
Côte d'Ivoire	-1.6	-3.8	1.8	4.4	3.1	3.8	3.2	2.7	6.2	4.9	2.4	2.5
South Africa	3.6	1.9	2.6	3.2	8.9	6.0	3.2	5.6	0.3	-1.2	-1.8	-2.1
<i>Memorandum</i>												
Oil importers	3.1	3.0	4.2	4.7	8.9	9.6	7.9	6.6	-1.9	-2.2	-2.8	-3.2
Oil exporters	4.6	8.0	4.2	7.7	12.3	12.6	10.9	7.0	-1.1	3.4	2.7	1.1

¹In 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.

²Percent of GDP.

³Excludes South Africa.

⁴The 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).

ters, political instability, and other unanticipated shocks—and these projections have considerable downside risk.

Notwithstanding the important progress that is being made, the challenge remains to achieve strong growth across Africa on a sustained basis. It is noticeable that even during the recent period of improved growth in the region, there have been large cross-country differentials. Over the past three years, real per capita GDP has declined in nearly one-third of the countries, while only a small number have realized real per capita GDP growth in excess of 4 percent. If sig-

nificant inroads into poverty are to be made, the performance of the faster-growing countries will need to be replicated throughout the region, and it is important that the lessons from the more successful countries are applied broadly across sub-Saharan Africa (see Box 1.5). Of particular importance are steps to reduce government involvement in the economy, promote private sector investment, develop infrastructure, and strengthen institutions, governance, and transparency, particularly in the natural resources industry to ensure that the benefits from this sector accrue broadly across the population.¹⁸ In

¹⁸See Chapter III of the April 2003 *World Economic Outlook* for an analysis of the link between growth and institutions.

Box 1.5. What Works in Africa

Economic performance in sub-Saharan Africa has not matched that of other regions. Growth in GDP per capita between 1960 and 2000 averaged 0.8 percent a year in sub-Saharan Africa compared with 2.7 percent in the industrial countries and 2.3 percent for all developing countries. A number of countries in sub-Saharan Africa did experience growth spurts, and in some instances for extended periods of time, but only few did it consistently enough to make the transition to the status of middle-income countries. It is also striking that sub-Saharan African growth has slowed sharply since the oil shocks, reflecting in large part an inability to manage the economic and political adjustment to them. In the period 1960–80, average growth rate was 1.3 percent a year, with 11 countries registering negative growth rates. In the period 1980–2000, the average growth rate was –0.5 percent, with 23 countries posting negative growth rates.

A few countries—Equatorial Guinea, Mozambique, and Uganda—fared well in the 1990s.¹ But two countries stand out for their consistently strong long-run performance—Botswana and Mauritius, whose real GDPs per capita have grown at an annual clip of 5.3 percent and 3.7 percent, respectively, between 1960 and 2000 (see the table).

Did Botswana and Mauritius succeed because they were in some ways atypical African countries? In other words, were they advantaged at the start of the development race with a better economic, social, and geographic inheritance than the typical African country? The voluminous literature on cross-country growth has identified a set of variables (which determine the initial conditions) that are important determinants of growth. These include human capital variables such as schooling and life expectancy, economic variables such as commodity dependence and the level of initial income, and geographic variables such as tropical climate and access to the sea. Botswana and Mauritius do fare better than the typical African

country in terms of these variables, but on balance these variables explain only a fraction of the actual difference in performance between Botswana and Mauritius, on the one hand, and sub-Saharan Africa, on the other.

Could it be then that Botswana and Mauritius pursued better macroeconomic and trade policies? Botswana and Mauritius certainly had lower inflation rates than the rest of Africa and also a lower share of government consumption in GDP, although the difference in the latter is more striking in the case of Mauritius (8.8 percent versus 16.4 for sub-Saharan Africa) than Botswana (13.4 percent). In contrast, the trade policies of Botswana were similar in terms of their restrictiveness to those of the average African country, while those of Mauritius were more restrictive.² So liberal trade policies, which cross-country evidence suggests have a positive impact on growth, cannot really explain the performance of these countries. And to the extent that sound macroeconomic policies can, the question then arises why these countries but not the rest of Africa were able to pursue such policies.

One, and perhaps the key, difference is that the quality of institutions in Mauritius and Botswana is much higher than in the rest of Africa, and indeed is comparable to those elsewhere in the world.³ The recent research on the impact of institutions on long-term development suggests that the superior institutional quality in Botswana and Mauritius helps explain the difference in their higher levels of income (see Acemoglu, Johnson, and Robinson, 2001; Rodrik, Subramanian, and Trebbi, 2002; and the April 2003 *World Economic Outlook*).

In addition to the standard benefits that good economic institutions provide—namely, an enabling climate for private investment—

²Botswana is part of a customs union that includes South Africa. In 1997, Mauritius and South Africa had a rating of 8 and 6, respectively, on the IMF's trade restrictiveness index (which has a range of 0–10, with higher values signifying greater restrictiveness), compared with 5.9 for sub-Saharan Africa as a whole.

³For example, Botswana and Mauritius are, respectively, 1.2 and 1.6 standard deviations above the world average on an index that measures the rule of law and the protection of property rights.

Note: The main author of this box is Arvind Subramanian.

¹The rapid growth in Equatorial Guinea is a consequence of sharply rising oil production.

Top Performers in Africa: Per Capita Income (PPP) and Its Growth Rate

Country	Income, 2000	Growth Rate			
		1960–2000		1990s	
Mauritius	13,932	Botswana	5.3	Equatorial Guinea	17.0
Seychelles	10,241	Mauritius	3.7	Mauritius	4.0
Gabon	8,402	Cape Verde	3.5	Uganda	3.3
Botswana	7,550	Congo	3.3	Mozambique	3.1
South Africa	7,541	Seychelles	3.1	Eritrea	2.9
Swaziland	5,227	Gabon	2.6	Cape Verde	2.9
Namibia	4,458	Swaziland	2.3	Botswana	2.6
Cape Verde	4,027	Lesotho	2.1	Lesotho	2.2
Sub-Saharan Africa	2,273	Sub-Saharan Africa	0.8	Sub-Saharan Africa	0.4

Sources: Penn World Tables for income and growth rate between 1960 and 2000; World Bank's World Development Indicators for growth rate in the 1990s.

institutions helped Botswana and Mauritius in three particular ways that are noteworthy in an African context.

- For Botswana, *institutions were crucial in preventing the natural resource curse* that has been shown to depress long-run growth. The political influence of the cattle-exporting groups also ensured that rising diamond production did not lead to an overvalued exchange rate, which could have crowded out the tradable sector.
- *Strong political institutions provided the scope and space for participation by all groups* in Mauritius, where ethnic and linguistic divisions are almost as acute as in the rest of Africa, thereby minimizing conflict that has had such a detrimental impact on economic activity. Strong institutions also explain why Mauritius was able to implement east Asian-style heterodox trade policies—such as creating export-processing zones and granting export subsidies—that failed elsewhere in Africa.
- *Strong institutions played an important role in helping these countries adjust to commodity shocks.* Robust domestic institutions, especially those that provide for wide participation, allow the distributional conflicts entailed by adjustment to be handled at the least possible cost, and prevent the initial economic shock from getting further magnified by the shocks emanating from such conflicts.

Political and economic institutions, although not immutable, are highly persistent, because they are the result of history, geography, and other

long-term influences. Even before colonial rule, Botswana had institutions for political participation. The *kgotla*, which was an assembly of adult males in which public interest issues were addressed and criticisms of the ruler voiced, was left relatively untouched by colonial rule (Acemoglu, Johnson, and Robinson, 2003). The transition to democracy after independence was, therefore, easy. In the case of Mauritius, participatory political institutions were seen to be imperative at the time of independence to assuage the concerns of the minority groups that voted against independence in a referendum. At the same time, an important element of strong economic institutions—a well-paid, meritocratic bureaucracy—was instituted, which was financed by taxing a portion of the rents accruing to a small group of sugar owners (Subramanian and Roy, 2003). It was significant that this tax was limited, preserving the incentives for sugar production, unlike in many other African countries where the taxation of agriculture, including through exchange rate overvaluation, was severe, with serious long-term consequences.

As these experiences suggest, institution-building, a prerequisite for sound long-run economic performance, is a slow process, and the challenge for Africa is to find ways of accelerating it. Over the past few years, the reduction in civil conflicts, the growing democratization of the continent, and the adoption of more market-oriented policies have improved the prospects of countries in sub-Saharan Africa being able to meet this challenge.

this regard, a number of recent regional initiatives are welcome, including the African Peer Review Mechanism—which will peer-review economic and political governance—launched through the New Partnership for Africa’s Development, and the African Union’s adoption of a Convention on Preventing and Combating Corruption. An effective strategy to mitigate the impact of the HIV/AIDs pandemic will also be critical. The international community has a key role to play in Africa’s development, including through higher aid flows, debt relief, and the reduction of industrial country restrictions on developing country exports, and it is to be hoped that the recently established Africa Partnership Forum will help strengthen the relationship between Africa and its development partners.

Turning to individual countries, growth in South Africa is expected to pick up modestly in 2004. Exporters should benefit from the stronger global economy and higher commodity prices, while domestic demand will be buoyed by lower interest rates—the central bank has cut interest rates by a cumulative 550 basis points since June 2003 as inflationary pressures have eased—and a mildly expansionary fiscal policy. The government will need to ensure that the fiscal stance is not loosened further so that market confidence is maintained and public debt kept on a declining path. South Africa still faces a considerable medium-term challenge to raise potential growth and reduce very high unemployment. Central to meeting these objectives will be policies that ease labor market rigidities and make South Africa a more attractive investment destination. The implementation of an effective strategy for dealing with HIV/AIDs and policies that promote greater social cohesion will be critical for the latter.

In Nigeria, increased oil production underpinned an exceptionally strong economic expansion during 2003, but growth is expected to slow sharply this year as the boom in the oil sector wanes. Expansionary fiscal and monetary policies have resulted in a pickup in inflation and a decline in international reserves, and action is

needed to strengthen macroeconomic policies to reduce vulnerabilities going forward. The measures contained in the 2004 federal budget—if implemented—would be an important step toward reestablishing fiscal discipline, but monetary policy will need to be tightened and greater exchange rate flexibility allowed to stem further losses in international reserves. Welcome steps have recently been taken to eliminate the price subsidy on domestic crude oil and to liberalize the retail market for petroleum products, while the authorities are developing an action plan to participate in the Extractive Industries Transparency Initiative.

Elsewhere in sub-Saharan Africa, growth is projected to strengthen in the Horn of Africa, where Ethiopia is expected to rebound after the disastrous famine last year; the CFA franc zone, although the political situation in Côte d’Ivoire remains a downside risk; the Great Lakes region, where the situation in the Democratic Republic of the Congo continues to improve; and east Africa, where the Kenyan economy is benefiting from the government’s focus on improving governance and accelerating reforms, although tourism continues to be adversely affected by terror-related risks. In southern Africa, the situation is more mixed. In Angola, strong growth is expected over the next two years as new oil production comes on stream and the non-oil economy gradually recovers as the peace process and reconstruction proceed, but macroeconomic instability in Zimbabwe is deepening, and output is expected to contract sharply again in 2004 (bringing the cumulative decline since 1999 to about 45 percent).

In north Africa, the outlook for Algeria in 2004 is broadly favorable, although growth is expected to slow relative to 2003 when favorable weather conditions, fiscal stimulus—partly related to reconstruction needs following the May 2003 earthquake—and increased oil output underpinned real GDP growth of 6¾ percent. The authorities need to take advantage of current conditions to push ahead with a strategy to reverse the recent deterioration in the underlying fiscal position and to accelerate medium-

term growth to help reduce high unemployment. Regarding the latter, structural and institutional reforms need to be reinvigorated, particularly to strengthen the banking sector, restructure and privatize large public enterprises, and increase labor market flexibility. Elsewhere in the Mahgreb, growth is expected to slow in Morocco and Tunisia this year as the impact of the strong rebound in agricultural production that followed the ending of a prolonged drought fades.

Appendix 1.1. Commodity Markets

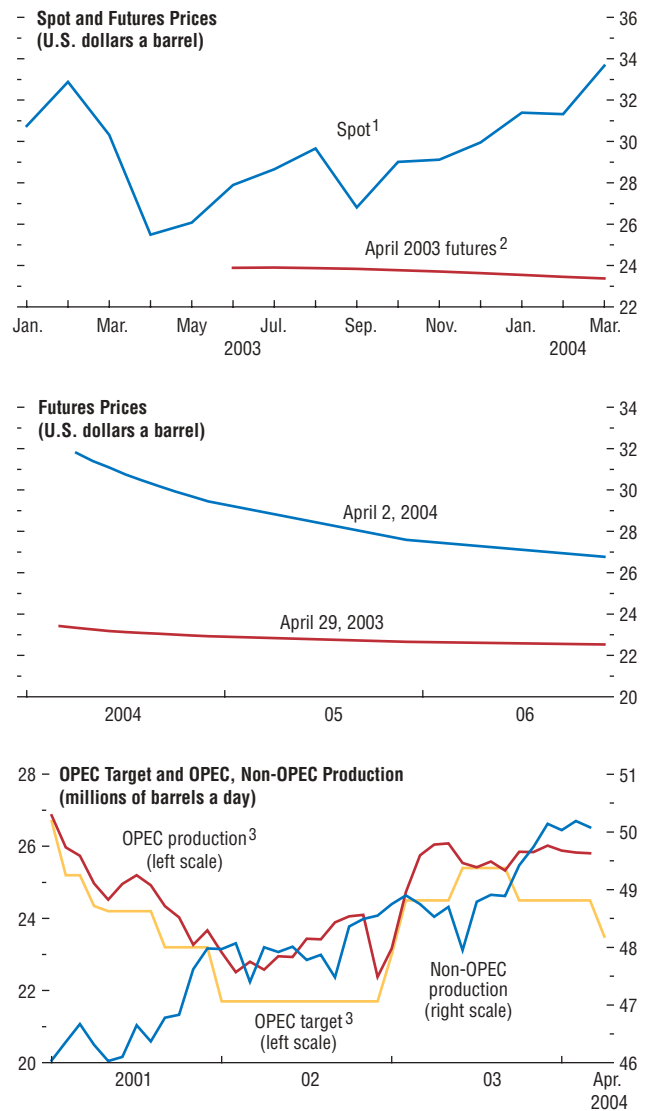
The authors of this appendix are Aasim Husain and Sam Ouliaris, with research assistance provided by Hussein Allidina and Paul Nicholson.

The overall index of primary commodity prices increased by about 20 percent in U.S. dollar terms and over 13 percent in SDR terms during the second half of 2003 and early 2004, as the pace of global economic activity picked up and the U.S. dollar depreciated against other major currencies. The surge in commodity prices was broad based, with both energy and nonenergy products contributing to the rise. Semiconductor markets also experienced a strong recovery in late 2003 and early 2004.

Crude Oil

Crude oil prices rose steadily during the second half of 2003 and early 2004, in marked contrast with the slight decline implied by futures quotations in late April 2003, in the aftermath of the war in Iraq (Figure 1.18). By early April 2004, spot prices had climbed to \$34 a barrel,¹⁹ over \$10 a barrel higher than had been implied by futures at end-April 2003. Current futures imply an average price of over \$32.50 a barrel in 2004, about \$8.50 a barrel higher than in late April 2003. The main factors accounting for the unanticipated increase in crude oil prices appear

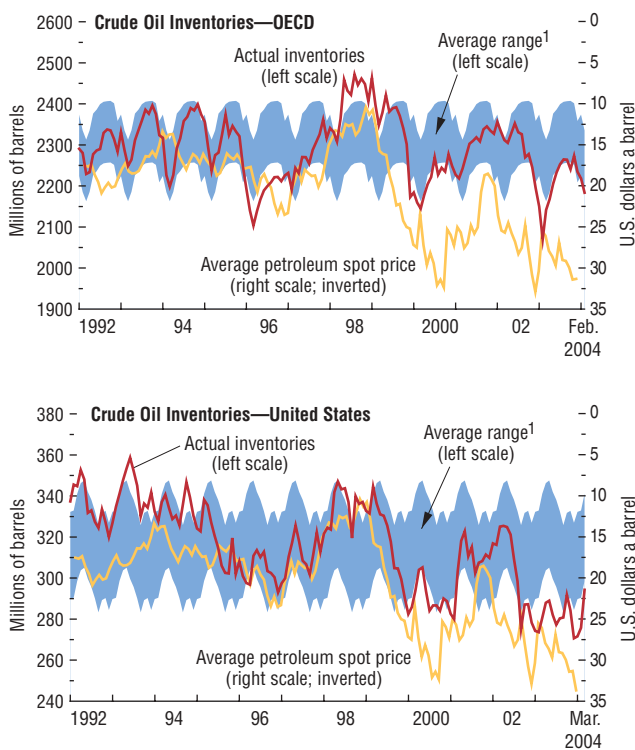
Figure 1.18. Oil Prices, Futures, and Production



Sources: International Energy Agency; Bloomberg Financial, LP; and IMF staff estimates.
¹Average petroleum spot price of West Texas Intermediate, U.K. Brent, and Dubai crude.
²Five-day weighted average of NYMEX Light Sweet Crude, IPE Dated Brent, and implied Dubai Fateh.
³Excluding Iraq.

¹⁹Prices refer to the average petroleum spot price (APSP) of West Texas Intermediate, U.K. Brent, and Dubai crudes.

Figure 1.19. Oil Inventories



Sources: U.S. Department of Energy; International Energy Agency; and IMF staff calculations.

¹Average of each calendar month during 1992–2002, plus a 60 percent confidence interval based on past deviations.

to be delays in restoring Iraq’s oil production and exports, a faster-than-expected pickup in oil consumption, and, consequently, continuing low commercial oil inventories. The depreciation of the U.S. dollar against other major currencies also contributed to the rise in the dollar price of crude oil.

According to the International Energy Agency (IEA), global oil demand in 2003 increased by 2.1 percent, or 1.6 million barrels a day (mbd), significantly higher than the 1.0 mbd projected in early 2003. China, North America, and non-OECD Asian countries accounted for the bulk of the increase, reflecting their robust economic growth, especially during the second half of 2003. The IEA data indicate record electricity and gasoline consumption raised crude oil demand in China by 14 percent (year-on-year) in the second half of 2003. Growth in oil consumption in North America also picked up—to 2 percent in 2003, from 0.7 percent in 2002.

The price effect of the underlying strength of global demand for crude oil was exacerbated by developments on the supply side. The tenuous security situation in Iraq, together with repeated sabotage and lootings of the oil production infrastructure and the northern pipeline to Turkey, kept Iraqi crude production and exports well below prewar levels for most of 2003. In addition, Venezuela’s production, according to IEA estimates, remained below levels achieved before the December 2002 strike. While the OPEC-10 (OPEC excluding Iraq) maintained production levels above targets to offset the shortfall in Iraqi supply, announcements of cuts in their output targets from November 2003 and further from April 2004 also placed upward pressure on prices.

These shocks to global oil demand and supply, and the persisting spread between spot and futures prices, resulted in a further tightening of the global oil inventory position. The widely anticipated rebuilding of commercial inventories in consuming countries did not materialize. Instead, commercial stocks of crude oil in the OECD actually fell further, with U.S. stocks in particular declining to levels last seen in the mid-1970s (Figure 1.19). This decline in

commercial stocks and concerns about low U.S. gasoline inventories resulted in a noticeable increase in the volatility of oil prices and the average price of crude oil. A buildup of large long speculative positions in futures markets also contributed to the increase in spot prices.

Another important development in the oil market in recent months has been the decline in the value of the U.S. dollar, which resulted in a terms-of-trade deterioration for oil exporters, possibly affecting their supply behavior. Although the average price of crude oil increased by approximately 25 percent in dollar terms between September 2003 and March 2004, prices in SDR terms only increased by 17 percent. On the basis of rough estimates of the responsiveness of prices to the unanticipated demand and supply developments that have taken place since mid-2003, up to one-half of the increase in dollar oil prices may be attributable to the depreciation of the dollar.

Looking forward, prices of crude oil in the futures market continue to suggest some softening of prices during the period ahead, once demand takes a seasonal dip. Nevertheless, the longer-term price implied by futures contracts has risen markedly since last summer. While part of the increase likely relates to depreciation of the dollar, other factors have also contributed. In particular, a security-related premium has persisted owing to ongoing geopolitical tensions, including in Iraq, Venezuela, and Nigeria, while excess capacity of oil-exporting nations has dwindled. According to the IEA, OPEC-10's excess capacity fell to less than 2.0 mbd in March 2004—under 3 percent of global demand—compared with 3.4 mbd in November 2002, prior to the supply disruption in Venezuela. In addition, while Iraq's production was near prewar levels by early 2004, analysts have questioned the longer-term viability of maintaining production in the absence of sizable investment and significant improvement in the security situation. Finally, as long as commercial inventories remain low, crude oil prices are likely to continue to exhibit considerable volatility.

Table 1.12. Nonenergy Commodity Prices
(Percent change from July 2003 to March 2004)

	U.S. Dollar Terms	Contribution ¹	SDR Terms
Food	26.8	42.7	19.1
Beverages	5.2	2.9	-1.3
Agricultural raw materials	7.1	7.7	0.5
Metals	38.5	46.7	30
Overall nonenergy	25.1	100	17.4

Sources: IMF, Primary Commodity Price Database; and IMF staff estimates.

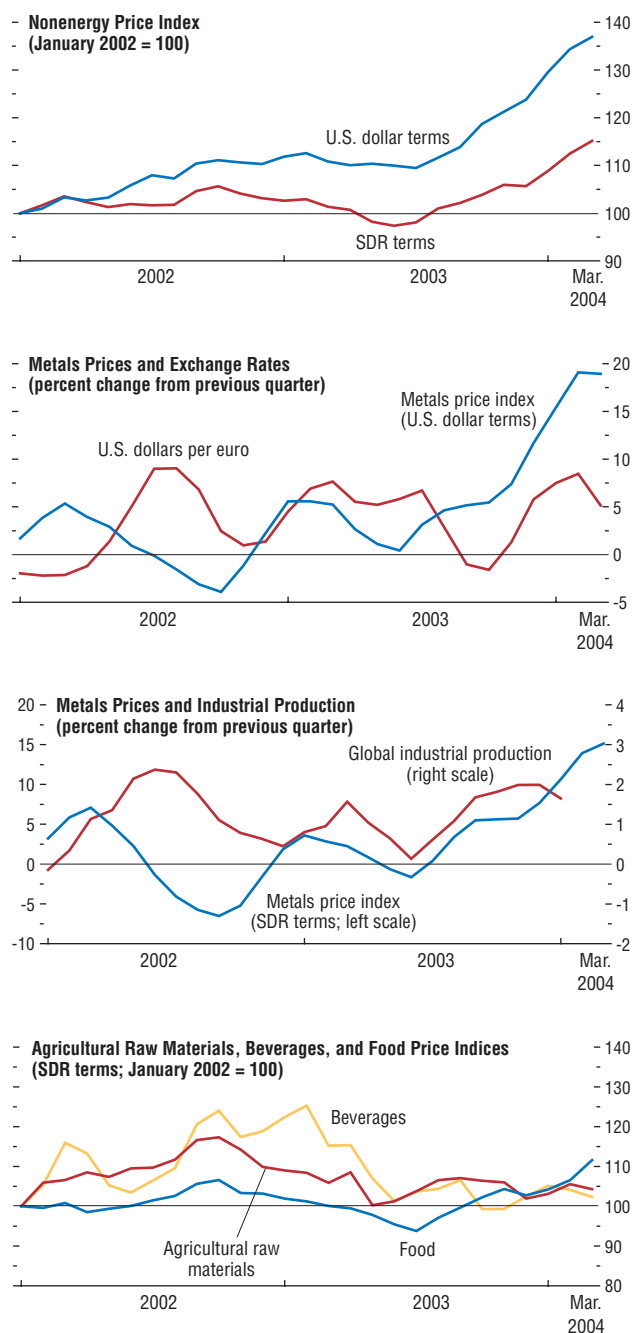
¹Contribution to change in overall nonenergy price index in U.S. dollar terms, in percent. Contributions to change in SDR terms are similar.

Nonenergy Commodity Prices

After falling slightly in the first half of 2003 because of weak demand, nonenergy commodity prices rallied in the second half of the year and early 2004 because of the pickup in the pace of economic activity, particularly in the United States and China, falling inventory levels for specific commodities, and the decline in the U.S. dollar against other major currencies (Figure 1.20). From July 2003 to March 2004, the IMF index of nonenergy commodity prices rose by 25 percent in U.S. dollar terms and by over 17 percent in SDR terms. While virtually all major components of the index rose, the metals and food commodities accounted for the bulk of the increase in the nonenergy index (Table 1.12). Looking forward, nonenergy commodity prices in 2004 are expected to remain firm in dollar terms as the global economic recovery gathers momentum, translating to a sizable further increase (in dollar terms) in the average level of nonenergy commodity prices during the year relative to 2003.

Metals prices have reacted strongly since mid-2003 to a pickup in demand due to stronger global economic activity and heightened speculative buying by investors. Moreover, a marked pickup in imports by China has fueled global demand for core materials. Copper, nickel, and zinc prices all reached multiyear highs during the period. Nickel prices increased by about 55 percent in U.S. dollar terms as demand to support stainless steel production

Figure 1.20. Nonenergy Commodities



Sources: IMF, *International Financial Statistics*; and IMF staff calculations.

surged, commercial stocks dwindled, and labor unrest at key producers threatened supply. Copper prices rose by 75 percent on stronger demand, especially from China and other Asian countries, a decline in the stocks-to-consumption ratio, and concerns over supply owing to labor unrest. Forward-looking indicators suggest that metals prices are likely to peak in 2004 as supply responds to higher prices.

Food prices also rose in the second half of 2003 and early 2004, boosted by both demand and supply factors. Wheat prices, recovering from recent lows, climbed by over 25 percent in dollar terms owing to shortfalls in projected supply in the United States and Europe, a pickup in demand, particularly from China and the European Union, and the resulting decline in the stockpiles of wheat. After remaining relatively subdued for much of the second half of 2003, maize prices rose by about 30 percent during December 2003–March 2004. The price of soybeans and soybean products increased sharply on announcements of lower supply forecasts by both the United States—the world’s largest producer—and Brazil owing to poor weather conditions, and increased imports by China. Despite the emergence of cases of mad cow disease in the United States and Canada, in late 2003, beef prices were over 20 percent higher in March 2004 than in July 2003 because of stronger global demand and concerns about supply from Australia owing to drought. In contrast, pork prices rose moderately owing to a sizable increase in supply from Canada. Looking forward, futures quotations broadly suggest that food prices are likely to rise in dollar terms during 2004 but at a slower pace than 2003.

Prices of several agricultural raw materials also responded strongly to a significant increase in global demand in the second half of the year, while the unwinding of supply shocks partially reversed earlier price surges for some items. Robust demand from China, together with a slight decline in global production, contributed to a large increase in the price of cotton.

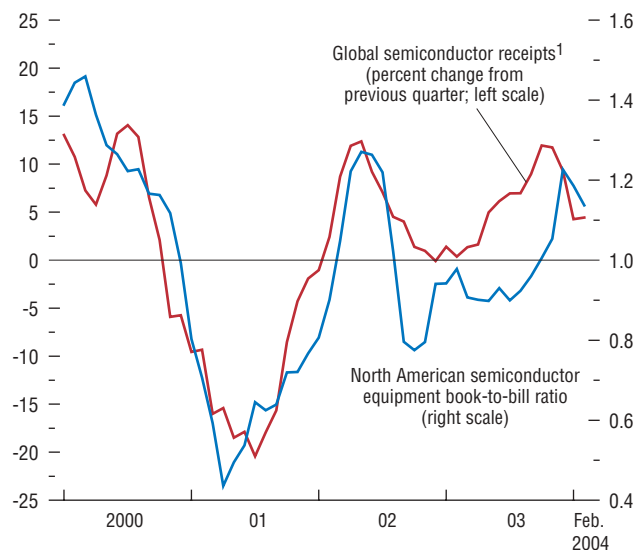
Demand for rubber and rubber products also boomed, while production growth moderated, resulting in a steep increase in the price of natural rubber. Wool prices, by contrast, eased in the second half of the year as the impact of the 2002 drought on Australian wool production diminished. Though softwood lumber prices continue to be influenced by the ongoing trade dispute between Canada and the United States, prices have increased by over 20 percent since July 2003 because of robust demand from home builders and the depreciation of the U.S. dollar.

While beverage prices have recovered in recent months, they remain markedly lower than a year ago. Following a significant decline in early 2003, cocoa prices have been broadly flat since midyear, although civil unrest in Côte d'Ivoire continues to threaten the reliability of its cocoa exports. Though coffee prices in general eased during the second half of 2003, reports of inventory rundowns and smaller crop estimates caused prices of higher-grade coffee to rise in early 2004.

Semiconductor Markets

There is growing evidence of a strong recovery in semiconductor markets. Seasonally adjusted global semiconductor sales grew strongly during the second half of 2003, with sales in Asia accelerating most sharply (Figure 1.21). Among end-use items, sales of wireless products were especially buoyant. Consequently, capacity utilization rates for leading-edge semiconductors, which are used to produce advanced wireless and high-end consumer electronics products, rose to levels last seen in early 2000. In the United States, manufacturers' shipments of computers and electronic equipment grew in the second half of 2003, as the stocks-to-consumption ratio fell gradually to levels last seen in 2000—around the peak of the IT boom. In Asia, electronic exports grew at a rapid pace, even in relation to overall exports, exceeding the rates experienced during the IT boom of the late 1990s.

Figure 1.21. Semiconductor Markets



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

¹Seasonally adjusted.

Although the pace of semiconductor sales has moderated somewhat in recent months, partly on account of the timing of the Chinese New Year, forward-looking indicators point to continued growth in 2004. Book-to-bill ratios in North America and Japan have risen significantly, with both orders and billings showing robust growth. Moreover, business's purchase indices for technology products have also started to rebound, and analysts expect confidence to recover further as higher corporate profits translate into stronger cash-flow positions. While semiconductor stock indices have edged down since late last year, their performance since mid-2003 remains stronger than that of the broader market, suggesting that financial markets see stronger growth prospects in the high-technology sector than in the broader economy.

Price Forecasts and Futures

While the share of primary commodities in global output and trade has declined over the past century, fluctuations in commodity prices continue to affect global economic activity. For many countries, especially developing countries, primary commodities remain an important source of export earnings, and commodity price movements have a major impact on overall macroeconomic performance. Hence, commodity price forecasts are a key input to macroeconomic policy planning and formulation.

The task of forecasting commodity prices with reasonable accuracy is complicated by their considerable variability (Table 1.13). Although researchers have found some support for small, albeit variable, long-run downward trends in real price data for many commodities, these trends tend to be small and variable, and are often swamped by the high volatility of commodity prices.²⁰ Moreover, commodity price shocks tend to persist, though the degree of persistence varies considerably across commodities. Among the primary commodities, prices of agricultural

Table 1.13. Volatility and Correlation of Spot and Futures Prices

Commodity	Volatility ¹		Correlation ³
	Spot	Futures ²	
Aluminum	0.10	0.08	95.4
Coffee, Arabica	0.16	0.14	93.2
Coffee, Robusta	0.16	0.17	94.2
Copper	0.09	0.06	93.2
Cotton	0.11	0.07	62.7
Lead	0.09	0.09	96.8
Maize	0.11	0.08	79.7
Nickel	0.14	0.14	95.0
Soybean meal	0.09	0.07	76.8
Soybean oil	0.10	0.07	74.5
Soybeans ⁴	0.06	0.05	85.8
Sugar	0.04	0.02	82.5
Tin	0.07	0.07	93.5
Wheat	0.09	0.07	70.8
Zinc	0.09	0.08	93.0

Sources: IMF, Primary Commodity Prices Database; and IMF staff estimates.

¹Standard deviation of nominal dollar prices.

²3-month futures for aluminum, lead, maize, nickel, tin, and zinc; 6-month futures for Arabica coffee, Robusta coffee, cotton, sugar, and wheat; 9-month futures for soybean meal, soybean oil, and soybeans; and 12-month futures for copper. Sample periods vary by commodity according to data availability.

³Correlation of log first differences of spot and futures prices, in percent.

⁴Outlier data point for 1994Q3 removed.

items have exhibited relatively high volatility, possibly because agricultural commodities are more susceptible to weather-related supply shocks.

Futures prices are a potentially useful guide for projecting commodity prices. Futures markets for several primary commodities have developed and deepened over the past two decades, and the associated futures prices reflect, in principle, all information available to market participants. Hence, these prices may well predict future spot price developments as accurately as sophisticated econometric models or judgmental forecasts. At the same time, spot and futures prices tend to move together, suggesting that they react to the same underlying shocks. While futures tend to exhibit less variability than spot prices, especially at longer horizons (Figure 1.22), their usefulness in predicting future actual

²⁰See, for example, Cashin and McDermott (2002).

spot price movements merits empirical investigation.²¹

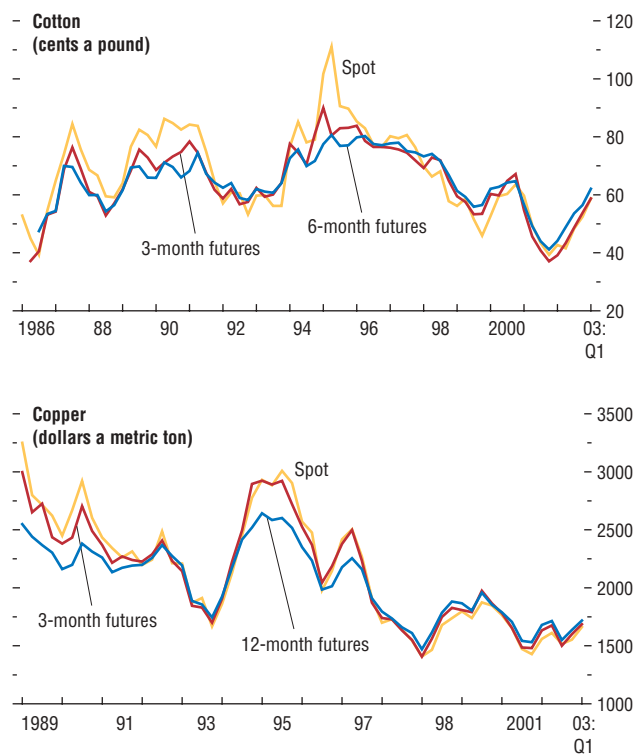
A comparison of forecasts generated by models incorporating futures with those that do not systematically employ futures data facilitates an empirical assessment of whether futures prices are indeed effective predictors of spot price developments. To this end, futures-based forecasts were generated for each quarter since early 1994 using simple unit root and error correction models for 15 primary commodities.²² The error correction models encompass a long-term cointegrating relation between spot and futures prices, which posits that the two prices move together over the longer term, along with short-run dynamics that explain temporary deviations of spot prices from their longer-term (trend) values. By contrast, the other models include only past changes in spot (and futures) prices as potential determinants of current spot prices changes. As spot and futures prices appear to move together over the long run for virtually every commodity in the sample, the error correction model—which capitalizes on this tendency—was expected to yield more accurate longer-term forecasts. The futures-based forecasts were then compared with forecasts generated by basic unit root models relying exclusively on historical commodity price data and with judgmental or “expert opinion” forecasts prepared by the staff of the IMF and the World Bank.²³ The latter

²¹A sizable volume of research has investigated the issue of whether commodity futures are unbiased predictors of spot price developments, including Kaminsky and Kumar (1990); Kumar (1992); Moosa and Al-Loughani (1994); Brenner and Kroner (1995); and Elfakhani, Wionzek, and Chaudhury (1999). Other studies, including Bessler and Brandt (1992); Irwin, Gerlow, and Liu (1994); and McKenzie and Holt (2002), have specifically considered whether futures improve models’ forecast accuracy. The latter set of papers, however, has focused on a small number of commodities (only two–four) over relatively short horizons (two months to two quarters).

²²The commodities analyzed were aluminum, copper, lead, nickel, tin, zinc, wheat, maize, soybeans, soybean meal, soybean oil, sugar, cotton, Arabica coffee, and Robusta coffee.

²³See Bowman and Husain (2004) for further details on the data and empirical methodology.

Figure 1.22. Spot and Futures Prices



Sources: Bloomberg Financial, LP; and IMF staff estimates.

Table 1.14. Forecast Performance¹

Commodity	One-Quarter Horizon			Eight-Quarter Horizon		
	Statistical accuracy	Directional accuracy	Overall	Statistical accuracy	Directional accuracy	Overall
Aluminum	J	J, FE	J, FE	J, FE	FE	FE
Coffee, Arabica	—	—	—	J, FE	H	H
Coffee, Robusta	J	J	J	J	FA	FA
Copper	J	J, FA, FE	J	J	—	J
Cotton	J, FA, FE	J, FA, FE	J, FA, FE	J, FE	—	J, FE
Lead	J, FA, FE	FA	FA	J, FE	FE	FE
Maize	J	J	J	J	FE	FE
Nickel	FE	FA, FE	FE	J	FE	FE
Soybean meal	J, H, FE	J, FE	J, FE	FE	FE	FE
Soybean oil	J, FE	FA	FA	J	J, FE	J, FE
Soybeans	J, H	J	J	FE	FE	FE
Sugar	J	J	J	J, FE	J, FE	J, FE
Tin	J	J	J	J, FE	—	J, FE
Wheat	J	J, FA, FE	J	FE	FE	FE
Zinc	J	FE	FE	J	FE	FE

Source: Bowman and Husain (2004).

¹Table indicates which type of forecast performed best over the 1993Q4–2003Q1 period. J denotes judgment-based forecasts, H denotes historical data-based forecasts, FA denotes unit root model forecasts augmented with futures, and FE denotes futures-based error correction model forecasts.

forecasts are based on assessments of supply and demand fundamentals, past price developments, global factors, as well as judgment. To the extent that judgment is affected by futures prices, albeit not in a systematic fashion, the judgmental forecasts may be expected to perform at least as well as the futures-based ones.

The analysis indicates that futures-based forecasts outperform historical data-based price projections, suggesting that futures prices indeed contain information that is useful for assessing commodity price prospects (Table 1.14). Forecast performance, measured in both a statistical (root mean squared error) as well as directional (identification of future turning points) sense, was at least as strong—and in most cases stronger—for the futures-based models as for the historical data models at the one-quarter-ahead horizon for 14 of the 15 commodities in the sample. The relative performance of models incorporating futures improves further as the forecast horizon increases. For eight-quarter-ahead forecasts, futures-based models markedly outperform historical data-based models for 13 commodities, and do no worse for one additional commodity. For nine commodities, the error correction

model produces significantly more accurate forecasts.

Futures-based forecasts also tend to produce more accurate results than judgment at longer horizons, but not at the shorter one-quarter-ahead horizon. For nine commodities, forecasts based on models using futures data are consistently better than judgmental forecasts at the eight-quarter horizon. For eight of these commodities, the best results are obtained from models exploiting the long-run cointegrating relation between spot and futures prices, and for an additional four commodities, the error correction model forecast performs as well as judgment. At the one-quarter horizon, however, the judgmental forecasts produce more accurate forecasts, especially in a statistical sense, than futures-based models for seven commodities and forecasts of comparable accuracy for an additional three commodities.

Thus, the results strongly suggest that futures prices can provide reasonable guidance about likely developments in spot prices over the medium term, particularly in terms of identifying future turning points. The relative accuracy of forecasts from error-correction models indicates that futures prices tend to act as an anchor

for spot prices, and deviations between spot and futures prices tend to narrow over time.

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