CHAPTER I ECONOMIC PROSPECTS AND POLICY ISSUES

Over the past year, the global recovery has become increasingly well established, with global GDP growth now projected to average 5 percent in 2004, the highest for nearly three decades (Figure 1.1 and Table 1.1). That said, growth momentum has slowed from the second quarter of 2004, notably in the United States, Japan, and China, while oil prices have risen sharply. Looking forward, the global expansion—while still solid—will therefore likely be somewhat weaker than earlier expected; the balance of risks has shifted to the downside with further oil price volatility a particular concern. On the policy side, interest rates will need to rise further as the recovery proceeds, although the pace and timing vary considerably across countries, depending on their relative cyclical positions. However, the key challenge—perhaps even more important in light of the somewhat less favorable short-term situation—is to take advantage of the upturn to make progress in addressing fundamental medium-term problems, including difficult fiscal positions, growth-restraining structural weaknesses, financial and corporate vulnerabilities, and—last but not least—continuing global current account imbalances. While progress is being made, it is generally limited; without further action there is a serious risk of shortfalls in many regions, leaving the world significantly more vulnerable to the shocks it will inevitably face in the future.

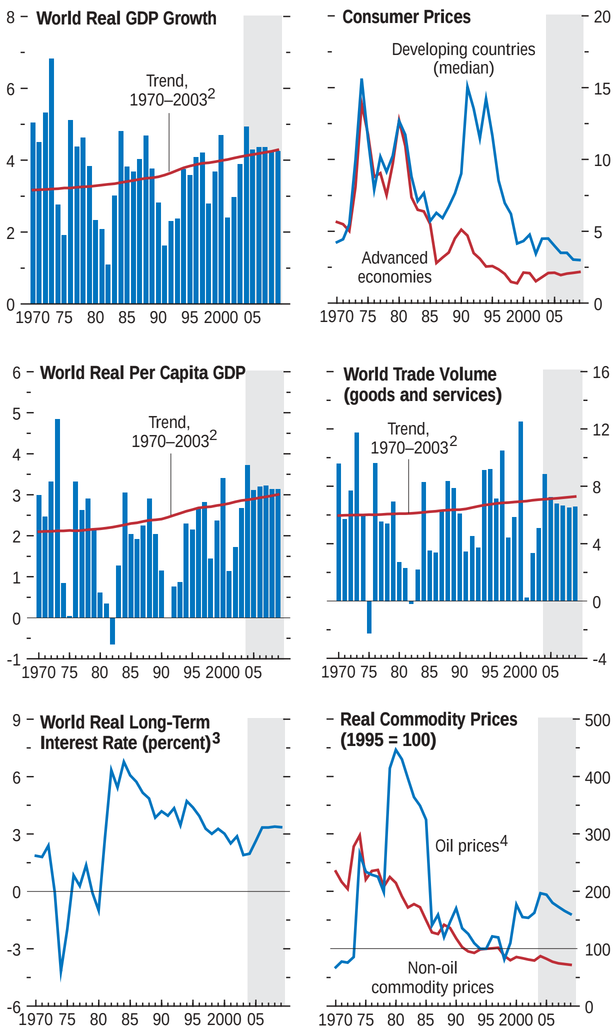
Over the past year, the global recovery has become increasingly well established. Between mid-2003 and mid-2004, global growth has averaged 5 percent—well in excess of the 4 percent historical trend—with strong growth in industrial countries and exceptionally rapid expansion in emerging markets, notably China. This has been accompanied by a strong upturn in industrial production and global trade flows; a pickup in private consumption growth, underpinned by generally improving labor market conditions; and continued strength in investment, as post-bubble corporate balance sheet restructuring has proceeded (Figure 1.2). While global growth in the first quarter was much stronger than earlier expected, the momentum of the recovery slowed thereafter. While some slowdown was both inevitable and desirable following three quarters of exceptionally rapid expansion, GDP growth in several major countries—including the United States and Japan—fell below expectations, raising concerns of an emerging "soft patch." GDP growth in China also eased—a welcome development, given concerns about incipient overheating—although recent data suggest a soft landing is not yet assured.

From a regional perspective, the recovery has become increasingly broad based, but some regions continue to grow more vigorously than others. Despite the weakness in the second quarter, global growth continues to be driven by the United States, with strong support from Asia; activity in Latin America and some other emerging markets has also picked up strongly. The recovery in the euro area is becoming more established, but remains relatively weak and is heavily dependent on external demand (particularly in Germany, which comprises one-third of the euro area). Despite stronger growth outside the United States, the U.S. current account deficit has continued to deteriorate over the past year, offset by higher surpluses in Japan and the euro area. Current account surpluses in emerging Asia have remained very high—notwithstanding generally strengthening domestic demand—aided by buoyant electronics exports but also by

Figure 1.1. Global Indicators[1]

(Annual percent change unless otherwise noted)

Global growth in 2004 will be the most rapid in nearly three decades, with a slower, but still solid, expansion projected for 2005.



[1]Shaded areas indicate IMF staff projections. Aggregates are computed on the basis of purchasing-power-parity weights unless otherwise noted.
[2]Average growth rates for individual countries, aggregated using purchasing-power-parity weights; the aggregates shift over time in favor of faster growing countries, giving the line an upward trend.
[3]GDP-weighted average of the 10-year (or nearest maturity) government bond yields less inflation rates for the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada. Excluding Italy prior to 1972.
[4]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil.

the competitiveness of exchange rates in that region.

Buoyant global demand, accompanied increasingly by a variety of supply-side factors, has led to a strong pickup in commodity prices, which have risen by 27 percent in SDR terms since December 2003 (Appendix 1.1). In the oil market, prices have risen sharply, underpinned by a combination of surging demand and—particularly from the second quarter—supply-side concerns in several major oil-exporting countries, including Iraq, Russia, and Venezuela (see Appendix 1.1 for a detailed discussion). This has been exacerbated by low excess capacity and speculative activity. Amidst considerable volatility, oil prices peaked at $44.71 a barrel on August 19 (a record high in U.S. dollar terms, although well below past peaks in real terms—see Figure 1.1). Thereafter, oil prices initially fell back, partly reflecting easing geopolitical concerns, but since mid-September have turned up once more. In contrast, nonfuel commodity prices, which rose substantially through early 2004, have since shown signs of easing, partly owing to slowing growth in China (which accounts for a substantial proportion of global consumption of some key commodities).

The sharp rise in oil prices has contributed to the weakening of the expansion in recent months, and will likely continue to do so for several quarters. To date, however, the overall impact appears moderate. As of early September, futures markets suggest that average oil prices in 2005 will be about $8 a barrel higher than in 2003; standard economic models suggest that such an increase would reduce global GDP by about ½ percentage point.[1] In contrast to previous episodes, the rise in oil prices has owed much to stronger global demand rather than supply concerns (although this has been less the case since the first quarter); and consumer confidence, which fell significantly in earlier episodes, has so far held up reasonably well.

[1]As discussed in Appendix 1.1, the size of this shock is less than one-tenth of the shocks experienced in the 1970s.

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

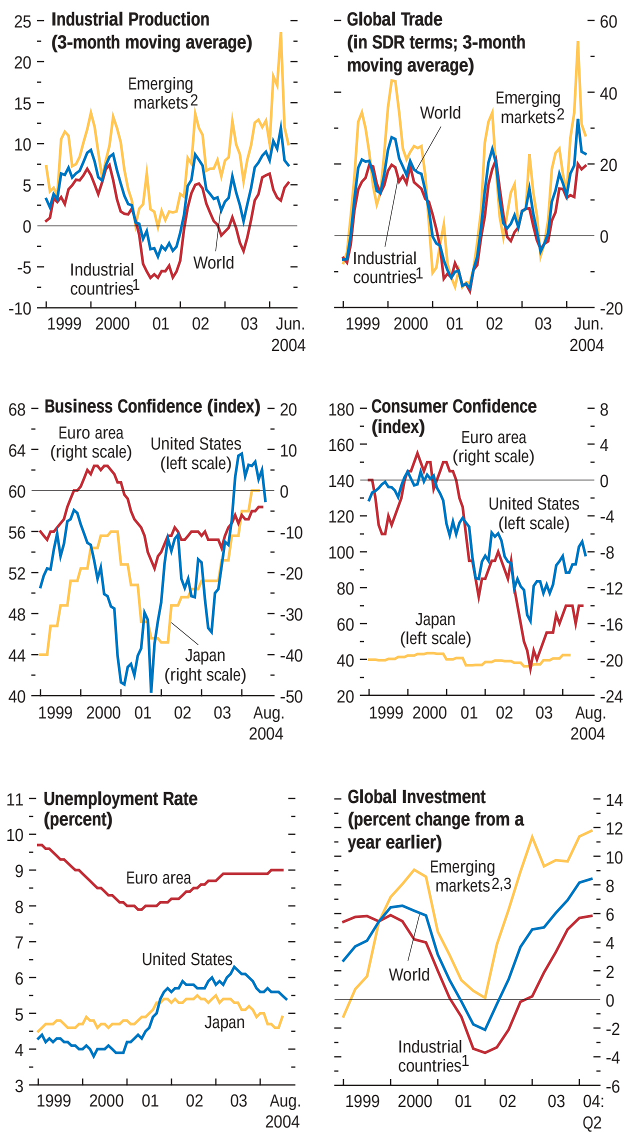
			Current Projections		Difference from April 2004 Projections[1]	
	2002	2003	2004	2005	2004	2005
World output	**3.0**	**3.9**	**5.0**	**4.3**	**0.3**	**–0.1**
Advanced economies	1.6	2.1	3.6	2.9	0.2	–0.2
United States	1.9	3.0	4.3	3.5	–0.3	–0.3
Euro area	0.8	0.5	2.2	2.2	0.4	–0.1
Germany	0.1	–0.1	2.0	1.8	0.5	–0.1
France	1.1	0.5	2.6	2.3	0.9	–0.1
Italy	0.4	0.3	1.4	1.9	0.2	–0.1
Spain	2.2	2.5	2.6	2.9	–0.1	–0.4
Japan	–0.3	2.5	4.4	2.3	1.1	0.5
United Kingdom	1.8	2.2	3.4	2.5	–0.1	–0.1
Canada	3.4	2.0	2.9	3.1	0.3	—
Other advanced economies	3.6	2.4	4.3	3.5	0.3	–0.5
Newly industrialized Asian economies	5.0	3.0	5.5	4.0	0.2	–1.0
Other emerging market and developing countries	4.8	6.1	6.6	5.9	0.5	—
Africa	3.5	4.3	4.5	5.4	0.3	—
Sub-Sahara	3.6	3.7	4.6	5.8	0.4	0.1
Central and eastern Europe	4.4	4.5	5.5	4.8	1.0	0.3
Commonwealth of Independent States[2]	5.4	7.8	8.0	6.6	2.0	1.4
Russia	4.7	7.3	7.3	6.6	1.3	1.4
Excluding Russia	7.0	9.0	9.6	6.5	3.7	1.5
Developing Asia	6.6	7.7	7.6	6.9	0.2	–0.1
China	8.3	9.1	9.0	7.5	0.5	–0.5
India	5.0	7.2	6.4	6.7	–0.4	0.6
ASEAN-4[3]	4.3	5.1	5.5	5.4	—	–0.1
Middle East	4.3	6.0	5.1	4.8	1.0	–0.1
Western Hemisphere	–0.1	1.8	4.6	3.6	0.7	—
Brazil	1.9	–0.2	4.0	3.5	0.5	—
Mexico	0.8	1.3	4.0	3.2	0.8	–0.1
Memorandum						
European Union	1.2	1.1	2.6	2.5	0.4	–0.1
World growth based on market exchange rates	1.7	2.7	4.1	3.4	0.3	–0.1
World trade volume (goods and services)	**3.3**	**5.1**	**8.8**	**7.2**	**2.0**	**0.7**
Imports						
Advanced economies	2.6	3.7	7.6	5.6	1.9	0.2
Other emerging market and developing countries	6.0	11.1	12.8	11.9	2.6	2.4
Exports						
Advanced economies	2.2	2.6	8.1	6.3	1.8	0.2
Other emerging market and developing countries	6.6	10.9	10.8	10.6	2.7	1.9
Commodity prices (U.S. dollars)						
Oil[4]	2.5	15.8	28.9	—	25.1	10.0
Nonfuel (average based on world commodity export weights)	0.6	7.1	16.8	–3.9	9.2	–3.1
Consumer prices						
Advanced economies	1.5	1.8	2.1	2.1	0.4	0.4
Other emerging market and developing countries	6.0	6.1	6.0	5.5	0.3	0.5
Six-month London interbank offered rate (LIBOR, percent)						
On U.S. dollar deposits	1.9	1.2	1.6	3.4	0.3	–0.1
On euro deposits	3.3	2.3	2.2	2.8	0.1	0.2
On Japanese yen deposits	0.1	0.1	0.1	0.3	—	–0.1

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during July 7–August 4, 2004.
[1]Using updated purchasing-power-parity (PPP) weights, summarized in the Statistical Appendix, Table A.
[2]Mongolia, which is not a member of the Commonwealth of Independent States, is included in this group for reasons of geography and similarities in economic structure.
[3]Includes Indonesia, Malaysia, the Philippines, and Thailand.
[4]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil. The average price of oil in U.S. dollars a barrel was $28.89 in 2003; the assumed price is $37.25 in 2004 and $37.25 in 2005.

Figure 1.2. Current and Forward-Looking Indicators

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

Industrial production and global trade growth have slowed somewhat recently, but remain strong; forward-looking indicators in particular suggest a continued solid recovery.



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. 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.

From a regional perspective, as discussed in more detail in Appendix 1.1, the impact of higher oil prices varies significantly, depending on—among other things—the energy intensity of production and consumption; the impact on the terms of trade; and the flexibility with which the economy adapts to shocks. Among industrial countries, the impact is somewhat larger in the United States and the euro area than in Japan and the United Kingdom. Among developing countries, oil producers clearly benefit; in aggregate, the adverse impact is largest in emerging Asia and Europe, and relatively small in Latin America. The impact on the poorest oil-importing countries—particularly in Africa and the Commonwealth of Independent States—is of particular concern, although in a number of cases it has been partly or fully offset by higher nonfuel prices (Figure 1.3).

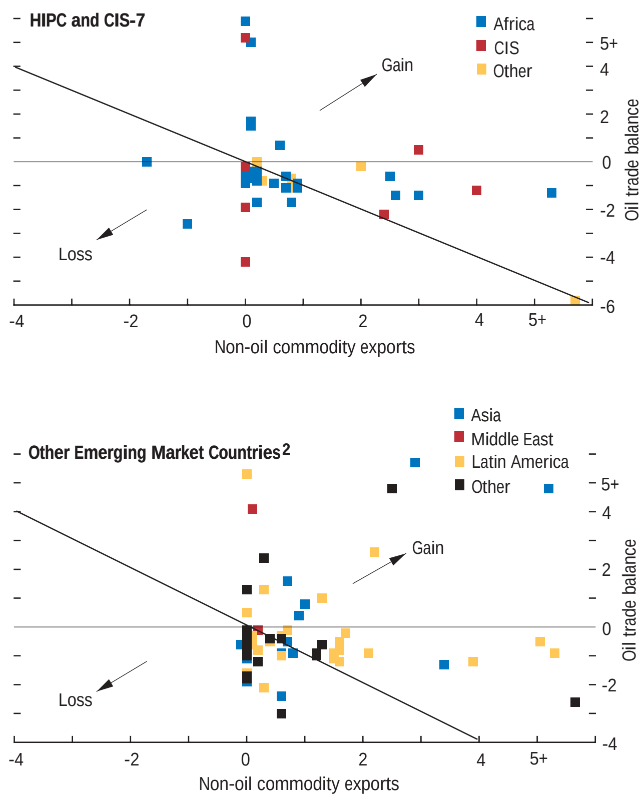
After falling to unusually low levels in mid-2003, inflation across the world has turned up, with earlier concerns about deflation replaced by fears that inflation is making a comeback. Headline inflation has inevitably increased with higher oil prices, but in a number of countries—including the United States—core inflation has also picked up, in part reflecting temporary or one-off factors, as well as higher prices of crude and intermediate materials (Box 1.1, pp. 16–18). Inflationary risks vary across countries and regions, but in most appear moderate, given substantial excess capacity in many countries; generally moderate wage settlements relative to productivity growth; strong corporate profitability, particularly in the United States, providing scope for firms to absorb price pressures; and reasonably well-anchored inflationary expectations (Table 1.2). Even so, central banks will need to be vigilant to ensure that the second-round effects of higher headline inflation are well contained, a task that will be easier in those countries where central bank credibility is well established.

Financial market developments have been dominated by changing expectations about the pace and timing of monetary tightening in the United States. The growing strength of the recovery, combined with the changing language in Federal Open Market Committee statements, triggered a significant rise in long-run interest rates through mid-June (Figure 1.4), accompanied by widespread deleveraging. To date—as described in the September 2004 *Global Financial Stability Report*—the market adjustment to these developments has been orderly, and has not posed a threat to financial stability or the health of financial institutions. Mature market equity valuations and corporate bond spreads generally held up relatively well, aided by rising corporate profitability and continued progress in balance sheet restructuring. The biggest impact was in emerging markets, where bond spreads—which had been close to historical lows—widened significantly, and new issuance slowed (Figure 1.5; Table 1.3). Since June, these trends have partially reversed, as weaker U.S. data have prompted a downward revision in the expected pace of U.S. monetary tightening. Long-run interest rates have fallen back, equity markets have weakened, and risk appetite has strengthened, accompanied by a corresponding improvement in emerging market financing conditions. Despite the apparent uncertainty as to future U.S. monetary developments—and other factors, notably oil prices and geopolitical risks—expected volatility in major stock and bond markets is at historically low levels, raising concerns that markets may be becoming unduly complacent.

In foreign exchange markets, rising expectations of higher U.S. interest rates and buoyant growth contributed to a moderate appreciation in the U.S. dollar through the International Monetary and Financial Committee (IMFC) meetings in April. Since then, despite some volatility, the major currencies have moved rather little in trade-weighted terms, with a moderate depreciation of the U.S. dollar and yen accompanied by small appreciations of the euro and the pound (Figure 1.6). Outside central Europe, most emerging market currencies have depreciated, notably in Asia and in Latin America, partly reflecting the deterioration in external financing conditions. Aided by rising

Figure 1.3. Trade Gains and Losses from Commodity Price Movements Between 2003 and 2004[1]
(Percent of GDP)

The impact of higher oil prices on many developing countries has been broadly offset by rising nonfuel commodities prices, although some countries—particularly in Africa and the CIS—have been harder hit.



Source: IMF staff estimates.
[1]The figure shows the impact of the projected rise in commodity prices between 2003 and 2004 on nonfuel exports (horizontal axis) and the oil trade balance (vertical axis).
[2]Excluding oil exporters.

Table 1.2. 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	**1.6**	**2.1**	**3.6**	**2.9**	**1.5**	**1.8**	**2.1**	**2.1**	**6.4**	**6.6**	**6.3**	**6.1**
United States	1.9	3.0	4.3	3.5	1.6	2.3	3.0	3.0	5.8	6.0	5.5	5.4
Euro area[1]	0.8	0.5	2.2	2.2	2.3	2.1	2.1	1.9	8.5	8.9	9.0	8.7
Germany	0.1	–0.1	2.0	1.8	1.3	1.0	1.8	1.3	8.7	9.6	9.7	9.5
France	1.1	0.5	2.6	2.3	1.9	2.2	2.4	2.1	8.9	9.4	9.4	9.0
Italy	0.4	0.3	1.4	1.9	2.6	2.8	2.1	2.0	9.0	8.7	8.3	8.2
Spain	2.2	2.5	2.6	2.9	3.9	3.0	2.8	2.7	11.4	11.3	11.1	10.3
Netherlands	0.6	–0.9	1.1	1.8	3.9	2.2	1.4	1.1	2.5	4.3	5.3	5.8
Belgium	0.7	1.1	2.5	2.3	1.6	1.5	1.8	1.6	7.3	8.1	8.3	8.3
Austria	1.4	0.7	1.6	2.4	1.7	1.3	1.7	1.6	4.3	4.4	4.4	4.2
Finland	2.3	2.0	2.8	2.6	2.0	1.3	0.1	1.3	9.1	9.0	8.8	8.5
Greece	3.9	4.3	3.9	3.0	3.9	3.4	3.3	3.4	10.0	9.0	8.9	8.8
Portugal	0.4	–1.2	1.4	2.2	3.7	3.3	2.5	2.2	5.1	6.4	7.1	6.8
Ireland	6.1	3.7	4.7	5.0	4.7	4.0	2.3	2.1	4.4	4.7	4.4	4.1
Luxembourg	1.7	2.1	2.8	3.4	2.1	2.6	2.1	2.0	2.9	3.8	4.5	4.8
Japan	–0.3	2.5	4.4	2.3	–0.9	–0.2	–0.2	–0.1	5.4	5.3	4.7	4.5
United Kingdom[1]	1.8	2.2	3.4	2.5	1.3	1.4	1.6	1.9	5.2	5.0	4.8	4.8
Canada	3.4	2.0	2.9	3.1	2.3	2.7	1.9	2.2	7.7	7.6	7.2	6.8
Korea	7.0	3.1	4.6	4.0	2.8	3.5	3.8	3.8	3.1	3.4	3.5	3.6
Australia	3.8	3.0	3.6	3.4	3.0	2.8	2.8	2.5	6.4	6.1	5.7	5.7
Taiwan Province of China	3.6	3.3	5.6	4.1	–0.2	–0.3	1.1	1.5	5.2	5.0	4.7	4.5
Sweden	2.1	1.6	3.0	2.5	2.0	2.3	0.9	1.4	4.0	4.9	5.6	5.0
Switzerland	0.2	–0.5	1.8	2.2	0.6	0.6	0.7	0.8	2.5	3.5	3.4	3.0
Hong Kong SAR	1.9	3.2	7.5	4.0	–3.0	–2.6	—	1.0	7.3	7.9	6.7	5.8
Denmark	1.0	0.5	2.1	2.5	2.3	2.1	1.7	1.8	4.9	5.8	5.9	5.6
Norway	1.4	0.4	2.7	2.7	1.3	2.5	0.5	1.8	3.9	4.5	4.3	4.0
Israel	–0.7	1.3	3.6	3.5	5.7	0.7	–0.3	1.4	10.3	10.8	10.7	10.1
Singapore	2.2	1.1	8.8	4.4	–0.4	0.5	1.8	1.6	4.4	4.7	4.3	3.9
New Zealand[2]	4.3	3.4	4.2	2.0	2.7	1.8	2.4	2.8	5.2	4.7	4.6	5.0
Cyprus	2.0	2.0	3.0	3.5	2.8	4.1	2.2	2.6	3.2	3.5	3.4	3.2
Iceland	–0.5	4.0	4.4	5.3	4.8	2.1	3.3	3.2	2.5	3.3	3.0	2.3
Memorandum												
Major advanced economies	1.2	2.2	3.7	2.9	1.3	1.7	2.1	2.1	6.5	6.7	6.4	6.2
Newly industrialized Asian economies	5.0	3.0	5.5	4.0	0.9	1.4	2.4	2.6	4.1	4.3	4.1	4.1

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

real yields, the U.S. current account deficit has continued to be financed without major difficulty, with over half of net portfolio inflows continuing to come from Asia.

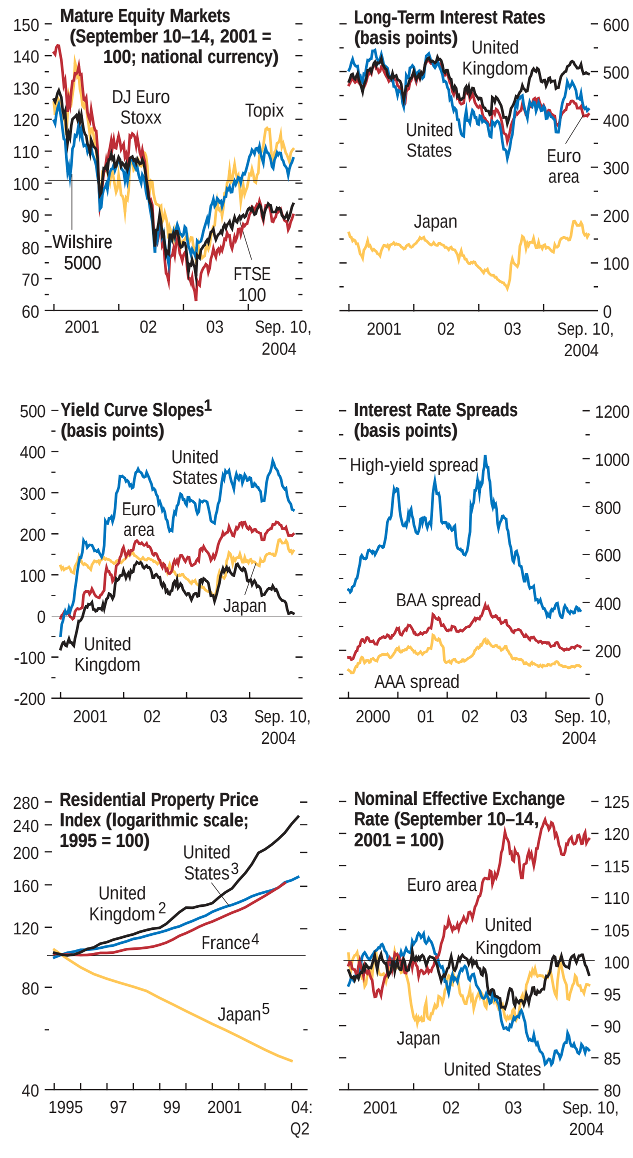
Against this background, and given the stronger-than-expected economic momentum in the first quarter of the year—consistent with the upside risks identified in the last *World Economic Outlook*—global GDP growth has been revised up to 5 percent in 2004. This has been underpinned by continued accommodative macroeconomic policies, rising corporate profitability, wealth effects from rising equity markets and house prices, rising employment, and—particularly relevant for Asian countries—the very strong growth in China. Looking forward, however, global growth is expected to moderate from the second quarter of 2004 (Figure 1.7) as these positive factors are offset by the steady decline in output gaps across the world; the ongoing withdrawal of fiscal and monetary stimulus (Figure 1.8); and the impact of higher oil prices. Correspondingly, global growth is projected to fall to 4.3 percent in 2005, slightly lower than expected last April, but still significantly above the historical trend.

Looking across individual countries and regions, we find the following.

- In *industrial countries*, the expansion continues to be led by the United States, with ebbing fiscal and monetary stimulus balanced by strong labor productivity growth. However, second-quarter GDP growth—especially private consumption—was weaker than expected, and employment growth has slowed. While this emergent “soft patch”—as discussed below—is most likely to be temporary, growth forecasts have been marked downward in both 2004 and 2005, and much continues to depend on a solid rebound in employment. In Japan, the upturn has also been strong, amid increasing signs that its long-standing problems—deflation and financial and corporate sector weaknesses—are easing. While growth slowed sharply in the second quarter, recent data suggest the near-term outlook remains solid. However, there are some downside risks to the staff forecast, with the key concerns including a further increase in oil prices and an eventual hard landing in China. The recovery is also taking root in the euro area with the 2004 forecast marked up significantly, but it remains heavily dependent on external demand. Final domestic demand—especially in Germany—has remained relatively weak. Looking forward, given the euro area’s past history of slow adjustment to shocks, and with employment likely to strengthen only gradually, the pace of the expansion is expected to remain moderate.
- *Emerging market and developing countries* continue to experience a generally strong recovery, with GDP growth forecasts for 2004 revised upward markedly in all major regions. In *emerging Asia*, GDP growth is projected to remain at 7¼ percent in 2004, led by booming activity in China—fueled by very rapid investment and credit growth—and in India, where—despite recent adverse weather conditions—growth is being underpinned by the global expansion and supportive monetary conditions. For the region as a whole, domestic demand growth is generally strong, and current account surpluses—and in some cases capital inflows—remain very high. With output gaps declining

Figure 1.4. Developments in Mature Financial Markets

Long-term interest rates have risen significantly since the first quarter of 2004, but have since fallen back, accompanied by some weakening of equity markets.

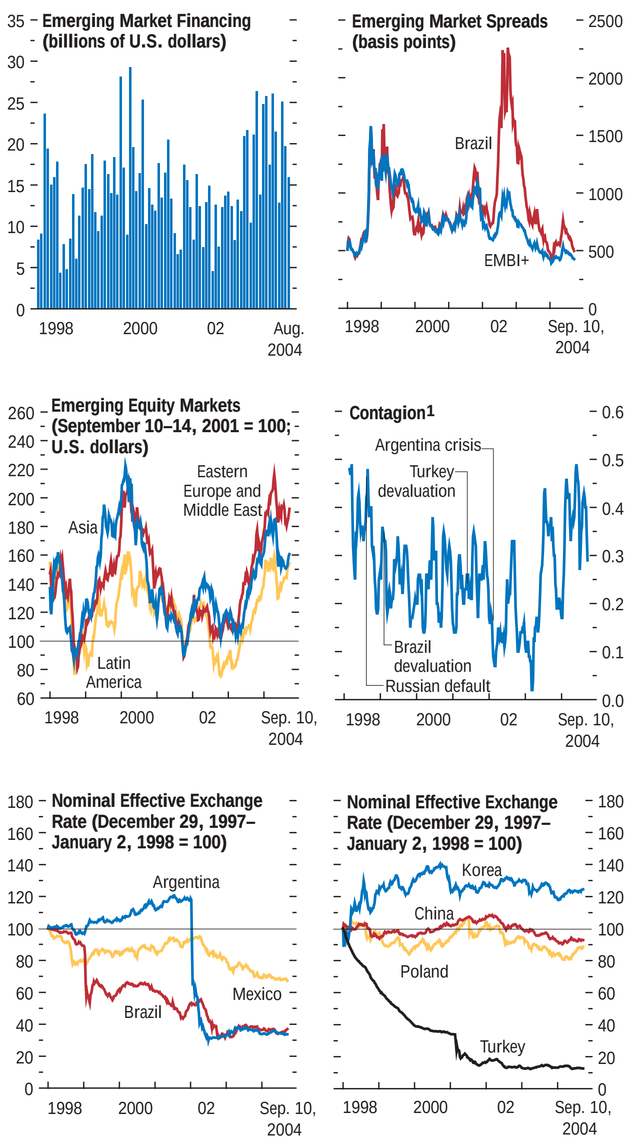


Sources: Bloomberg Financial Markets, LP; State Street Bank; HBOS Plc.; Office of Federal Housing Enterprise Oversight; National Sources; Japan Real Estate Institute; and IMF staff calculations.

[1]10-year government bond minus 3-month treasury bill rate.
[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]Residential property prices: existing dwellings.
[5]Urban land price index: average of all categories in six large city areas.

Figure 1.5. Emerging Market Financial Conditions

After deteriorating in April and May 2004, emerging market financing conditions have improved, partly reflecting the decline in global long-term interest rates.



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

and exchange rates competitive, continuing very large reserve increases will increasingly complicate the conduct of monetary policy. The region remains relatively vulnerable to external developments, notably oil prices and a downturn in the information technology sector. A hard landing in China would also adversely affect a number of countries, particularly the newly industrialized and ASEAN economies, although the global consequences would likely be moderate (see Box 1.2, pp. 19–21). In *Latin America*, the recovery appears increasingly well established, with regional GDP growth projected to jump to 4.6 percent in 2004, supported by the global recovery, rising commodity prices, and, increasingly, domestic demand. With most countries taking advantage of earlier benign financing conditions to prefinance sovereign debt repayments for 2004, the deterioration in external financing conditions has so far proved manageable; however, with underlying regional vulnerabilities remaining large, adverse external shocks remain a key source of risk. In the *Middle East*, notwithstanding the still-fragile security situation, GDP forecasts have been revised upward in response to higher oil production and prices. GDP growth in *Turkey* is also exceeding expectations, although the widening current account deficit—exacerbated by higher oil prices—is a source of concern. Turning to the *Commonwealth of Independent States (CIS) countries*, rising global demand for oil and metals has boosted the already strong growth momentum in the region, with growth forecasts for Russia and Ukraine revised upward sharply, although some CIS-7 oil importers have been adversely affected. The expansion in *central and eastern Europe* also continues, with large fiscal and current account deficits remaining the central vulnerability.

- In the *poorest countries*, projected GDP growth in sub-Saharan Africa has been revised upward to 4.6 percent in 2004, mainly owing to higher-than-expected growth in Nigeria, and to 5.8 percent in 2005 (which, if achieved, would be the highest in three decades). This is being

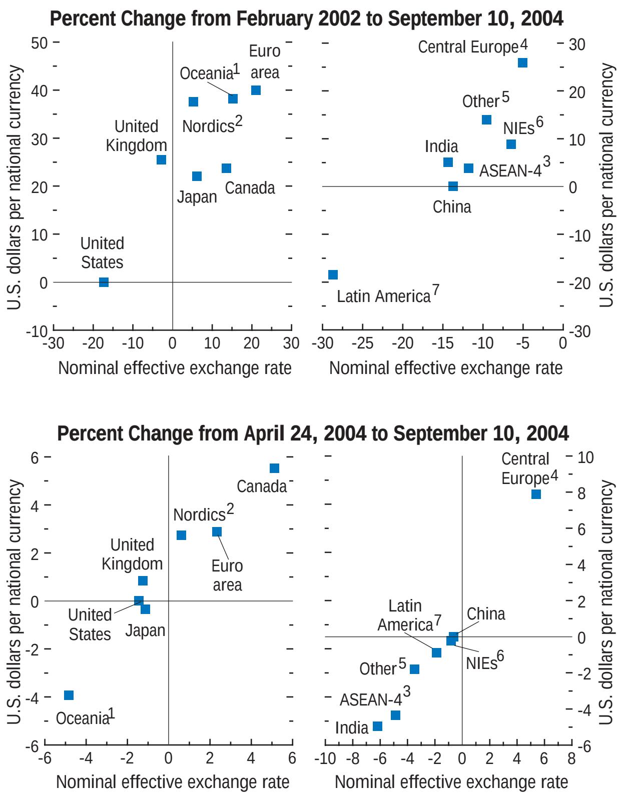
Table 1.3. Emerging Market and Developing Countries: Net Capital Flows[1]
(Billions of U.S. dollars)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total										
Private capital flows, net[2]	196.7	195.0	70.5	88.1	46.6	47.8	61.2	120.4	81.6	47.5
Private direct investment, net	116.0	144.9	155.0	173.4	177.1	191.2	143.5	147.6	166.9	175.2
Private portfolio flows, net	86.3	63.3	41.9	66.6	16.1	–91.3	–99.6	–11.0	–21.3	–23.4
Other private capital flows, net	–5.6	–13.2	–126.4	–151.8	–146.6	–52.0	17.3	–16.2	–64.0	–104.4
Official flows, net	–6.8	34.6	49.7	6.5	–27.7	15.7	1.7	–24.8	–31.0	–42.1
Change in reserves[3]	–90.3	–103.8	–33.9	–92.5	–115.6	–113.2	–197.1	–367.0	–350.1	–291.2
Memorandum										
Current account[4]	–93.8	–83.3	–52.7	38.0	126.3	89.7	145.0	235.3	285.7	269.2
Africa										
Private capital flows, net[2]	4.5	12.3	8.3	12.2	5.6	13.5	11.9	14.8	16.6	13.7
Private direct investment, net	3.1	7.9	6.6	9.0	8.0	23.8	13.1	13.6	14.4	15.5
Private portfolio flows, net	2.9	7.0	3.7	8.7	–1.7	–8.4	–0.5	–0.1	1.4	1.1
Other private capital flows, net	–1.5	–2.6	–2.0	–5.5	–0.7	–2.0	–0.7	1.3	0.8	–2.9
Official flows, net	–2.6	–6.4	1.8	1.5	0.9	0.5	3.7	5.2	2.3	2.6
Change in reserves[3]	–5.9	–10.5	3.3	–2.9	–12.8	–12.3	–7.6	–20.0	–22.9	–23.4
Central and eastern Europe										
Private capital flows, net[2]	23.0	20.2	27.2	36.7	39.1	12.1	55.3	51.5	53.2	49.3
Private direct investment, net	10.4	11.6	19.2	22.6	23.9	24.2	25.1	14.9	22.7	24.7
Private portfolio flows, net	1.9	5.4	–1.4	5.7	3.1	0.5	1.5	7.0	9.2	10.0
Other private capital flows, net	10.7	3.2	9.4	8.4	12.1	–12.6	28.7	29.6	21.2	14.6
Official flows, net	0.1	–3.3	0.3	–2.6	1.6	5.5	–7.6	–5.5	–6.6	–5.5
Change in reserves[3]	–7.4	–10.6	–9.5	–11.3	–3.3	5.8	–14.4	–13.6	–9.4	–5.7
Commonwealth of Independent States[5]										
Private capital flows, net[2]	–3.8	19.6	7.2	–6.1	–12.6	–1.7	–9.2	15.2	–19.2	–5.8
Private direct investment, net	4.9	5.9	5.3	4.3	2.4	4.6	3.9	3.8	5.7	6.0
Private portfolio flows, net	–0.1	17.6	7.7	–3.0	–6.0	–9.2	–8.2	–5.0	–7.9	–8.2
Other private capital flows, net	–8.6	–3.9	–5.8	–7.4	–9.0	2.9	–4.8	16.4	–17.1	–3.5
Official flows, net	10.6	8.4	9.9	–0.1	–4.0	–4.2	–1.5	–4.7	–2.6	–2.5
Change in reserves[3]	2.2	–3.8	7.5	–2.2	–17.1	–11.2	–11.8	–33.6	–27.8	–34.7
Emerging Asia[6]										
Private capital flows, net[2,7]	119.4	37.6	–52.2	8.6	–4.5	9.6	25.4	52.8	79.8	8.6
Private direct investment, net	53.4	56.5	56.1	66.4	67.4	60.5	53.8	70.0	77.2	77.5
Private portfolio flows, net	32.5	6.7	8.1	56.1	19.8	–56.9	–59.6	5.5	12.0	–1.8
Other private capital flows, net[7]	33.5	–25.5	–116.4	–113.9	–91.7	6.0	31.2	–22.8	–9.4	–67.1
Official flows, net	–14.5	22.6	17.9	2.2	4.5	–1.8	–1.8	–16.3	–6.9	–8.8
Change in reserves[3]	–46.3	–36.4	–52.7	–87.2	–60.9	–90.9	–158.4	–234.2	–232.6	–158.0
Middle East[8]										
Private capital flows, net[2]	–1.0	7.8	13.3	–0.6	–20.6	–7.9	–23.6	–14.0	–45.5	–32.5
Private direct investment, net	4.6	5.3	5.8	5.3	6.4	7.8	5.8	13.4	8.8	12.2
Private portfolio flows, net	1.0	–2.7	–2.1	–2.3	–0.3	–7.9	–15.6	–16.7	–33.3	–27.5
Other private capital flows, net	–6.6	5.2	9.6	–3.5	–26.7	–7.8	–13.8	–10.7	–21.0	–17.2
Official flows, net	7.1	6.2	1.0	–1.0	–24.4	–10.7	–13.0	–26.3	–25.0	–28.1
Change in reserves[3]	–18.0	–16.1	10.2	–0.2	–26.1	–9.6	–3.3	–29.9	–44.8	–56.3
Western Hemisphere										
Private capital flows, net[2]	54.8	97.4	66.6	37.3	39.6	22.2	1.4	—	–3.3	14.2
Private direct investment, net	39.6	57.7	61.9	65.8	69.0	70.2	41.7	31.8	38.0	39.3
Private portfolio flows, net	48.2	29.4	25.8	1.5	1.3	–9.4	–17.1	–1.7	–2.8	3.0
Other private capital flows, net	–33.0	10.4	–21.1	–30.0	–30.6	–38.6	–23.2	–30.1	–38.5	–28.2
Official flows, net	–7.4	7.1	18.8	6.5	–6.1	26.5	22.0	22.7	7.8	0.2
Change in reserves[3]	–15.0	–26.3	7.3	11.3	4.7	4.9	–1.6	–35.7	–12.7	–13.2
Memorandum										
Fuel exporters										
Private capital flows, net[2]	–24.4	30.2	15.6	–17.7	–52.4	–11.8	–33.3	1.8	–66.7	–46.9
Nonfuel exporters										
Private capital flows, net[2]	221.1	164.8	54.9	105.8	99.0	59.6	94.5	118.6	148.3	94.4

[1]Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing. In this table, Hong Kong SAR, Israel, Korea, Singapore, and Taiwan Province of China are included.
[2]Because of data limitations, “other private capital flows, net” may include some official flows.
[3]A minus sign indicates an increase.
[4]The sum of the current account balance, net private capital flows, net official flows, and the change in reserves equals, with the opposite sign, the sum of the capital and financial account and errors and omissions. For regional current account balances, see Table 25 of the Statistical Appendix.
[5]Historical data have been revised, reflecting cumulative data revisions for Russia and the resolution of a number of data interpretation issues.
[6]Consists of developing Asia and the newly industrialized Asian economies.
[7]Excluding the effects of the recapitalization of two large commercial banks in China with foreign reserves of the Bank of China (US$45 billion), net private capital flows to emerging Asia in 2003 were US$97.8 billion while other private capital flows net to the region amounted to US$22.2 billion.
[8]Includes Israel.

Figure 1.6. Global Exchange Rate Developments

Trade-weighted exchange rates in most industrial countries are broadly unchanged since the last IMFC meeting in April; outside central Europe, exchange rates in emerging markets have remained stable or depreciated.



Sources: Bloomberg Financial, LP; and IMF staff calculations.
[1]Australia and New Zealand.
[2]Denmark, Norway, and Sweden.
[3]Indonesia, Malaysia, the Philippines, and Thailand.
[4]Czech Republic, Hungary, and Poland.
[5]Russia, Turkey, and South Africa.
[6]Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.
[7]Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

underpinned by improved macroeconomic stability; sharply increasing oil production, as new facilities come on stream in several countries; improved political stability; and a recovery in agricultural production following severe droughts in 2003. It should be noted that IMF forecasts have consistently overestimated African GDP growth in the past, in part owing to unanticipated political instability and natural disasters.[2] Moreover, developments in some specific countries—notably, the humanitarian catastrophe unfolding in western Sudan and the economic collapse in Zimbabwe—are of deep concern. Nonetheless, prospects for much of Africa appear more favorable than they have been for many years, a particularly welcome aspect of the current outlook.

Given the continued uncertainties in the oil market, as well as the softer-than-expected incoming data in the United States and some other countries, the risks to the outlook have shifted to the downside. In the short run, geopolitical risks, while hard to quantify, remain very much present and, in contrast to the past, the room for policy easing in response to geopolitical disturbances is relatively limited. Beyond that, the two following risks appear most immediate.

- *With spare capacity at historical lows, and concentrated in one country, the oil market remains highly vulnerable to shocks.* As the *World Economic Outlook* went to press, oil prices had risen somewhat above the World Economic Outlook baseline, and supply-side risks are substantial, with a sustained $5 a barrel increase in oil prices tending to reduce global growth by about 0.3 percent (Appendix 1.1). This would be of particular concern in countries where domestic demand remains weak; for highly indebted oil importers (including the Philippines and Turkey); and for many poor countries. Looking forward, spare capacity in the oil market is expected to remain low

[2]See “The Accuracy of World Economic Outlook Growth Forecasts: 1991–2000,” Box 3.1, *World Economic Outlook,* December 2001.

through the remainder of the decade. Consequently, with terrorist attacks on oil supply a continuing risk, higher and more volatile oil prices may persist. This underscores the need to reduce vulnerability to such conditions, both through concerted measures to restrain the growth of oil demand and through investment in capacity expansion in oil-producing countries.

- *Inflationary pressures could prove stronger than expected—although this concern is tempered by downside risks to global growth—necessitating a sharper rise in interest rates than markets presently price in*. This seems unlikely to give rise to major problems in mature financial markets,[3] but there could be a significant impact on housing markets, which are surprisingly synchronized across countries (see the first essay in Chapter II). This would be of particular concern in countries where housing prices appear richly valued—notably, the United Kingdom, Australia, Ireland, and Spain—and where a large share of mortgage debt is at adjustable rates. Nonetheless, slower house price growth could also adversely affect domestic demand in other countries. Higher interest rates would also result in a further deterioration in emerging market financing conditions. While this by itself would in most cases be manageable, the risks would be significantly greater if it were accompanied by other adverse shocks.

Looking beyond the short term, there are both opportunities and significant risks.

- *The information technology (IT) revolution, along with China's emergence, presents an opportunity for sustained higher global productivity growth*.[4] To date, the benefits of the IT revolution have come primarily from higher productivity in the IT sector itself and from higher investment. However, history suggests that the

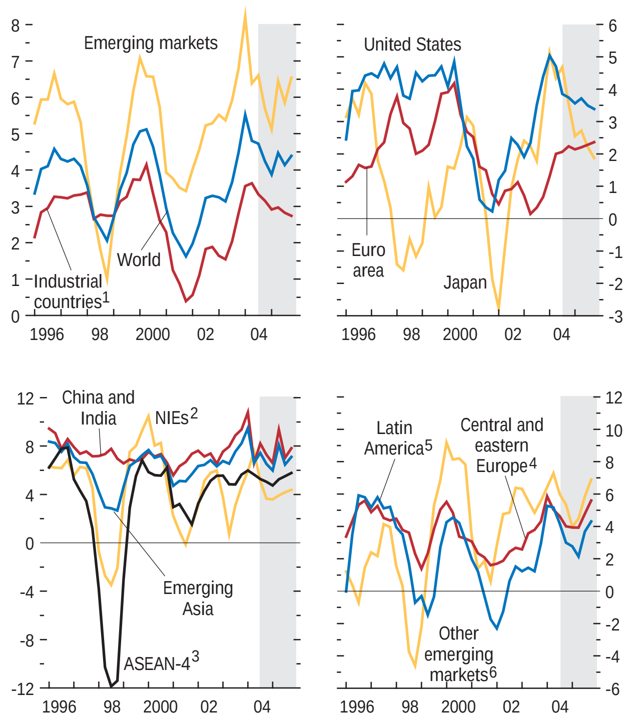
[3]See the September 2004 *Global Financial Stability Report* for a detailed discussion.

[4]See Martin Wolf, "Three Reasons To Be Cheerful About The World Economy," *Financial Times*, Wednesday, June 30, 2004, for an eloquent statement of this view.

Figure 1.7. Global Outlook

(Real GDP; percent change from four quarters earlier)

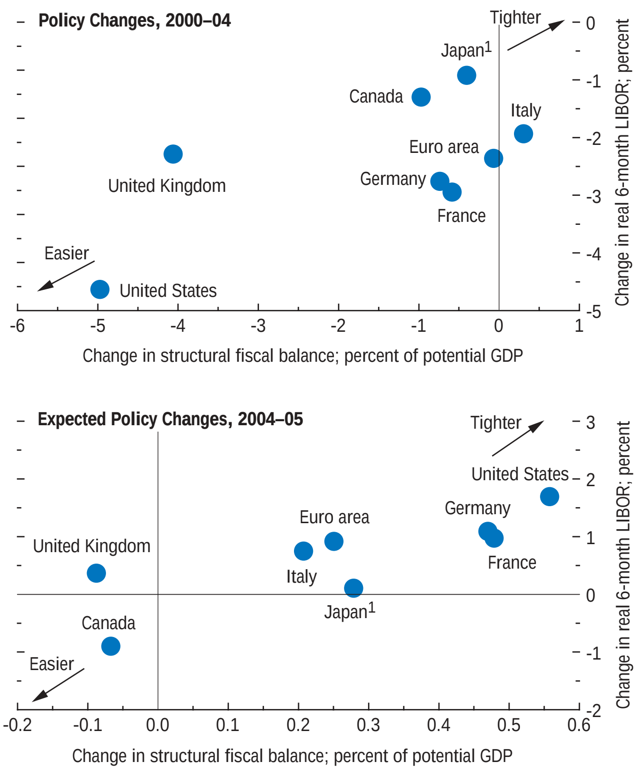
Following the very rapid expansion since mid-2003, global growth has slowed since the first quarter of 2004, but is expected to remain relatively strong.



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

Figure 1.8. Fiscal and Monetary Easing in the Major Advanced Countries

Monetary and fiscal policies in most industrial countries are projected to tighten in 2005, most rapidly in the United States.



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

largest gains will come from the reorganization of production processes to take advantage of the new technology,[5] a process that has only just begun—outsourcing being one example—and is likely to continue for a considerable period. China's rapid growth, which may well be sustained for two decades or more, will also result in a substantial—although smaller-scale—reorganization of global production, the more so if it is joined by India.[6] Both these developments suggest the scope for substantial productivity gains in coming years, coming most rapidly in those countries that are sufficiently adaptable to take advantage of them.

- However, *significant economic vulnerabilities remain in both industrial and emerging market countries*, particularly on the fiscal side (Figure 1.9 and Table 1.4). With much still to do on pension and health reform (see Chapter III), many industrial countries are still far from prepared for the impact of aging populations. In emerging markets, external vulnerabilities have generally been reduced. However, high and poorly structured public debt is for many an Achilles' heel, which if not addressed is very likely to lead to further financial crises in the future. Corporate and financial sector vulnerabilities—in both industrial and emerging markets—also remain significant, particularly in countries where nonperforming loans remain large or private credit growth is rapid.
- *The global imbalances, notably the large U.S. current account deficit and surpluses elsewhere, remain a key risk.* The U.S. current account deficit has continued to increase through the first half of 2004 and, despite the past depreciation of the U.S. dollar, is projected to remain above 4 percent of GDP over the medium term (Table 1.5). The question is not whether the U.S. deficit will adjust—it will—but when and how

[5]One such example is the invention of electricity, which allowed the introduction of the production line. For a detailed discussion, see "The Information Technology Revolution," Chapter III, *World Economic Outlook*, September 2001.

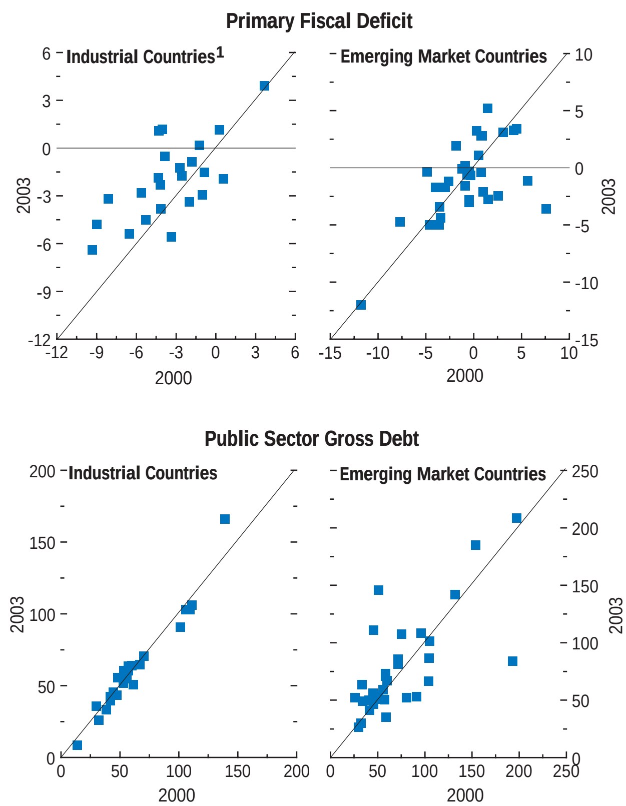
[6]See "China's Emergence and Its Impact on the Global Economy," *World Economic Outlook*, April 2004.

that adjustment will take place, and in particular whether it will be associated with an abrupt exchange rate adjustment. Some factors—notably strong U.S. productivity growth and deepening global capital markets—are supportive of an orderly adjustment; however, others—including the high level of the U.S. deficit in relation to exports—are less so. And since current account corrections have historically tended to be associated with a slowdown in growth in the deficit country, even an orderly adjustment carries risks, given the central role that the United States has played in supporting global growth in recent years.

With the global expansion expected to remain solid, the key short-term policy challenge is still to manage the transition toward higher interest rates, ensuring that nascent inflationary pressures are contained while facilitating—through effective communication—a continued orderly adjustment in financial markets. Within that, the desirable pace and timing vary significantly, ranging from China—where monetary conditions have already been tightened and more may be needed to prevent incipient overheating—to Japan, where despite stronger growth and easing deflationary pressures, monetary policy should remain accommodative until deflation and deflationary expectations turn around decisively. In the United States, the long-awaited tightening cycle began in June; with considerable economic slack persisting, the Federal Reserve has appropriately indicated that future interest rate increases are likely to be measured, although with uncertainties about both the pace of recovery and the strength of inflationary pressures, much will depend on the nature of incoming data. In the euro area, headline inflation has again risen above 2 percent, in part reflecting higher oil prices and one-off factors. But with underlying inflationary pressures—including wage increases—still moderate, the European Central Bank (ECB) has appropriately remained on hold, and monetary policies should remain accommodative until a self-sustaining pickup in domestic demand is clearly under way.

Figure 1.9. Fiscal Vulnerability Indicators
(Percent of GDP unless otherwise indicated)

Fiscal deficits in many countries have increased since 2000, accompanied by rising public debt.



Source: IMF staff calculations.
[1]Structural primary deficit in percent of potential GDP.

Table 1.4. Major Advanced Economies: General Government Fiscal Balances and Debt[1]

(Percent of GDP)

	1988–97	1998	1999	2000	2001	2002	2003	2004	2005	2009
Major advanced economies										
Actual balance	–3.7	–1.5	–1.2	–0.2	–1.8	–4.0	–4.6	–4.5	–4.0	–2.8
Output gap[2]	–0.2	0.1	0.5	1.2	–0.4	–1.8	–2.3	–1.3	–1.0	—
Structural balance	–3.6	–1.5	–1.3	–1.2	–1.7	–3.4	–3.6	–3.9	–3.5	–2.8
United States										
Actual balance	–3.8	0.1	0.6	1.3	–0.7	–4.0	–4.6	–4.9	–4.3	–2.9
Output gap[2]	–0.9	0.9	1.9	2.2	–0.4	–2.0	–2.3	–1.3	–1.0	—
Structural balance	–3.5	–0.3	–0.1	0.5	–0.6	–3.3	–3.8	–4.4	–3.9	–2.9
Net debt	55.3	52.8	48.2	43.3	41.9	44.5	47.0	48.9	50.3	52.3
Gross debt	69.1	66.2	62.8	57.1	56.6	58.6	60.5	61.5	62.2	61.9
Euro area										
Actual balance	. . .	–2.3	–1.3	–0.9	–1.7	–2.3	–2.8	–2.9	–2.5	–1.1
Output gap[2]	. . .	–0.4	0.2	1.3	0.7	–0.5	–1.9	–1.8	–1.7	—
Structural balance	. . .	–1.9	–1.3	–1.6	–2.1	–2.2	–1.7	–1.7	–1.4	–1.0
Net debt	. . .	62.0	61.6	59.1	58.9	58.8	60.2	60.6	60.5	57.1
Gross debt	. . .	73.8	72.7	70.4	69.4	69.2	70.6	70.9	70.6	66.3
Germany[3]										
Actual balance	–2.4	–2.2	–1.5	1.3	–2.8	–3.7	–3.8	–3.9	–3.3	–1.6
Output gap[2]	0.6	–0.4	–0.1	0.9	0.3	–1.1	–2.6	–2.2	–2.0	—
Structural balance[4]	–2.7	–1.7	–1.2	–1.6	–2.9	–2.9	–2.2	–2.4	–1.9	–1.7
Net debt	35.3	53.3	54.9	52.8	53.5	55.5	58.7	60.8	62.3	62.8
Gross debt	48.4	60.9	61.2	60.2	59.4	60.9	63.8	65.7	67.1	67.0
France										
Actual balance	–3.7	–2.7	–1.8	–1.4	–1.4	–3.2	–4.1	–3.4	–2.8	–1.0
Output gap[2]	–0.9	–1.5	–0.6	1.2	1.0	—	–1.4	–1.1	–1.0	—
Structural balance[4]	–3.0	–1.8	–1.4	–2.0	–2.1	–3.2	–3.2	–2.6	–2.1	–1.0
Net debt	35.2	49.8	48.8	47.5	48.2	49.1	54.0	54.6	54.7	52.5
Gross debt	44.2	59.5	58.5	57.1	56.8	58.7	63.7	64.3	64.4	62.2
Italy										
Actual balance	–9.2	–2.8	–1.7	–0.6	–2.6	–2.3	–2.4	–2.9	–2.8	–1.6
Output gap[2]	0.1	–0.1	—	1.0	0.6	–1.0	–2.5	–2.8	–2.7	—
Structural balance[4]	–9.0	–2.8	–1.8	–2.4	–3.1	–2.6	–1.4	–2.1	–1.9	–1.6
Net debt	104.4	110.1	108.4	104.5	103.9	101.4	99.8	99.4	97.9	91.4
Gross debt	110.3	116.4	114.6	111.2	110.6	108.0	106.2	105.8	104.2	97.3
Japan										
Actual balance	–1.3	–5.5	–7.2	–7.5	–6.1	–7.9	–8.2	–6.9	–6.5	–6.1
Excluding social security	–3.7	–6.9	–8.2	–8.0	–6.2	–7.7	–7.7	–6.4	–5.9	–5.2
Output gap[2]	1.2	–1.2	–2.4	–1.4	–2.6	–4.3	–3.4	–0.8	–0.2	0.1
Structural balance	–1.7	–5.1	–6.3	–6.9	–5.1	–6.2	–6.9	–6.6	–6.4	–6.2
Excluding social security	–3.9	–6.6	–7.7	–7.7	–5.6	–6.8	–7.0	–6.2	–5.9	–5.3
Net debt	20.2	45.8	53.5	59.1	65.1	71.4	79.7	85.2	90.8	107.2
Gross debt	81.0	117.9	131.0	139.3	148.8	158.4	166.2	169.6	173.8	180.7
United Kingdom										
Actual balance	–3.7	0.1	1.0	3.9	0.8	–1.7	–3.4	–3.0	–2.9	–2.6
Output gap[2]	—	0.6	—	1.1	0.9	–0.1	–0.6	—	—	—
Structural balance[4]	–3.7	–0.2	0.9	1.3	0.2	–1.9	–3.2	–2.8	–2.9	–2.6
Net debt	31.4	42.4	40.2	34.4	33.0	33.0	34.8	34.8	35.9	39.4
Gross debt	43.3	47.3	44.8	41.9	38.6	38.2	39.6	39.9	40.9	44.5
Canada										
Actual balance	–5.6	0.1	1.6	2.9	1.1	0.3	0.6	0.7	0.9	1.2
Output gap[2]	—	–0.8	0.6	2.0	0.3	0.4	–0.8	–0.7	–0.3	—
Structural balance	–5.4	0.5	1.4	2.1	1.0	0.3	1.1	1.1	1.0	1.2
Net debt	76.1	83.8	75.4	65.3	59.5	56.5	51.9	48.3	45.0	33.2
Gross debt	108.0	114.8	111.6	101.5	99.1	95.4	90.9	85.0	79.8	62.0

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

[1]Debt data refer to end of year. Debt data are not always comparable across countries. For example, the Canadian data include the unfunded component of government employee pension liabilities, which amounted to nearly 18 percent of GDP in 2001.

[2]Percent of potential GDP.

[3]Data before 1990 refer to west Germany. Beginning in 1995, the debt and debt-service obligations of the Treuhandanstalt (and of various other agencies) were taken over by general government. This debt is equivalent to 8 percent of GDP, and the associated debt service, to ½ to 1 percent of GDP.

[4]Excludes one-off receipts from the sale of mobile telephone licenses (the equivalent of 2.5 percent of GDP in 2000 for Germany, 0.1 percent of GDP in 2001 and 2002 for France, 1.2 percent of GDP in 2000 for Italy, and 2.4 percent of GDP in 2000 for the United Kingdom). Also excludes one-off receipts from sizable asset transactions.

The central issue, however, must be to address the medium-term vulnerabilities and concerns discussed above. The key issues include the following.

- *Strengthening medium-term fiscal positions, through both consolidation and reforms of pension and health systems.* While most industrial countries target a gradual fiscal consolidation, in many cases this depends on relatively optimistic fiscal assumptions (the United States), and the policies to achieve it are not well defined (the euro area and Japan). Despite some progress on pension reform, notably in the euro area and Japan, much remains to be done to address the pressures from aging, the more so since past population projections have systematically underestimated the size of the problem (see Chapter III). In emerging markets, fiscal consolidation is under way in much of Latin America and beginning in some countries in Asia, but is lagging in much of emerging Europe. For many countries, large primary surpluses will need to be sustained for a considerable period to bring public debt down to manageable levels, in the face of substantial—and understandable—pressures for additional social and infrastructure spending. This underscores the importance of other measures to improve public debt sustainability, especially broadening tax bases, strengthening frameworks for public expenditure management, and last, but not least, structural measures to boost growth (historically the key to most successful debt reduction efforts).
- *Strengthening the foundations for sustained and sustainable growth.* In industrial countries, the price of economic inflexibility has risen with increasingly rapid technological change and globalization, and in a number of countries past tradeoffs between social and economic goals may need to be reevaluated. There has been progress in the euro area (notably, labor market reforms under Agenda 2010 in Germany) and in Japan (where banking and corporate sectors have been strengthened), but a substantial agenda remains. In emerging markets, priorities include completing financial and corporate sector reform in Asia; improving the investment climate—including through tax reform—in Latin America; strengthening banking supervision in eastern Europe; and, in the Middle East, putting in place the institutional infrastructure to underpin non-oil private sector development. From a multilateral perspective, the central objective is to achieve substantive trade liberalization under the Doha Round. The end-July package of agreements reached in Geneva is therefore a welcome step forward, putting the

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

	2002	2003	2004	2005
Advanced economies	**–0.8**	**–0.8**	**–0.8**	**–0.8**
United States	–4.5	–4.8	–5.4	–5.1
Euro area[1]	0.8	0.3	0.8	0.9
Germany	2.2	2.2	4.4	4.8
France	1.0	0.3	–0.6	–0.6
Italy	–0.6	–1.5	–1.1	–0.8
Spain	–2.4	–2.8	–3.4	–3.6
Netherlands	2.5	2.2	2.9	3.1
Belgium	5.3	3.8	4.5	4.6
Austria	0.3	–0.9	–1.0	–1.1
Finland	6.8	5.7	5.8	6.2
Greece	–6.0	–5.7	–6.0	–5.7
Portugal	–6.8	–5.1	–6.1	–6.3
Ireland	–1.3	–1.4	–1.6	–1.3
Luxembourg	11.5	9.3	10.1	11.4
Japan	2.8	3.2	3.4	3.2
United Kingdom	–1.7	–1.9	–2.0	–1.9
Canada	2.0	2.0	2.9	2.4
Korea	1.0	2.0	3.1	3.3
Australia	–4.4	–5.9	–5.3	–4.9
Taiwan Province of China	9.1	10.2	6.9	6.0
Sweden	5.4	6.4	6.7	5.7
Switzerland	8.5	10.2	10.3	10.6
Hong Kong SAR	7.9	10.7	10.0	9.6
Denmark	2.0	3.0	1.8	1.9
Norway	12.9	13.0	15.9	16.0
Israel	–1.6	0.1	–0.5	–0.1
Singapore	21.4	30.9	25.7	23.9
New Zealand	–3.1	–4.2	–4.4	–4.4
Cyprus	–5.4	–4.4	–4.3	–4.2
Iceland	–0.3	–5.4	–5.9	–9.7
Memorandum				
Major advanced economies	–1.5	–1.6	–1.5	–1.5
Euro area[2]	0.8	0.4	0.3	0.5
Newly industrialized Asian economies	5.8	7.6	6.8	6.5

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

Box 1.1. Is Global Inflation Coming Back?

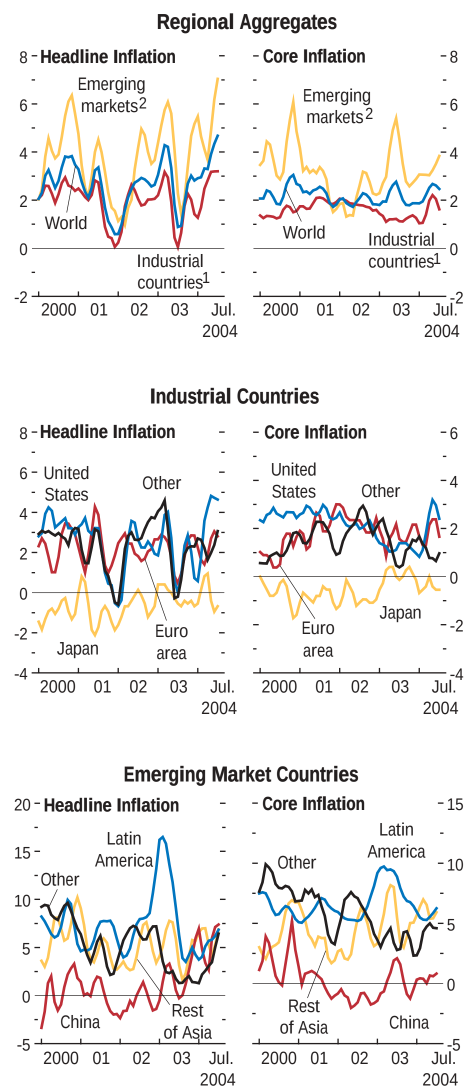
Over the past 15 years, global consumer price inflation has been reduced dramatically, in advanced and developing countries alike, underpinned by a combination of more effective and independent central banking institutions and, just as important, the pressures from globalization (Appendix 2.1 of the April 2002 *World Economic Outlook;* and Rogoff, 2003). As of 2003, only three countries had annual inflation rates in excess of 40 percent, the level above which it is generally considered to be acutely damaging. In none of the G-7 countries did inflation exceed 3 percent (and in Japan, of course, deflation persisted). Moreover, in many middle-income countries where high inflation had once been almost a permanent feature of the economic landscape, inflation has been brought well into single digits.

Since 2000, annual global headline and core inflation (based on the CPI excluding energy products) has averaged about 3 percent (see the figure), although this historically low figure has masked some volatility.[1] In particular, in the middle of 2003, headline inflation fell to unusually low levels, in industrial and emerging countries alike, which—with the recovery still weak—raised fears of global deflationary pressures. From end-2003, with global output growing rapidly and commodity prices rising sharply, headline inflation turned up significantly, although it still remains moderate. Correspondingly, deflationary fears dissipated, and—with monetary policies across the globe still quite accommodative—there have been concerns that inflation could make a comeback.

A significant proportion of the recent rise in headline inflation appears to have been due to higher commodity prices (as of July 2004, oil

Global Inflation

(Annualized percent change of three-month moving average over previous three-month average)



Sources: Haver Analytics; and IMF staff calculations.
[1]Canada, Denmark, euro area, Japan, Norway, Sweden, United Kingdom, and United States.
[2]Brazil, Chile, China, India, Indonesia, Hungary, Korea, Mexico, Poland, and South Africa.

prices were 27 percent and non-oil commodity prices were 9 percent above their end-December,

Note: The main authors of this box are David J. Robinson and Sandy Mackenzie.

[1]The remainder of this box focuses on inflation in a group of 29 industrial and emerging market countries, covering about 80 percent of global output, for which monthly data on both headline and core CPI inflation are available.

2003 level). Core inflation has risen by considerably less than headline inflation (see the figure), and remains at relatively moderate levels.[2] From a regional perspective, headline inflation has increased almost everywhere, but developments in core inflation have varied considerably. The rise in core inflation in the United States has been surprisingly steep,[3] possibly partly reflecting a rebound from the abnormally low levels experienced in 2003, although it has eased in recent months. In contrast, the increase in the euro area is not pronounced. Despite substantial monthly fluctuations, some upward trend in core inflation is also discernable in China, other emerging Asian countries, and emerging Europe and Latin America.

A key question for monetary policymakers is whether the recent rise in both headline and core inflation will be one-off in nature, or whether it could feed through to wages, and thereby become more entrenched. Such risks would be greater if excess capacity in the economy is small (since labor markets are then correspondingly tight and putting pressure on profit margins) or if inflationary expectations are rising (making it more likely that higher inflation will be built into future wage awards). Looking at the evidence across the globe, we find the following.

- *Margins of spare capacity are declining, but in most countries are still significant*. Given the robust growth of the global economy—projected to reach 4.9 percent in 2004, almost 1 percentage point above its trend—capacity utilization rates must be on the rise. Even so, spare capacity in most industrial countries, except the United Kingdom, Australia, and Norway, appears significant, with estimated output gaps still sizable. This is particularly so in the euro area, where output gaps of close to 2 percent of GDP are expected to persist over the next several years. In the United States, the output gap is smaller, but not expected to close until 2007. That said, it should be recognized that such estimates are subject to both large margins of error and substantial revisions (one key uncertainty—particularly relevant in the United States—being the pace of labor productivity growth in the future). In emerging market and developing countries, output gaps are even more difficult to measure, but—as discussed in the main text—overheating pressures are becoming a concern in some countries in Asia and in the CIS.
- *Inflationary expectations have risen moderately, but still appear relatively well grounded*. Since December, the consensus forecast for global inflation in 2005 has been revised upward by 0.3 percent to 2.6 percent. The largest upward revisions have been for emerging markets—notably China, Poland, and Brazil (where domestic measures of inflationary expectations have also picked up)—with smaller increases in industrial countries (see the table). Looking over the longer term, professional forecasts—where available—have remained relatively well grounded. Financial market expectations for long-run U.S. inflation—proxied by the spread between the rates of nominal and indexed 10-year treasury bills[4]—rose by 0.25 percent between December and June—with similar increases observed for the United Kingdom, France, and Canada—but have since fallen back, perhaps because the latest monthly statistics implied some abatement of inflation.

Overall, the combination of higher global growth and rising commodity prices will mean that monetary policies will generally need to be tightened somewhat faster than earlier

[2]For most countries, core inflation is defined as the CPI excluding food and energy. For countries where these data are not readily available, another relatively stable price index is used.

[3]Federal Reserve economists estimate that only one-fourth to one-half of the increase in core inflation in 2004 over 2003 reflects higher commodity prices (Federal Reserve Board, 2004).

[4]The spread between nominal and index-linked bonds is only an imperfect measure of inflationary expectations, since it can also increase when investors are more uncertain about their forecasts and willing to pay a premium for a hedge.

Box 1.1 *(concluded)*

Consensus Forecasts: Projected Inflation in 2005[1]
(Percent)

	January	March	August
World	2.3	2.3	2.6
United States	2.1	1.9	2.4
Euro area	1.7	1.6	1.8
Japan	–0.2	–0.2	0.0
China	2.4	2.8	3.2
Brazil	5.4	5.2	6.0
Poland	2.7	2.8	3.2[2]

Source: Consensus Forecasts.
[1]World projection based on 18-country sample, including the euro area.
[2]July.

expected, depending—as discussed in the main text—on the cyclical positions in individual countries and regions. In most cases the risks of a marked pickup in inflation appear moderate, given still-significant margins of excess capacity; well-grounded inflationary expectations; and—outside the most cyclically advanced countries—relatively moderate labor market pressures and rising profit margins. That said, policymakers will need to respond promptly if inflationary pressures intensify or capacity utilization tightens more rapidly than expected, not least since waiting too long to respond to signs of incipient inflation could be costly to reverse, and would lose central banks some of the credibility that took so long to build up in the 1980s and 1990s.

Looking beyond the short term, however, is there a risk that the long-term factors that supported the recent global disinflation could go into reverse? At the present juncture, the fundamental forces underlying disinflation—more effective and independent central banks, and globalization—remain broadly in place. While this appears most likely to continue, as Rogoff (2003) notes, "one must acknowledge that any pronounced or widespread relapses in the relatively favorable backdrop of globalization, deregulation, productivity increase, and relatively benign fiscal policies could begin to roll back the extraordinary achievements of recent years." Two particular concerns—relevant to the current policy challenges discussed in the main text—include the possibility of reversals in globalization through rising terrorist risks or renewed protectionist pressures, and a failure to address medium-term fiscal problems, increasing the incentives to inflate debt away at some time in the future.

Round formally back on track (Box 1.3, pp. 22–23). That said, the agreements provide the minimum necessary in terms of ambition and specificity for continuing the next phase of negotiations—particularly in the key areas of agriculture, industrial products, trade facilitation, and development issues—and much work remains to be done before the December 2005 Ministerial Meeting in Hong Kong SAR.

- *All countries and regions need to play their part in addressing the global imbalances.* The key policy requirements include medium-term fiscal consolidation in the United States to boost savings; structural reforms to boost growth prospects outside the United States; and greater exchange rate flexibility in Asia, consistent with an orderly reduction in current account surpluses. The first two are to varying degrees moving forward, although much remains to be done, but little progress has been made on the third. The continued rapid buildup in reserves in Asia, the dependence of the United States on financial inflows from that region, and the uncertainty about how the situation will be resolved remain important sources of potential instability, and the longer this is expected to persist, the more likely the situation is to be resolved in a disorderly fashion.
- *Poverty reduction must remain at the top of the international agenda.* The recent strength of growth in the regions where poverty is most concentrated—China, India, and sub-Saharan Africa—is welcome; nevertheless, Africa is still likely to fall well short of the Millennium

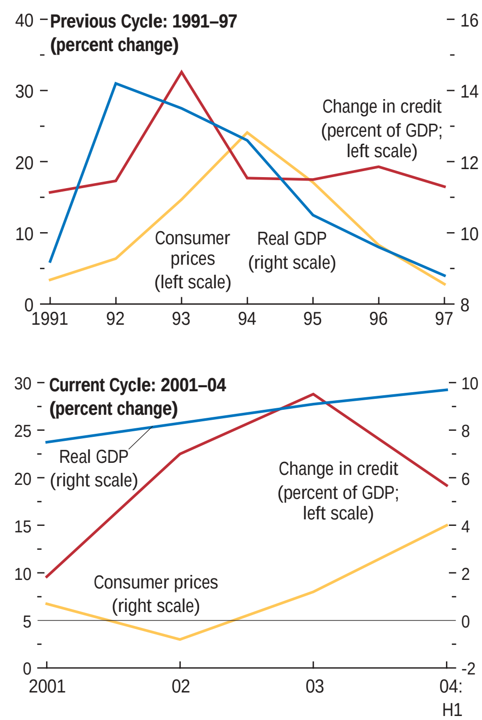
Box 1.2. What Are the Risks of Slower Growth in China?

China's economic growth has been marked by periods of cyclical surges in economic activity and inflation, followed by periods of retrenchment. In the 1980s, two cycles ended with hard landings characterized by sharp slowdowns in growth. These periods were often influenced by political changes and typically began with an early relaxation of monetary and fiscal policies to support state-owned enterprises, leading to a significant increase in inflation. The authorities eventually responded with a heavy reliance on direct controls and other administrative measures. Inflation was quickly brought under control, but growth slowed sharply, and the administrative measures adopted were not based on market criteria, with adverse implications for the efficiency of resource allocation.

This general pattern was repeated during the 1991–97 cycle. By 1992, an easing in monetary and fiscal policies led to an investment boom with real GDP growth exceeding 14 percent and an acceleration in inflation. Early attempts at tightening policies hit state-owned enterprises hard, prompting a relaxation of policies. This easing, and a devaluation of the official exchange rate when it was unified with the swap rate, resulted in inflation rising to a peak of over 24 percent in 1994 (see the figure). The authorities eventually achieved a "soft landing" of the economy, with inflation in single digits by 1996 and only a modest slowdown in growth. Factors contributing to this included structural reforms to increase the market orientation of the economy, a record grain harvest in 1996 that reduced food prices, the buildup of excess capacity that put downward pressure on prices, and a tightening of monetary policy. However, this episode is directly linked to the key current problems in the financial sector as the rapid pace of credit growth in 1992–96 contributed to the weakness of the financial sector today. It is thought that many of the nonperforming loans in the banking system date from this period,

Note: The main author of this box is Thomas Rumbaugh.

China: Another Soft Landing?



Sources: CEIC Data Company Limited; and IMF staff calculations.

reflecting bank funding of state-owned enterprises with little regard for credit risk.

The current cycle (2002–04) bears some of the characteristics of previous overheating cycles, such as high GDP growth, rapid credit growth, and high investment rates (see the figure). Actions to address these pressures were delayed during the Severe Acute Respiratory Syndrome (SARS) outbreak in the second quarter of 2003, but the authorities moved to tighten monetary policies beginning in mid-2003. As a result, credit growth has slowed. However, investment has remained high, and inflation has increased. In current circumstances, a soft landing, which would maintain underlying growth momentum, appears achievable. However, this will require taking into account the lessons

Box 1.2 *(concluded)*

learned from earlier cycles. In addition to the early action to rein in credit and investment growth already initiated by the authorities, these include the consistent implementation of monetary tightening actions to restrain the upswings, contain inflation, and mitigate eventual nonperforming loans problems; introducing greater interest rate liberalization and hard budget constraints for state-owned enterprises to support the effectiveness of monetary policy; and increasing the use of indirect monetary policy instruments rather than administrative measures to improve resource allocation and reduce the severity of the cycles. In the near term, it will be important to avoid the tendency seen in earlier cycles to loosen policies prematurely. Moreover, there is scope for fiscal policy to play a more supportive role by using strong growth in revenue to reduce the overall fiscal deficit.

Given China's rapid integration with the global economy, the prospect of a slowing in growth and imports has raised concerns about the impact this would have on other countries. For example, China's share of global trade (6 percent) has tripled since the early 1990s, revealing much stronger trade linkages and the prospect that changes in China's growth could have significant repercussions. The current World Economic Outlook baseline envisages that China's real growth momentum would slow to about 7½ percent by the end of 2004 and remain at that level in 2005. Import growth would also slow from 40 percent in 2003 to a projected 30 percent in 2004 and 24 percent in 2005. Despite the slowdown in Chinese import growth, the growth of global imports is projected to remain strong, given the generally positive prospects in industrial countries and other emerging markets.

But what if there is a sharper slowdown in China? Simulations were conducted to assess the impact on other countries in the region (relative to the World Economic Outlook baseline) of an additional one-time 10-percentage-point decline in the growth of China's imports for domestic use arising from a further slowdown in domestic investment (i.e., the export processing trade was assumed not to be affected).[1] Such a decline would roughly correspond to a 7 percent decline in China's overall imports and is estimated to be consistent with an initial drop of 5½ percentage points in real investment growth. This would correspond to an initial drop of 2½ percentage points in GDP and eventually a 4 percentage point decline if multiplier effects are taken into account, assuming no offsetting policy adjustments.

The impact on the rest of Asia, after allowing for multiplier effects, is estimated to be a 0.4 percentage point drop in GDP growth. The impact varies considerably across the economies of the region, with declines in growth rates ranging from near zero to as high as 0.6 percentage point, depending on the importance of China as an export destination. Asian newly industrialized economies are most affected, with their GDP growth slowing by 0.6 percentage point (see the table). These estimates are subject to a number of caveats: (1) offsetting policy adjustments by affected economies are not considered; (2) the secondary impact of slower growth in each economy on the other economies in the region also is not taken into account; and (3) import and export prices are assumed to remain unchanged, thus excluding possible terms of trade effects.

The IMF's new Global Economy Model (GEM) provides additional insights regarding the impact on the rest of the world within a general equilibrium framework. While the GEM model does not yet allow for the more detailed investigations into the different impacts within Asia excluding Japan, a four-region model was developed consisting of the United States, Japan, Asia excluding Japan, and the rest of the world. The model was used to simulate the

[1]The estimates derived are based on a framework that captures the main trade flows within Asia. Because economic relationships in the framework are assumed to be linear, the results can be adjusted for impacts of different magnitude. The estimated impacts derived from this exercise are expressed relative to the World Economic Outlook baseline forecasts.

Estimated Impact of a 10-Percentage-Point Decline in China's Nonprocessing Import Growth

	Real GDP Growth (percentage points reduction)	Current Account Balance (reduction in billions of US$)
Asia excluding China	–0.4	–6.5
Japan	–0.5	–3.5
Asian newly industrialized economies	–0.6	–2.0
Other Asia	–0.3	–0.7
ASEAN-4	–0.3	–0.5

Source: IMF staff calculations.

impact of a slowdown in China of the same order of magnitude as in the above experiment. Results suggest that such a slowdown could reduce world GDP growth by about ⅓ of a percentage point (at world market prices). In line with the above results, Japan would be affected more than the other areas, because of its stronger trade linkages with China, while the United States and the rest of the world would only be marginally affected. However, the effects on Japan would be more muted relative to the partial equilibrium analysis because of offsetting real exchange-rate changes. It is also important to note that China has played an important role in the increase in global commodity prices over the past two years, and a slowing in China's growth could help reverse some of these increases. The effect could be particularly strong for nonfuel commodities, of which China is a large importer. This would produce positive terms of trade effects for many consuming countries, but raises the prospect of some adverse effects for commodity producers.[2]

While both the partial and general equilibrium results show a significant impact for several Asian economies, such a shock would still be manageable given the fairly robust outlook for Asia and the global economy. Despite China's increasingly important role in the region, other Asian economies are still largely dependent on the U.S. and EU markets for their exports, and the share of the region's exports to China is still only about 15 percent (*including* exports for processing). As a result, a substantial drop in the growth of exports to China would still leave countries in the region with relatively robust export growth rates provided that growth momentum in industrial markets is sustained.

[2]See Appendix 1.1 for a discussion of the effects of commodity prices on economic activity in both producer and consumer countries.

Development Goal target.[7] With macroeconomic stability generally achieved, the key challenge—as recognized in the New Partnership for Africa's Development—is to strengthen institutions and governance. The global community, in turn, needs to support strengthened reform efforts with substantially increased and better coordinated financial and technical assistance and, perhaps even more important, by eliminating barriers to exports, particularly of agricultural goods.

Against this background, a central question now is whether countries will take full advantage of the recovery to address these medium-term problems. To date, progress is at best mixed, and in some countries signs of reform fatigue have already emerged. There is a clear need for politicians—in industrial and developing countries alike—to be more forthright about the costs of doing too little. At the same time, politicians are often responding to genuine popular fears, given that the benefits of reform are usually

[7]See the September 2004 *Global Monitoring Report*.

Box 1.3. Is the Doha Round Back on Track?

On July 31, the General Council of the World Trade Organization (WTO) reached consensus on a set of framework agreements for pursuing negotiations under the Doha Round of multilateral trade talks—thus finishing the task left undone when discussions collapsed during the September 2003 WTO Ministerial Meeting in Cancún, Mexico. The framework agreements lay out the modalities for how trade liberalization is to occur, leaving the details of how much and how fast for later discussion. The decision to adopt the package of agreements puts the Round "back on track" in that formal negotiations can resume on the specific commitments that would lead to a successful conclusion. As noted by WTO Director-General Supachai Panitchpakdi, the July package is "a minor victory for multilateralism"—recognizing that negotiators still face a long and difficult road ahead.

Some significant compromises were made on the original Doha Development Agenda to facilitate agreement before the end-July deadline. A number of thorny issues, for example, were either dropped from the agenda or folded into a larger framework. The WTO General Council also agreed to postpone the original January 2005 target for completing the Round to a yet-unspecified date, at least until the sixth WTO Ministerial Meeting to be held in Hong Kong SAR in December 2005. The result is a "slimmer" formal agenda, with a longer and more realistic timeline for completion. Key points of the July package include the following.

- The agreement on agriculture calls for the elimination of export subsidies, the reduction of trade-distorting domestic support by 20 percent in the first year, and substantial tariff reductions. Developing countries will continue to benefit from special and differential treatment, including the possibility of maintaining state trading monopolies.
- The sectoral initiative on cotton advanced by several African countries during the Cancún Ministerial will be handled within the agriculture framework, rather than as a stand-alone issue. A committee will be established to address the trade-related aspects affecting cotton. The WTO Director-General is also to work with international organizations, including the Bretton Woods institutions, on the economic development of countries where cotton is an important export.
- The agreement is less ambitious and specific on industrial products (non–agricultural market access—NAMA), as members could not bridge all their differences. The text is largely identical to the last version produced in Cancún and is viewed as little more than a platform for discussion rather than an agreed framework.
- The agreement launches negotiations on trade facilitation, the least controversial of the so-called Singapore issues, which were supported by the European Union, Japan, and others. The remaining three Singapore issues (investment, competition, and transparency in government procurement) have been removed from the formal agenda.
- The agreement recommits members to fulfilling the development dimension of the Doha Round through enhanced market access, a balanced approach to trade rules, and well-targeted technical assistance and capacity-building programs. The WTO General Council reiterated the Doha Declaration's call for the provisions for special and differential treatment in all WTO agreements to be made more precise, effective and operational, with clear recommendations for a decision no later than July 2005.

The July package of agreements opens the way for more detailed negotiations to start in September, but it is generally expected that a cooling-off period in the negotiations will last until after the forthcoming U.S. presidential elections and the installation of the new European Commission. It is hoped that significant progress can be made before the December 2005 WTO Ministerial Meeting in Hong Kong SAR. Another key deadline, how-

Note: The main authors of this box are Todd Schneider and Jean-Pierre Chauffour.

ever, is June 2007, when legislation granting trade promotion authority (also known as "fast-track") to the U.S. president expires. Trade promotion authority enables the administration to submit trade agreements to the U.S. Congress for a yes/no vote, without amendment.

Filling out the framework agreements for agriculture, industrial products, trade facilitation, and special and differential treatment with detailed commitments—the nuts and bolts of how far and how fast to eliminate subsidies, reduce tariffs, and allow other forms of market access—is expected to be difficult. Further, some of the agreements are less developed than others. Discussions on NAMA have thus far fallen in the shadow of the discussions on agriculture. Limited progress has been made in other key areas, such as services, where only a small number of countries have tabled offers. It thus remains to be seen whether the July package represents a solid platform for negotiation or a hastily concluded set of agreements that may reveal significant fault lines in the coming months.

longer-term, there are substantial and unpredictable effects on income distribution within and across generations, and also concern that the fruits of reform will not be spread widely. Moreover, with limited political capital, simultaneous structural reform and fiscal consolidation—as are required now—are particularly difficult, even in a recovery.

How can progress be accelerated? While there is probably no single or simple answer to this question, greater efforts to build national consensus are clearly required, with—for example—reductions in barriers to competition accompanied by measures to equip people to compete by improving education, health care, access to finance, and safety nets. Policymakers should also take advantage of trade-offs. For example, a temporary deterioration in fiscal positions could be an acceptable price to pay to facilitate structural reform (especially when, as with pension and health reform, this improves medium-term fiscal sustainability). However, international leadership and cooperation could also play a supporting role, particularly since the global implications of every aspect of the current reform agenda are significant. For example, strong reform efforts by a small group of large countries could increase pressures on others to adjust, and multilateral trade liberalization could also play a central role. Looking further into the future, one key issue will be how best to strengthen the international economic infrastructure in the face of the coming demographic transition; as discussed in Chapter III, greater mobility of goods, capital, and labor will all have important roles to play. The benefits of multilateral cooperation in trade are already evident, and will need to continue. To supplement this, greater multilateral cooperation on capital and labor mobility may also be required.

United States and Canada: How Long Will the U.S. Soft Patch Persist?

In the United States, the economic expansion remained generally strong early this year, but hit a soft patch in the second quarter, with real GDP growth slowing to 2¾ percent from an above-potential 4½ percent in the first quarter. Personal consumption growth fell back markedly, apparently reflecting a combination of higher oil prices, weaker-than-expected employment growth, and a sharp fall in spending on durable goods, due in part to temporarily lower incentives for purchases of motor vehicles. Net exports made a large negative contribution to growth, mainly the result of a sharp increase in imports, and the current account deficit widened to 5¾ percent of GDP. By contrast, business fixed investment accelerated, underpinned by the continued healthy growth of profits and temporary accelerated depreciation allowances.

Economic slack remained, with manufacturing capacity utilization below its long-term average and the unemployment rate higher than most estimates of the natural rate, reflecting continued rapid labor productivity growth. The rise in core CPI inflation from 1.1 percent in December to 1.7 percent in August was due in part to increases in the prices of crude and intermediate materials, reflecting the strength of the global expansion, and the elimination of one-off factors that lowered inflation in 2003.

Looking forward, output growth is projected to pick up in the second half of 2004, supported by continuing strength in profits and household labor income, as well as the restoration of incentives for automobile purchases, and stay above potential through 2005–06, though growth this year and next has been revised down since the April 2004 *World Economic Outlook*. Slowdowns in household demand—responding to higher energy prices, the waning effects of mortgage refinancing and tax cuts, and a gradual rebound in the saving rate—and government spending, as the fiscal position improves, are balanced by continued strength in business fixed investment, reflecting firms' healthy balance sheets and strong profitability, and a modest improvement in external demand, as trade volumes respond to the depreciation of the dollar since 2002. The current account deficit is projected to narrow to 5 percent of GDP in 2005 but—assuming no further real depreciation of the U.S. dollar and a moderate fiscal consolidation (Table 1.4)—is expected to remain above 4 percent of GDP through the rest of the decade.

Given the recent rise in oil prices and declines in some forward-looking indicators, downside risks and uncertainties have increased in recent months. On the positive side, business confidence and indicators of investment spending remain healthy, and labor productivity, which has consistently exceeded expectations, could continue to grow faster than projected. The annual growth rate of output an hour in the nonfarm business sector increased to about 2½ percent in the late 1990s, reflecting capital deepening, gains in total factor productivity in the information technology sector, and—more recently—an acceleration in total factor productivity in industries using information technology. During 2001–03, labor productivity growth increased further to about 3¾ percent, reflecting in part the typical rise during the early phase of economic recovery. The baseline forecast treats the recent acceleration conservatively, assuming that labor productivity growth will slow over the medium term to slightly below the average in the late 1990s, but still well above the average for 1975–95. Faster growth would boost domestic incomes, ease policy challenges by moderating pressures on prices and raising government revenues, and encourage capital inflows needed to fund the current account deficit.

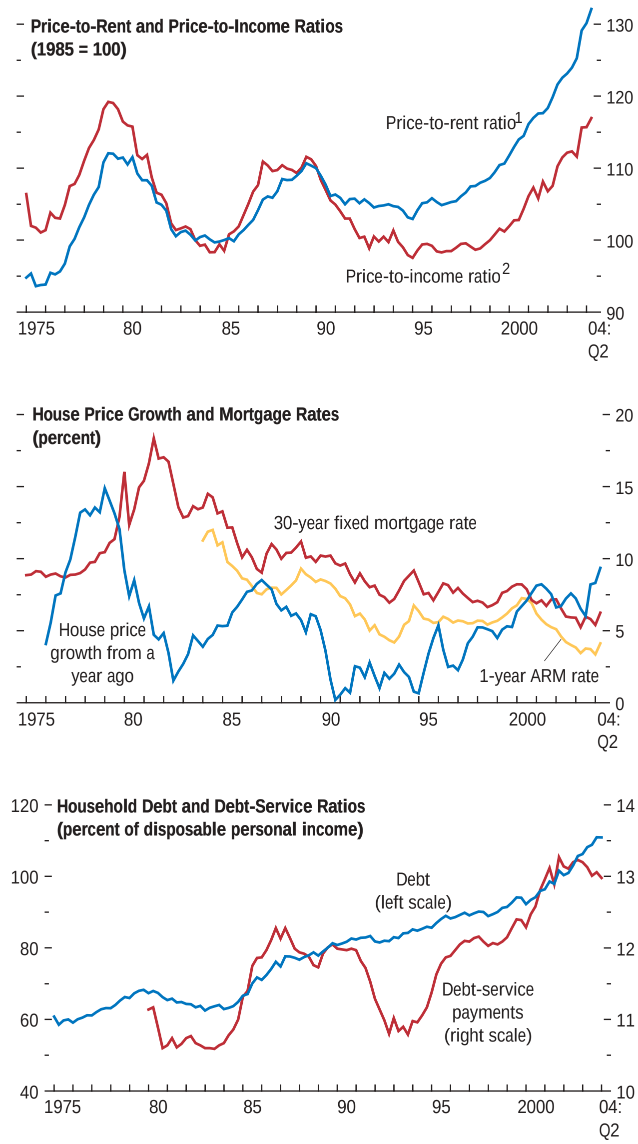
On the downside, however, there is increasing concern that the soft patch in consumption—the reasons for which are not fully understood—could persist for longer than assumed in the IMF staff's baseline projection. While most forward-looking indicators signal continued expansion, weaker labor market conditions and higher oil prices will reduce consumption growth (and to a lesser extent investment growth) in the third quarter and beyond. More generally, risks to household spending include the possibility of an increase in the household saving ratio (which recent revisions to the national accounts suggest is lower than originally thought) or a moderation of house price appreciation. Both the ratio of house prices to disposable income per worker and the ratio of house prices to rent (equivalent to a price-earnings ratio for housing) have risen rapidly (Figure 1.10), though—as discussed in Chapter II—the unexplained portion of the increase in house prices is smaller than in some other countries. Unusually, the pace of house price appreciation in recent years (about 7–8 percent) has been greater than fixed mortgage rates (about 5–6 percent), raising the possibility that some housing purchases may have been motivated in part by the expectation of capital gains. Assuming house prices rise less rapidly as interest rates increase, this will weaken the support for household spending from capital gains on housing, though this effect may take some time to materialize, given the usual transmission lags. The adverse impact on household spending could be exacerbated by the high levels of household debt and debt service as shares of disposable income, though much of this debt is at fixed interest rates.

Given impending demographic pressures and the need to establish a sustainable fiscal position, fiscal policy should aim to bring the federal government budget back to balance, excluding Social Security, by the end of the decade. This is also important for the orderly resolution of global current account imbalances. Although the pace of deficit reduction targeted for FY2005 and FY2006 in the budget is appropriate, the size of the fiscal imbalance suggests that the better-than-projected outcome for FY2004 (as revenues have exceeded projections) should be used to strengthen the targeted outcomes in the coming two years. Beyond that, the fiscal objective that has been set for the medium term—of halving the budget deficit over five years—does not appear sufficiently ambitious. In addition, the government's revenue projections are predicated on a significant increase in the number of tax filers falling under the Alternative Minimum Tax, which will likely trigger legislative action at potentially significant fiscal cost. Finally, the government's targets depend largely on expenditure restraint, which by FY2009 would take nondefense discretionary spending as a share of GDP to its lowest level since the early 1960s. In light of the magnitude of the required fiscal adjustment, tax revenues may also need to rise. To avoid unwinding the supply-side benefits of recent cuts in marginal tax rates, consideration could be given to broadening the tax base, for example by cutting tax exemptions, and introducing a national indirect tax. Early steps to reform Social Security and, more important, Medicare are essential to ensure their long-term sustainability.

The challenge for monetary policy is to return interest rates to neutral, in the face of uncertainties about the inflationary effects of oil prices and moderating growth. Starting early this year, the Federal Reserve prepared financial markets for

Figure 1.10. United States: House Prices

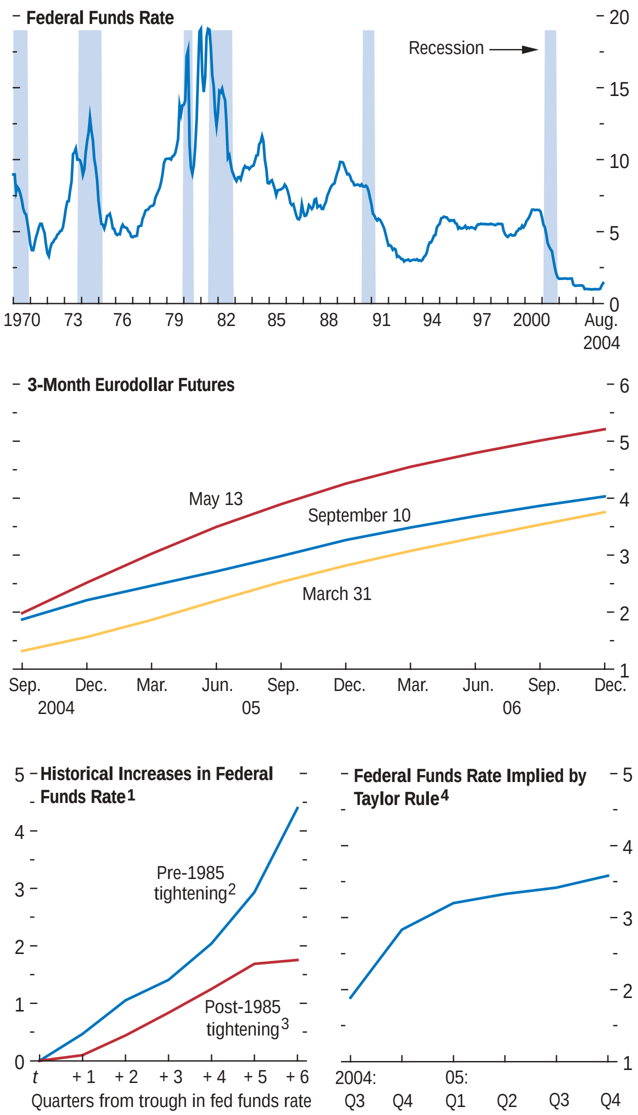
The ratio of house prices to rent and the ratio of house prices to disposable income per worker have both increased sharply. House prices have risen more rapidly since late 2000 than the cost of mortgage finance. Household debt and debt service relative to disposable income have surged to record levels.



Sources: Office of Federal Housing Enterprise Oversight (OFHEO); Global Insight; and IMF staff calculations.
[1]OFHEO house price index divided by CPI rent of primary residence.
[2]OFHEO house price index divided by disposable personal income per worker.

Figure 1.11. United States: Interest Rates
(Percent)

The Federal Reserve raised interest rates in June from their 40-year low. Financial markets are anticipating a steady rise in interest rates over the coming year at a pace broadly in line with the average post-1985 tightening, though somewhat slower than that implied by a Taylor rule estimated over the past 20 years.



Sources: Haver Analytics; Bloomberg Financial, LP; and IMF staff estimates.
[1]For turning point methodology, see Chapter III of the April 2002 *World Economic Outlook*.
[2]Average increases in 1972–74, 1977–81, and 1983–84.
[3]Average increases in 1986–89, 1993–95, and 1999–2000.
[4]Estimated over 1982–2003. See Rabanal (2004).

the gradual withdrawal of monetary stimulus and—since late June—has raised the key federal funds rate by ¾ percentage point (Figure 1.11). As of early September, financial markets were expecting a steady rise in interest rates over the coming year at a pace broadly in line with the average post-1985 tightening, though somewhat slower than that implied by a Taylor rule estimated over the past 20 years. While the spread between nominal and inflation-indexed bonds rose sharply through May, it has subsequently fallen, and surveys indicate that inflationary expectations remain well anchored. Looking forward, the Federal Reserve's approach of "measured tightening" appears generally appropriate, but, with considerable uncertainties about both the short-term strength of the expansion and the extent of underlying inflationary pressures, much will depend on the nature of the incoming data.

Strong fundamentals have left the financial system well prepared for the expected rise in interest rates, and ongoing reforms of corporate governance have helped increase investor confidence in market integrity. However, the large and increasing share of mortgage-backed securities held by Fannie Mae and Freddie Mac (the government-sponsored housing enterprises) has concentrated interest rate risk, the hedging of which could amplify interest rate movements, underlining the importance of improving supervisory oversight and establishing an independent regulator.

In Canada, the economic expansion has gained momentum, reflecting both the global expansion and low domestic interest rates, and the forecast for growth in 2004 has been revised up. Real GDP growth accelerated from 3 percent in the first quarter to 4¼ percent in the second quarter. Personal consumption is being driven by surging employment, rising disposable income, and a buoyant housing market; business investment, by robust profitability; and exports, by global demand, especially from the United States, despite the appreciation of the Canadian dollar. Strong export volumes and higher world commodity prices are projected to boost the current account surplus to about 3 percent of GDP this year. With the acceleration in growth helping to close the output gap and gradually push core inflation nearer to the midpoint of the Bank of Canada's 1–3 percent target range, the increase in interest rates in September was appropriate. Given the generally robust economic outlook, monetary policy will likely need to continue removing stimulus gradually over the coming months. While Canada's fiscal position is the most favorable among G-7 countries, the government's efforts to sustain surpluses and maintain the federal debt to GDP ratio on a downward track remain appropriate, given impending fiscal pressures from population aging.

Western Europe: A Solidifying, but Uneven, Recovery

The recovery in the euro area has finally gained some momentum, with GDP growth projected to rise to 2.2 percent in 2004, 0.4 percentage point higher than expected in April. However, the upturn remains moderate and has so far been heavily dependent on external demand; and while industrial production and business confidence are gradually improving, consumer confidence and retail sales continue to lag. That said, aggregate figures disguise substantial differences within the region. In particular, the composition of growth varies markedly, with final domestic demand growing strongly in France and Spain, but weaker in Italy and dormant in Germany. Developments in Germany partly reflect slow household income growth in the context of ongoing labor market adjustments, and some increased savings by households in response to cuts in future benefits under recent pension reforms (see Chapter III).

Looking forward, the recovery is projected to be increasingly supported by domestic demand, as private consumption is boosted by rising disposable incomes, and investment picks up as corporate balance sheet restructuring—which has proceeded relatively more slowly than elsewhere—continues. Nonetheless, with GDP growth in the remainder of 2004 and 2005 expected to exceed potential only modestly, the output gap will remain substantial, and area-wide unemployment will decline only marginally. Overall, the risks appear tilted to the downside, and include a further rise in oil prices, especially in those countries where domestic demand is still weak; a slower-than-anticipated pickup in employment—which was unusually resilient during the recession; and a renewed appreciation of the euro. Elevated housing prices in some countries, notably Ireland and Spain (see the second essay in Chapter II), are also a concern.

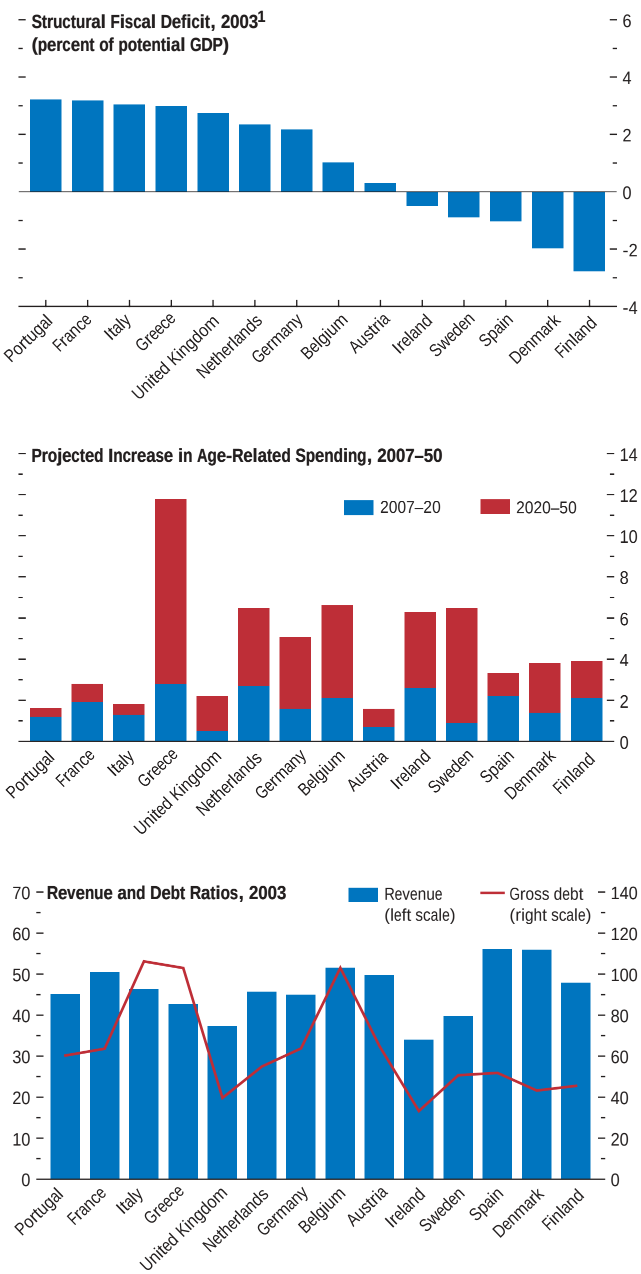
After slowing in early 2004, headline inflation has again risen above 2 percent, driven by higher energy prices and hikes in indirect taxes and administrative prices; core inflation[8] has remained stable at 1¾ percent. Given substantial excess capacity, the lagged effect of the past appreciation of the euro, and continued wage moderation, inflation is projected to fall back below 2 percent in 2005. While the ECB will need to watch carefully for second-round effects from recent shocks, short- and long-term inflationary expectations still appear well-grounded and monetary policy should therefore remain accommodative until a self-sustaining upturn in domestic demand is in place.

Since 2000, fiscal policies for the euro area as a whole have been broadly neutral, with automatic stabilizers allowed to operate fully (Table 1.4). This has clearly been appropriate in the cyclical circumstances, despite the resulting serial breaches of the Stability and Growth Pact (SGP) deficit limit in some countries; however, the longer-term fiscal situation in many countries remains difficult (Figure 1.12) and the onset of population aging is now only 5 to 10 years away. While fiscal positions and risks vary widely, those countries with the weakest underlying positions should seek to reduce underlying deficits by at least ½ percent a year (more if the upswing were to prove more rapid than

[8]Defined to exclude energy, food, alcohol, and tobacco.

Figure 1.12. European Union: Fiscal Challenges
(Percent of GDP unless otherwise noted)

Fiscal positions vary widely across the European Union, with the four largest countries, Portugal, Greece, and the Netherlands having the largest deficits, but France, Italy, and the United Kingdom face more moderate pressure from aging. Tax rates outside Ireland, Spain, and the United Kingdom are high, and public debt is a serious problem in Belgium, Greece, and Italy.



Sources: European Commission; and IMF staff calculations.
[1]For Italy, excluding 1.7 percent of GDP of one-off measures. For Portugal, excluding 2.5 percent of GDP of one-off measures.

expected) while allowing the automatic stabilizers to operate. Reductions in tax burdens in many countries are also highly desirable, but—unless financed through offsetting measures—are a lower priority until a significant downpayment on fiscal adjustment is in place.

While most countries have broadly committed to adjustment along these lines in their Stability Programs, in a number of countries the underlying adjustment required is substantial, and the measures to achieve it have not yet been identified. Among the three largest countries, the near-term budgetary objectives are most likely to be achieved in France, aided by higher-than-expected growth; given the relatively strong expansion, the targets for 2005 and beyond should be made more ambitious. In Germany, little progress is expected in 2004, and further measures will be required to achieve the targeted reduction in 2005. In Italy, significant one-off measures have been required to keep the deficit within the 3 percent of GDP limit in 2004; the government's recent annual update of its medium-term economic plan targets a small decline in the deficit in 2005, followed by a steady ½ percent annual deficit reduction thereafter. Substantial measures will be required to achieve the 2005 target, especially given the intention to implement tax cuts. On the positive side, the recent further pension reform will moderate spending trends over the medium term. Overall, as emphasized in the third essay of Chapter II, a repeat of the experience of 1999–2000—when many euro area countries failed to take advantage of strong growth to accelerate fiscal consolidation—remains a serious danger.

While the recent judgment by the European Court of Justice has clarified a number of issues relating to the implementation of the SGP, there is a growing consensus on the need for reform. A strong fiscal framework remains an essential element of the monetary union, especially given Europe's history of procyclical fiscal policies, the accession of new members with significant deficits, and the likelihood that market discipline would be too little, too late. In many respects, current problems can be traced to the failure to adjust in 1999–2000, and much of the basic design of the SGP remains appropriate. However, recent experience and the reform proposals put forward by the European Commission underscore the desirability of strengthening the incentives for adjustment in good times; of greater focus on medium-term sustainability issues; and for SGP procedures—including the pace and timing of required adjustments—to be conditioned more closely on the proximate reasons for any breach. Greater flexibility should be accompanied by efforts to improve political incentives to comply with the Pact. In this connection, published assessments of fiscal sustainability by independent national institutions could be helpful, including through stimulating public discussion and awareness.

The widespread endorsement of the Lisbon reform agenda has not been matched by equally widespread implementation, and the goal of transforming the European Union into the world's most dynamic and competitive economy remains far off. Progress has been greatest in centrally led reform, notably the Financial Services Action Plan and the Single Market; nationally sponsored reforms have lagged, particularly in labor markets (although recent developments in Germany are encouraging), but also in product markets, where some countries' new focus on creating "national champions" is a retrograde step. The recovery provides a renewed opportunity for progress, but increasing signs of reform fatigue and the political economy difficulties of simultaneously undertaking structural reform and fiscal consolidation[9] are complicating factors. While political leadership—especially in major countries—remains key, greater prioritization of the Lisbon Agenda, focused on the key issue of raising labor utilization, could be helpful. Renewed central initiatives for product market deregulation—by putting competitive pressure on profit margins—might also add to incentives for national labor market reforms.

In the United Kingdom, activity remains robust. Despite higher oil prices, private consumption remains strong, underpinned by sustained income growth and rising housing wealth; private investment has turned up; and government expenditures have continued to support domestic demand. The central risk remains an abrupt adjustment in the housing market, where—despite signs of cooling in recent months—prices still appear higher than can be explained by developments in fundamentals (see the first essay of Chapter II). With interest rates on a rising trend, and most house purchases financed with adjustable rate mortgages, house buyers should exercise particular caution at the present juncture.[10] While inflation remains low, the economy is now running at close to capacity and cost pressures are increasing; the Bank of England has appropriately raised interest rates five times since November 2003, and a continued "early but gradual" approach appears desirable. Following the large increase in the fiscal deficit in recent years, some consolidation is expected in 2004, mainly reflecting higher revenues. In 2005 and beyond, stronger fiscal consolidation than presently seems in prospect would be desirable, both from a cyclical perspective and to reduce the risk of a breach in the golden rule in the future.

Elsewhere in Europe, GDP growth in the Nordic countries is also accelerating, aided by the global recovery and generally accommodative fiscal and monetary policies. Despite higher oil prices, inflation is still moderate, owing to continued excess capacity and past currency appreciation. As the recovery proceeds, monetary policies will need to tighten (in Denmark, with the krone linked to the euro, in line with the ECB); in Norway and to a lesser extent Sweden, the impact of higher interest rates on highly indebted households will need to be carefully

[9]See "Fostering Structural Reforms in Industrial Countries," *World Economic Outlook*, April 2004.

[10]See Bank of England Governor King's speech to the CBI Scotland Dinner, Glasgow, June 14, 2004 (http://www.bankofengland.co.uk/speeches/speech221.pdf).

monitored. Fiscal positions are generally solid, although in Sweden and Norway tight expenditure control will be needed in coming years to ensure that medium-term fiscal targets are met; pension reform (Norway) and further structural measures to boost labor supply (Sweden and Denmark) are also priorities. In Switzerland, which was particularly hard hit by the global slowdown, activity is also starting to pick up and deflationary risks have eased, prompting an increase in benchmark interest rates to ½ percent in mid-June. Fiscal balance will need to be restored gradually, in line with the authorities' medium-term fiscal framework, accompanied by reform of sheltered domestic markets, notably agriculture and network industries, which continue to weigh on productivity growth.

Japan: Is Deflation Finally Coming to an End?

In Japan, real GDP grew very strongly in the first quarter of 2004, with exports, especially to Asia, and business fixed investment remaining key driving forces, although a pickup in private consumption growth also contributed, as consumer confidence improved with the increasingly sustained recovery and firming labor market conditions. In contrast, second-quarter growth turned out to be weaker than expected, primarily on account of a sharp drop in inventory accumulation and a larger-than-expected decline in public investment. The expansion in private fixed investment was also more tepid than expected on the basis of other indicators and private consumption growth moderated by more than was anticipated after the spurt during the previous two quarters. That said, recent forward-looking indicators generally suggest that underlying private domestic demand and external demand remain robust, with profits continuing to grow strongly and household surveys indicating steady consumer demand growth. Against this background, the outlook remains for a sustained, broad-based expansion, and GDP growth is now projected to accelerate to 4.4 percent in 2004, more than 1 percentage point higher than projected in the April 2004 *World Economic Outlook*, and to fall back to 2.3 percent—still higher than potential—during 2005. Nevertheless, the slowdown has highlighted short-term downside risks—notably those arising from higher oil prices, a slowdown in export growth due, for example, to a hard landing in China, higher long-term U.S. rates, or a renewed yen appreciation.

Looking beyond 2005, prospects are underpinned by continued progress in reducing financial vulnerabilities in the corporate and banking sectors (Figure 1.13). Specifically, improved profitability—due to rising sales proceeds, cost restructuring, including by reducing employment costs, and low interest rates—has allowed corporations to increase capital spending and at the same time reduce their balance sheet leverage—the average debt-equity ratio of nonfinancial corporations (measured at book value) has reached levels last observed in the early 1960s—and income gearing (debt service as percent of profits and depreciation). Moreover, as reflected in improved ratings for some banks, banking sector health has improved in this recovery—new loan-loss provisions have been reduced and the share of nonperforming loans has declined further. Nevertheless, the adjustment process still has some way to go, and vulnerabilities remain.

- Corporate debt levels in terms of sales remain high and overall return-on-assets is still low by historical standards. Manufacturing firms have reduced their debt-to-sales ratios close to the levels that prevailed in the first half of the 1980s, but nonmanufacturing firms' debt ratios remain higher. The return-on-assets ratio has recovered slowly in part because of unproductive assets that do not generate sales and thus profits. Corporate restructuring, including closures of firms with little prospect for return to profitability, would be facilitated by a strengthened banking system, by allowing banks to more easily shoulder the losses involved in dealing with weak borrowers.
- Progress in restoring the financial soundness of the banking system has been uneven—with larger banks having progressed faster than

regional banks, which still grapple with substantial nonperforming loans. Bank profitability is still generally low and the quality of bank capital needs to be improved, which could restrain a turnaround in bank lending at precisely the time that the external funding needs of nonfinancial corporations are increasing because of the sustained expansion.

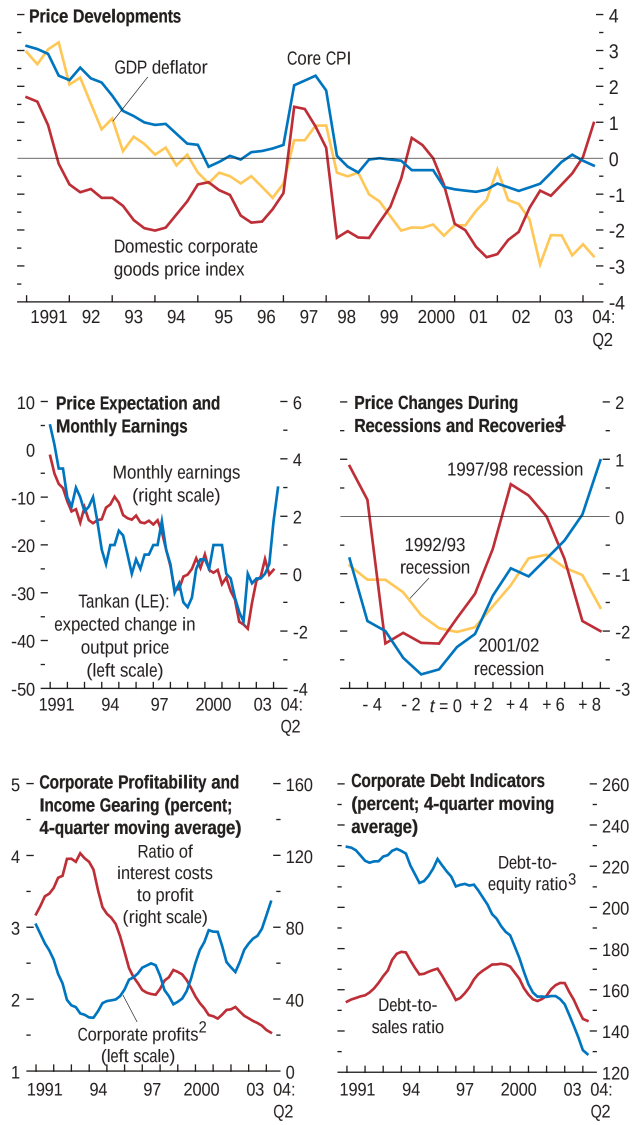
With the gradual reduction in economic slack over the past year, deflationary pressures have eased. The 12-month fall in the core CPI (which excludes fresh food) narrowed to 0.2 percent in July, reflecting the declining output gap and temporary influences such as oil prices; net of transitory factors, the core CPI is falling by about 0.3 percent. The GDP deflator has continued to fall more rapidly than the CPI, reflecting the interaction between differences in the composition of the two indices (with the GDP deflator putting higher weight on electrical goods, the prices of which have generally been falling faster than for other categories while their share in real demand has increased) and in the methodology (with the changes in the CPI—a Laspeyres index—biased upward and in the GDP deflator—a Paasche index—biased downward in this particular constellation of price and demand behavior). Looking forward, deflationary pressures are likely to ease further as economic slack diminishes, and 12-month CPI deflation is projected to ebb to about zero during 2005.

As the prospects for an end to deflation have improved significantly but such an outcome is far from guaranteed, the current monetary stance is appropriate and should be maintained until inflation is firmly positive. If financial markets became concerned that the policy of quantitative easing might end too early, the Bank of Japan could increase the current account target to signal its resolve to maintain the framework until deflation is decisively subdued. Looking forward, as the onset of inflation draws nearer, enhancements to the Bank of Japan's communication strategy could help to focus inflation expectations, including by setting a suitably positive medium-term inflation objective and by pub-

Figure 1.13. Japan: The End of Deflation?

(Percent change from a year ago)

Deflationary pressures have eased, partly reflecting the reduction in economic slack. With a sustained expansion increasingly likely, underpinned by continued progress in reducing financial vulnerabilities, prospects for ebbing deflationary expectations appear better than during other recent post-bubble recoveries.



Sources: Haver Analytics; Bank of Japan; and Ministry of Finance.

[1]Based on domestic corporate goods price index. Quarters before and after output trough.

[2]Corporate profit to sales ratio.

[3]Equity valued at book value.

lishing more of the Bank's views on monetary policy and the inflation outlook.

With improved economic prospects, policymakers now face the daunting task of addressing Japan's difficult fiscal position. Gross public debt stood at 166 percent of GDP at end-2003—the highest among advanced economies by a substantial margin, although net debt, while rising, is considerably lower at 80 percent of GDP at end-2003—and the structural deficit (including social security but excluding bank support) was 6½ percent of GDP in FY2003. Against that background, the government aims for a primary surplus (excluding social security) by the early 2010s, which is in part to be achieved through expenditure restraint in FY2004 and FY2005, but further measures to achieve this target are yet to be defined. In light of the favorable economic environment, achieving savings in FY2004 relative to the budget would be desirable. Looking ahead, options for consolidation include further cuts in capital spending, broadening the personal income tax base, and—in the medium term—raising the consumption tax.

With population aging posing further challenges in the medium term, as discussed in Chapter III, the recent reform of the public pension system was a step in the right direction. However, the reform relies heavily on increases in contribution rates, which are likely to hurt economic growth, and it deepens intergenerational inequality as the younger generations will bear most of the burden of the reform. Looking ahead, a further increase in the retirement age is likely to be needed for financial viability of the public pension system—which would most likely increase growth—as are reforms of the medical and long-term care systems to contain rapidly growing costs. Besides fiscal adjustment, stepped-up structural reforms could also improve Japan's fiscal position by increasing potential output growth. The priorities are public enterprise reforms, strengthened competition policy, and enhanced labor market flexibility, including an increase in pension portability.

Emerging Asia: Prospects Are Bright but Can Macroeconomic Policies Rise to the Challenges?

Growth in emerging Asia has continued to exceed expectations, despite the adverse impact of higher oil prices on many countries, underpinned by the global recovery; very strong growth in China; the recovery in the global information technology sector; generally supportive macroeconomic policies, including highly competitive exchange rates; and, increasingly, solid domestic demand growth, including in fixed investment. From mid-2003 to the first quarter in 2004, the regional growth rate averaged over 10 percent, with particularly rapid growth in China and the Asian newly industrialized economies. This has raised fears that China, despite some slowing in the second quarter, is at risk of overheating; some other economies, including Singapore, also appear to be increasingly close to capacity.

Looking forward, on the assumption of a soft landing in China, the regional outlook is for continued solid but slowing growth. Given the strong first half, regional GDP growth is projected to average 7.3 percent in 2004, 0.1 percentage point higher than expected in April, moderating to 6.5 percent in 2005, 0.3 percentage point lower than projected earlier—with the revisions largely reflecting a more delayed slowdown in China and a growth surge in most newly industrialized economies in early 2004 compared with the last *World Economic Outlook* (Table 1.6). The outlook for China plays a particularly important role in the risks to the regional outlook. If China's growth were to slow less than expected, both external and domestic demand—particularly in the newly industrialized economies and the ASEAN-4—would be stronger, although this would clearly come at the risk of a harder landing later on, with significant but manageable regional repercussions (Box 1.2). The region is also relatively more vulnerable to higher oil prices—with the impact on growth and inflation being greater than elsewhere (see Appendix 1.1)—and to the outlook for the information technology sector, where there is some concern

Table 1.6. 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 Asia[3]	**6.4**	**7.2**	**7.3**	**6.5**	**1.9**	**2.5**	**4.3**	**3.9**	**3.8**	**4.4**	**3.6**	**3.3**
China	8.3	9.1	9.0	7.5	–0.8	1.2	4.0	3.0	2.8	3.2	2.4	2.8
South Asia[4]	**4.9**	**6.9**	**6.2**	**6.5**	**4.2**	**3.9**	**4.9**	**5.1**	**1.3**	**1.3**	**0.3**	**–0.2**
India	5.0	7.2	6.4	6.7	4.3	3.8	4.7	5.0	1.0	1.1	0.5	—
Pakistan	4.4	6.2	6.3	6.0	3.2	2.9	4.6	4.5	4.5	3.5	0.3	–0.3
Bangladesh	4.9	5.4	5.5	5.7	3.8	5.4	6.4	6.1	0.6	0.4	–0.5	–1.3
ASEAN-4	**4.3**	**5.1**	**5.5**	**5.4**	**5.8**	**4.0**	**4.7**	**4.8**	**5.8**	**6.1**	**5.0**	**3.5**
Indonesia	3.7	4.1	4.8	5.0	11.8	6.8	6.5	6.5	4.5	3.5	2.9	1.9
Thailand	5.4	6.8	6.2	6.4	0.6	1.8	2.7	1.8	5.5	5.6	3.8	2.0
Philippines	4.3	4.7	5.2	4.2	3.1	3.0	5.4	6.8	5.8	4.9	2.8	1.8
Malaysia	4.1	5.3	6.5	6.3	1.8	1.1	2.2	2.5	8.4	12.9	12.4	10.1
Newly industrialized Asian economies	**5.0**	**3.0**	**5.5**	**4.0**	**0.9**	**1.4**	**2.4**	**2.6**	**5.8**	**7.6**	**6.8**	**6.5**
Korea	7.0	3.1	4.6	4.0	2.8	3.5	3.8	3.8	1.0	2.0	3.1	3.3
Taiwan Province of China	3.6	3.3	5.6	4.1	–0.2	–0.3	1.1	1.5	9.1	10.2	6.9	6.0
Hong Kong SAR	1.9	3.2	7.5	4.0	–3.0	–2.6	—	1.0	7.9	10.7	10.0	9.6
Singapore	2.2	1.1	8.8	4.4	–0.4	0.5	1.8	1.6	21.4	30.9	25.7	23.9

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

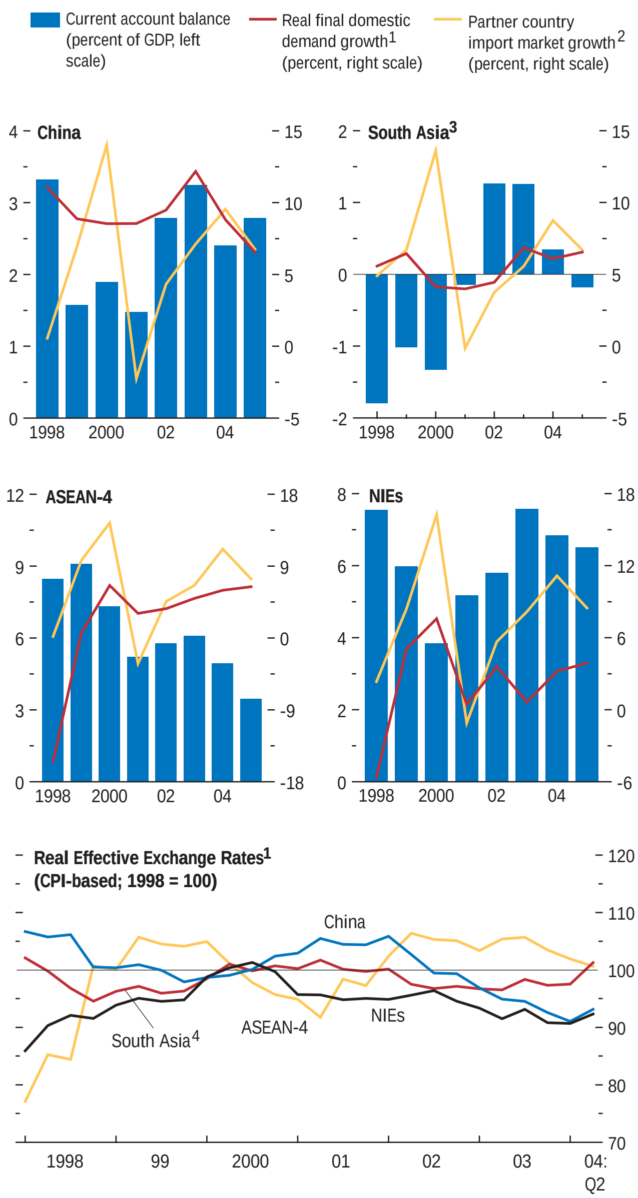
that recent high rates of investment could lead to the emergence of excess capacity in 2005 (Appendix 1.1). Higher real interest rates in the United States could adversely affect countries relying on external budget financing (Indonesia and the Philippines), but in countries experiencing large capital inflows, this could facilitate monetary policy management.

External current account surpluses have generally remained strong across the region, reflecting in part a relatively faster acceleration in external demand growth compared with domestic demand growth; stable or depreciating real exchange rates; gains in market shares in services, especially in South Asia; and, in the case of South Asia and China, increased remittances (Figure 1.14). While current account surpluses are expected to narrow in 2004 and thereafter as domestic demand strengthens further, the decreases as a percent of GDP are small considering that higher-than-expected oil prices alone contribute some 0.3–0.4 percentage point on average in net oil importers. Net private capital flows to the region—with China and India being the largest recipients—while slowing, have remained large. Allowing for the effects of the recapitalization of two large commercial banks in China with official foreign exchange reserves at end-2003, net private capital flows to emerging Asia are expected to fall by about $18 billion to $80 billion this year. Correspondingly, gross external reserves are projected to increase by some further $230 billion to nearly $1.5 trillion by end-2004, equivalent to nine months of imports, and about eight times larger than short-term debt.

While buoyant activity and rising commodity prices have led to some pickup in inflationary pressures—most obviously in China—headline and core inflation have remained moderate. Looking forward, with growth expected to remain strong and policies generally still highly accommodative, monetary policies will need to be tightened—at varying paces—across the region, a process that has already begun in China and, more recently, in Thailand. Given the continued strength of external positions—and the increasing difficulty and cost of steriliz-

Figure 1.14. Emerging Asia: Current Account Surpluses Remain Strong

External current account surpluses have remained strong, partly reflecting relatively faster acceleration in external demand growth compared with domestic demand growth but also stable or depreciating real exchange rates. Together with substantial capital inflows, this has led to the rapid accumulation of gross external reserves.



Sources: Haver Analytics; Global Insight; and IMF staff calculations.
[1]Regional aggregates are purchasing-power-parity-weighted averages.
[2]Export-weighted import demand for individual countries; regional aggregated are PPP-weighted averages.
[3]Includes Bangladesh, India, Maldives, Pakistan, and Sri Lanka.
[4]Includes India, Nepal, Pakistan, and Sri Lanka.

ing their impact on domestic liquidity—this would in many countries be facilitated by greater exchange rate flexibility. As discussed above, this would also play an important role in helping resolve global imbalances in an orderly fashion. From both an external and a domestic perspective, the strong regional and global recovery, combined with buoyant export growth, would seem to provide near-ideal conditions for such a move. Moreover, as discussed in Chapter II, voluntary transitions to more exchange rate flexibility do not seem to have been associated with disruptions to macroeconomic stability, or to have led to sustained exchange rate volatility.

Turning to individual countries, growth in China—particularly fixed investment—moderated in the second quarter in response to tightening measures. However, activity remains very strong and growth in fixed investment accelerated again in June and July. This suggests that risks of overheating have not yet abated. Against this background and considering that short-term real interest rates have remained negative, further monetary tightening is likely to be needed, which would be aided, as discussed above, by greater exchange rate flexibility. Fiscal policy also has a key role to play in cooling down the economy, including through saving revenue overperformance and reducing public investment at both central and local government levels. This would also contribute to the needed fiscal consolidation over the medium term, given still sizable contingent liabilities associated with banking sector weaknesses, pension obligations, and pressures to increase social safety net, health care, and environmental expenditures. On the structural side, banking reform remains crucial, especially since buoyant credit growth may well lead to an increase in nonperforming loans, as was the case during the boom in the early 1990s (Box 1.2). The recent recapitalization of two major banks was an important step forward, and needs to be accompanied by recapitalization of other banks and enforcement of capital requirements and adequate loan-loss provisioning throughout the banking system. Linked to that, imposition of hard budget constraints on public enterprises, labor market reform to help absorb the rapidly growing labor force, and trade liberalization in line with World Trade Organization (WTO) commitments are also key priorities.

The boost from strong growth in China has fed through to the rest of east Asia, although GDP growth rates vary significantly across countries depending on the strength of domestic demand. In the ASEAN-4, economic activity has continued to expand at a solid pace in Malaysia. In Thailand, growth slowed in the first half of 2004, owing to the avian flu, a drought, and higher oil prices. Among the newly industrialized economies, export-based growth has recently been bolstered by a pickup in domestic demand in Hong Kong SAR (where deflation appears to have ended and asset prices have begun to recover), Singapore, and Taiwan Province of China. In contrast, domestic demand in Korea remains relatively weak, weighed down by the legacy of debt problems of households and domestically oriented enterprises. Correspondingly, monetary and fiscal policies should remain supportive for relatively longer than elsewhere in the region until the recovery is firmly established.

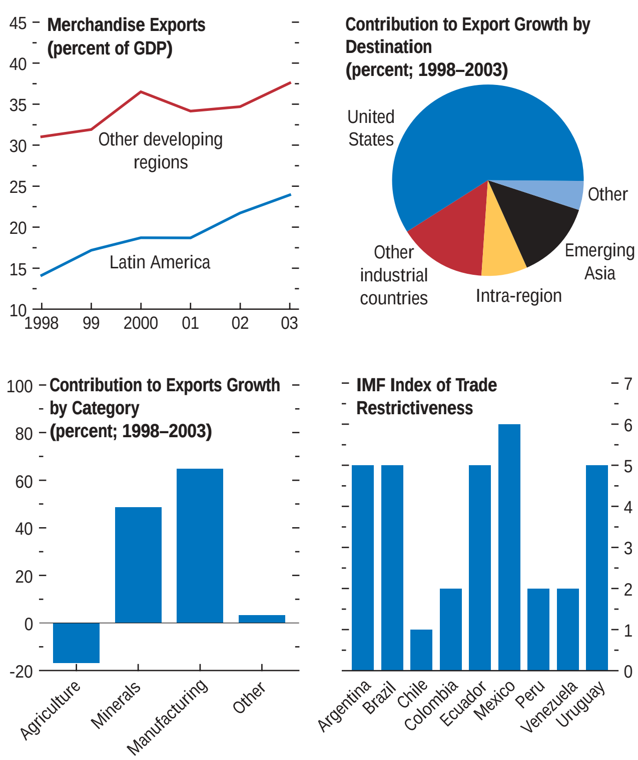
Both Asian newly industrialized economies and the ASEAN-4 have made significant progress in reducing external and domestic vulnerabilities since the 1997–98 crisis, and the strong global environment provides an opportunity to advance further. In particular, banking sector weaknesses, including still-substantial unresolved nonperforming assets, remain a key vulnerability in most countries, underscoring the need for stepped-up banking supervision and strengthened incentives to resolve nonperforming assets, including through the enforcement of adequate loan-loss recognition and provisioning. With many countries facing difficult medium-term fiscal problems, and public debt having risen sharply since the crisis, fiscal consolidation is also a priority. This is particularly the case in the Philippines, where long-standing vulnerabilities related to fiscal and financial imbalances underscore the need for the new administration to press ahead with measures to secure the increases in the tax revenue required to reduce the budget deficit, restructure the power sector and restore its financial viability, and increase banking system capitalization. In Indonesia, where public debt—while decreasing—remains high and market confidence eroded during the prolonged election period, early implementation of the fiscal adjustment for 2004–05 envisaged by the outgoing administration is key, including, if needed, through additional measures.

In India, GDP growth is projected at 6.4 percent in 2004, underpinned by the global expansion and supportive monetary conditions, although unfavorable patterns in this year's monsoon are raising concerns about agricultural growth. Large budget deficits and high and rising levels of public debt remain the Achilles' heel of the economy. Beyond long-run sustainability concerns, high public borrowing may choke off the nascent recovery in private investment needed to sustain the expansion. The newly elected ruling coalition intends to effect ambitious fiscal adjustment to balance the current budget by 2009 (targeting annual adjustment of at least ⅓ percent of GDP in the overall central government balance) while increasing expenditure in priority areas—including health and education, and infrastructure investment. While this target path appears broadly appropriate, the supporting measures that were recently proposed will take time to be implemented and yield results. In view of this uncertainty, expenditure increases should be contingent on progress on the revenue front. Accelerating structural reforms—including agricultural and trade liberalization—remains key to step up potential growth and reduce poverty.

Elsewhere in south Asia, the improved macroeconomic performance in Pakistan has reduced external vulnerabilities and provided some room to address long-standing fiscal adjustment and development issues, including the need for increased development and social spending. In view of the large outstanding public debt, it will, however, be critical that the increased development expenditure planned for the current fiscal

Figure 1.15. Latin America: Trade Share Rising, But Scope for Further Reduction in Restrictiveness

The ratio of merchandise exports to GDP rose by 10 percentage points between 1998–2003, reflecting in particular growing exports to the United States and emerging Asia and increasing exports of manufactured goods. However, Latin America's trade share is still substantially lower than in other developing country regions and there remains considerable scope to reduce trade restrictions.



Sources: IMF, *Direction of Trade Statistics*; United Nations Commodity Trade database; and IMF staff calculations.

year be offset by other measures. In Bangladesh, growth has remained solid, aided by a strong recovery in exports, particularly ready-made garments, but recent floods may adversely affect economic activity for the remainder of 2004. Looking forward, the removal of quotas in textile trade under the Multifiber Arrangement at the end of 2004 poses a key risk, as the country is expected to experience a sharp reduction in export market shares without a timely policy response. The latter could include an exchange rate adjustment, reductions in trade taxes to enhance competitiveness, and infrastructure reforms.

In both Australia and New Zealand, GDP growth is expected to remain robust in 2004, underpinned by strong exports and commodity prices and buoyant domestic demand. Monetary policy has been tightened in both countries over the past year, most recently in New Zealand in early September. While core inflation appears subdued, aided by past real exchange rate appreciation, further interest rate increases are likely to be necessary, particularly in New Zealand, given favorable near-term growth prospects, low unemployment rates, and high rates of capacity utilization. Fiscal positions in both countries are very strong, although further actions will be needed to sustain this over the medium term in the face of pressures from rising populations, including reforms to the pension and health systems and measures to increase labor participation and promote high productivity growth.

Latin America: Will the Economic Rebound Be Used To Build Resilience?

In Latin America, economic activity is rebounding strongly this year, supported by a pickup in domestic demand—underpinned by easier monetary conditions in most countries and improved confidence—and the robust global expansion, reinforced by the rising share of trade in GDP (Figure 1.15 and Table 1.7). Higher oil prices are benefiting major oil exporters, such as Colombia, Ecuador, Mexico, and Venezuela, but hurting oil importers, espe-

Table 1.7. 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**	**1.8**	**4.6**	**3.6**	**9.0**	**10.6**	**6.5**	**6.1**	**–1.0**	**0.3**	**0.5**	**–0.3**
Mercosur[3]	**–0.9**	**2.0**	**4.8**	**3.7**	**11.3**	**13.5**	**5.8**	**6.0**	**0.1**	**1.6**	**1.1**	**–0.2**
Argentina	–10.9	8.8	7.0	4.0	25.9	13.4	4.8	7.1	9.0	6.2	1.1	–1.4
Brazil	1.9	–0.2	4.0	3.5	8.4	14.8	6.6	5.9	–1.7	0.8	1.2	0.4
Chile	2.2	3.3	4.9	4.7	2.5	2.8	1.1	2.9	–1.3	–0.8	0.5	–1.9
Uruguay	–11.0	2.5	10.0	3.5	14.0	19.4	9.8	9.3	1.6	0.7	0.1	0.2
Andean region	**0.1**	**1.6**	**5.8**	**4.0**	**9.1**	**10.2**	**8.4**	**8.8**	**1.4**	**2.7**	**4.7**	**3.6**
Colombia	1.6	3.7	4.0	4.0	6.3	7.1	6.0	5.0	–1.8	–1.9	–1.1	–2.2
Ecuador	3.3	2.6	5.4	4.0	12.6	7.9	3.2	2.7	–5.0	–1.7	2.8	3.0
Peru	4.9	4.1	4.5	4.5	1.5	2.5	3.5	2.5	–2.0	–1.7	–0.4	–0.7
Venezuela	–8.9	–7.6	12.1	3.5	22.4	31.1	23.7	31.3	7.9	11.3	13.5	12.1
Mexico, Central America, and Caribbean	**1.2**	**1.6**	**3.6**	**3.3**	**5.2**	**5.9**	**6.7**	**5.0**	**–2.7**	**–1.8**	**–1.6**	**–1.9**
Mexico	0.8	1.3	4.0	3.2	5.0	4.5	4.4	4.0	–2.2	–1.5	–1.2	–1.5
Central America[4]	2.3	3.2	3.3	3.3	6.3	5.9	6.5	5.5	–4.9	–5.2	–5.2	–4.6
The Caribbean[5]	3.1	1.9	0.3	3.3	5.2	18.6	30.3	12.5	–5.5	–0.2	–1.2	–2.0

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Includes Argentina, Brazil, Paraguay, and Uruguay, together with Bolivia and Chile (associate members of Mercosur).
[4]Includes Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama.
[5]Includes Antigua and Barbuda, The Bahamas, Barbados, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago.

cially countries in Central America, the Dominican Republic, and Uruguay. The rise in nonfuel commodity prices is leading to trade gains in exporters of metals (Chile, Jamaica, and Peru) and agricultural products (Argentina, Bolivia, Brazil, Ecuador, and Paraguay). Inflationary pressures are increasing in some countries, reflecting higher oil prices and exchange rate depreciations.

External financing conditions became less buoyant in late spring, as the rise in U.S. interest rates prompted investors to reduce their demand for Latin American securities. However, sovereign borrowers had already fulfilled most of their funding requirements for 2004 and spreads have since returned to near their historical lows. Gross debt issuance remained heavy in the first half of the year, as borrowers locked in low interest rates and extended maturities. Looking beyond 2004, many countries have large external financing requirements and remain vulnerable to external shocks (such as an abrupt rise in global interest rates, commodity price volatility, or a weakening of global growth) and adverse domestic developments (such as political uncertainties, policy slippages, or social upheaval).

The economic rebound and still relatively favorable external financing conditions provide a window of opportunity for governments to build resilience and set the stage for sustained growth. Given that stable inflation expectations may be less well entrenched in some countries, central banks may need to be relatively more proactive about stemming any second-round effects of higher oil prices. The key to reducing vulnerability is to cut public debt ratios, which remain high (well over 100 percent in some countries), by pressing ahead with fiscal reforms needed to improve debt sustainability. To lay the foundation for stronger and more durable growth—which would also improve debt sustainability—and lower unemployment, it is crucial not only to entrench macroeconomic stability but also to strengthen the rule of law and investor rights, foster financial sector development, further liberalize trade, and promote labor market flexibility. Actions to address poverty and income inequality are crucial to ensure the sustainability of policies, including broader access to education and health care.

Turning to individual countries, the economic recovery in Argentina is continuing, but structural reforms have been delayed. Low interest rates and high commodity prices have helped maintain the recovery, but recent data suggest that the economic expansion is gradually moderating, with growth projected to slow further in 2005. Tax revenues have been buoyant and, on current trends, the consolidated public sector primary surplus in 2004 could end well above the authorities' target of 3 percent of GDP. Inflation has picked up recently, to 5.3 percent year-on-year in August, but remains consistent with the low end of the central bank's end-2004 target band of 7–11 percent. To sustain growth in the medium term, the key priorities are reaching a comprehensive agreement with creditors on the restructuring of defaulted sovereign debt, fiscal reforms, finalizing compensation to banks for losses from asymmetric pesoization and reforming state-owned banks, and establishing an appropriate legal framework for public services. In Uruguay, the economy is also recovering strongly, supported by robust consumption, and the primary surplus target of 3.2 percent of GDP in 2004 is likely to be surpassed. However, the October presidential election is heightening uncertainty, so it is important to push ahead with the reform of tax administration, improve the oversight of asset disposals, and restructure the state-owned banks. In Bolivia, economic activity is recovering gradually, following the political upheavals in late 2003. The policy priorities are to contain the fiscal deficit while increasing pro-poor spending, strengthen the financial and corporate sectors, and develop an appropriate legal framework for the hydrocarbons sector aimed at fostering investment.

In Brazil, the economic recovery is gathering strength, boosted by robust export growth and increasing domestic demand, and the forecast for real GDP growth in 2004 has been revised up. While Brazil has taken important steps to boost resilience, including increasing international reserves, reducing the share of foreign-exchange-linked public debt, and improving banks' net foreign exchange position, the rise in sovereign spreads in April and May was nevertheless a reminder that vulnerabilities remain. Reflecting the favorable impact of the recovery on tax revenues, as well as expenditure restraint by the federal government, the consolidated public sector primary surplus in 2004 is projected to be about 4¼ percent of GDP. The government has set a primary surplus target for the nonfinancial public sector of 4¼ percent of GDP for 2005–07 and limited the increase in the minimum wage. On monetary policy, the announcement of an inflation target of 4½ percent and the narrowing of the band for 2006 was welcome. With higher oil prices slowing the deceleration in core inflation, the recent increase in the policy interest rate to 16¼ percent was appropriate. To ensure that the current rebound in growth is sustained, structural reforms need to be extended and deepened, including by increasing labor market flexibility, implementing judicial and regulatory reform, improving the business environment, reforming state-level taxes, and de-earmarking federal taxes.

In Chile, real GDP growth is projected to accelerate to about 5 percent in 2004–05, underpinned by a pickup in investment. Risks from the disruption in the supply of natural gas from Argentina appear manageable. Notwithstanding the increase in oil prices, inflation remains below the 2–4 percent target band. In September, the central bank raised the policy interest rate by ¼ percent to 2 percent. Fiscal policy remains anchored by the structural balance rule (a central government surplus of 1 percent of GDP) and the government has successfully resisted pressures to increase spending in the context of high copper prices. To sustain high growth, the priorities are to encourage greater competition in the financial sector and lower rigidities in the labor market, including by promoting part-time work, increasing the flexibility of working hours, and reducing severance payments. The recent implementation of a well-targeted social program for the poor (*Chile Solidario*) is welcome.

In the Andean region, higher oil production and prices are providing a large boost to economic activity in Ecuador and Venezuela, but difficult political situations remain important risks. In Ecuador, inflation is declining, confidence in the financial sector is broadening, and fiscal performance remains broadly positive, but further fiscal consolidation is needed to reduce financing needs and public debt. In Venezuela, the recent improvement in economic conditions is not sustainable without major changes in policies, including a reduction in the non-oil fiscal deficit, the phasing out over time of foreign exchange controls, and an improvement in the business environment.

The favorable external environment has also helped to support growth in Colombia and Peru. In Colombia, private investment has been especially strong, reflecting improved confidence and low interest rates. However, public debt—though declining—is still high and the security situation—while improving—remains fragile. In Peru, growth continues to be solid and inflation moderately low. However, given high public debt, further gradual fiscal consolidation is important.

In Mexico, economic growth is projected to accelerate to 4 percent this year, reflecting both still relatively easy monetary conditions and strong demand from the United States, reinforced by rising trade and financial integration due to the North American Free Trade Agreement (Box 1.4). However, prospects for 2005 and beyond are clouded by the stalling of structural reforms. With headline inflation projected to remain above the Bank of Mexico's target range of 2–4 percent, the recent tightening of monetary policy was appropriate, and further tightening may be necessary to bring inflation expectations back within the target range. Given the desirability of bringing down the level of public debt from about 50 percent of GDP, fiscal priorities are to resist pressures for spending increases in the absence of new revenue measures, establish a fiscal rule that will ensure that future windfall oil revenues are saved, undertake comprehensive tax and pension reforms, and continue to strengthen the structure of public debt. While the banking system appears healthy, lending by nonbanks—especially mortgage lending—is rising rapidly, underlining the importance of improving oversight of such institutions. To raise potential growth and maintain competitiveness, it is essential to reform the energy and telecommunications sectors and the labor market, including reducing impediments to hiring and firing workers, and lowering nonwage costs. In Central America and the Caribbean, it is important to strengthen the institutional basis for macroeconomic stability, private sector development, and effective social policies, so as to boost growth, increase resilience to shocks, and reduce poverty in a lasting way.

Emerging Europe: Will the Recovery Be Used to Address Fiscal Vulnerabilities?

In emerging Europe, GDP growth is projected to rise to 5.5 percent in 2004, with a stronger-than-expected upturn in much of central and southern Europe, led by Poland and Turkey, more than offsetting moderating—but still very strong—growth in the Baltics (Table 1.8). Looking forward, GDP growth is expected to remain well-sustained in the remainder of 2004 and in 2005, underpinned by rising domestic demand and strong export growth. Stronger activity, combined with higher oil prices, has led to a pickup in inflation—except in Turkey and Romania—and in some new European Union (EU) members is significantly above the Maastricht target. For similar reasons, regional current account deficits remain very high, and outside Turkey little improvement is expected in 2005.

In the immediate future, the risks to the outlook appear broadly balanced. With recent data generally surprising on the upside, the underlying momentum of the recovery could be stronger than projected. However, most countries are vul-

Table 1.8. Emerging Europe: 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 Europe	**4.3**	**4.5**	**5.5**	**4.8**	**15.3**	**9.5**	**7.1**	**5.9**	**–3.3**	**–4.1**	**–4.3**	**–4.1**
Turkey	7.9	5.8	7.0	5.0	45.0	25.3	11.4	10.8	–0.8	–2.9	–4.0	–3.5
Excluding Turkey	3.0	3.9	4.9	4.7	5.3	3.8	5.3	4.0	–4.3	–4.6	–4.5	–4.5
Baltics	**6.8**	**7.7**	**6.6**	**6.3**	**1.5**	**0.6**	**2.6**	**2.8**	**–6.7**	**–8.8**	**–8.7**	**–7.9**
Estonia	7.2	5.1	5.8	5.4	3.6	1.3	3.0	2.5	–10.2	–13.2	–11.2	–9.5
Latvia	6.4	7.5	6.5	6.0	1.9	2.9	5.8	3.5	–6.5	–8.6	–9.3	–8.2
Lithuania	6.8	9.0	7.0	7.0	0.3	–1.2	0.6	2.5	–5.2	–6.7	–7.1	–6.9
Central Europe	**2.1**	**3.5**	**4.8**	**4.4**	**2.8**	**2.2**	**4.5**	**3.7**	**–4.1**	**–3.9**	**–3.8**	**–3.9**
Czech Republic	1.5	3.1	3.3	3.4	1.8	0.1	3.2	3.0	–5.6	–6.2	–5.5	–4.9
Hungary	3.5	2.9	3.5	3.7	5.3	4.7	6.9	4.4	–7.2	–8.9	–8.8	–8.2
Poland	1.4	3.8	5.8	5.1	1.9	0.8	3.7	3.8	–2.6	–1.9	–1.7	–2.1
Slovak Republic	4.4	4.2	4.8	4.3	3.3	8.5	7.7	3.0	–8.0	–0.9	–2.3	–2.6
Slovenia	3.4	2.3	3.9	4.1	7.5	5.6	3.7	3.2	1.4	0.1	–0.6	–1.4
Southern and south-eastern Europe	**4.6**	**4.3**	**4.8**	**4.9**	**16.1**	**10.7**	**9.3**	**5.8**	**–4.0**	**–6.2**	**–5.8**	**–5.7**
Bulgaria	4.9	4.3	5.2	5.2	5.8	2.3	6.3	3.6	–5.3	–8.4	–8.7	–8.3
Cyprus	2.0	2.0	3.0	3.5	2.8	4.1	2.2	2.6	–5.4	–4.4	–4.3	–4.2
Malta	1.2	–1.7	1.3	1.7	2.2	1.3	3.0	2.0	–1.1	–6.0	–4.0	–2.6
Romania	5.0	4.9	5.0	5.0	22.5	15.3	11.5	7.2	–3.4	–5.9	–5.2	–5.3

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

nerable to higher oil prices, which, apart from adversely affecting growth, could also add to pressures on inflation and current accounts. The weakness in euro area domestic demand—especially in Germany, a key regional trading partner—remains sluggish. Looking forward, high external deficits—and linked to that, the high fiscal deficits—in a number of countries remain a key concern, especially given that they are increasingly debt financed. With most countries facing substantial future expenditure pressures—notably from rapidly aging populations (see Chapter III), the need to upgrade infrastructure, and contributions to the EU budget—it is now critical to take advantage of the upturn to make progress with fiscal consolidation (Figure 1.16). Prudential risks from rapid private credit growth as financial deepening proceeds also bear close monitoring—especially when financing consumption rather than investment—underscoring the need to make additional progress in strengthening bank supervision.

On May 1, 2004, 10 countries in the region joined the European Union, with Bulgaria and Romania—and possibly Croatia, which will begin accession negotiations in early 2005—expected to follow later this decade. Following this historic enlargement, Estonia, Lithuania, and Slovenia have moved quickly to join the Exchange Rate Mechanism (ERM2), the precursor to Economic and Monetary Union (EMU), with Latvia expected to follow shortly. Most other countries aim to join toward the end of the decade, although much remains to be done—especially on the fiscal side—if this timetable is to be met. More generally, as the experience of previous entrants—notably Greece through the mid-1990s—has shown, EU accession facilitates, but does not guarantee, rapid growth. With the spur of qualification for EU entry no longer present, it will be important to avoid any slowdown in implementing key structural reforms, particularly in those countries—notably Poland—where growth has disappointed in past years.

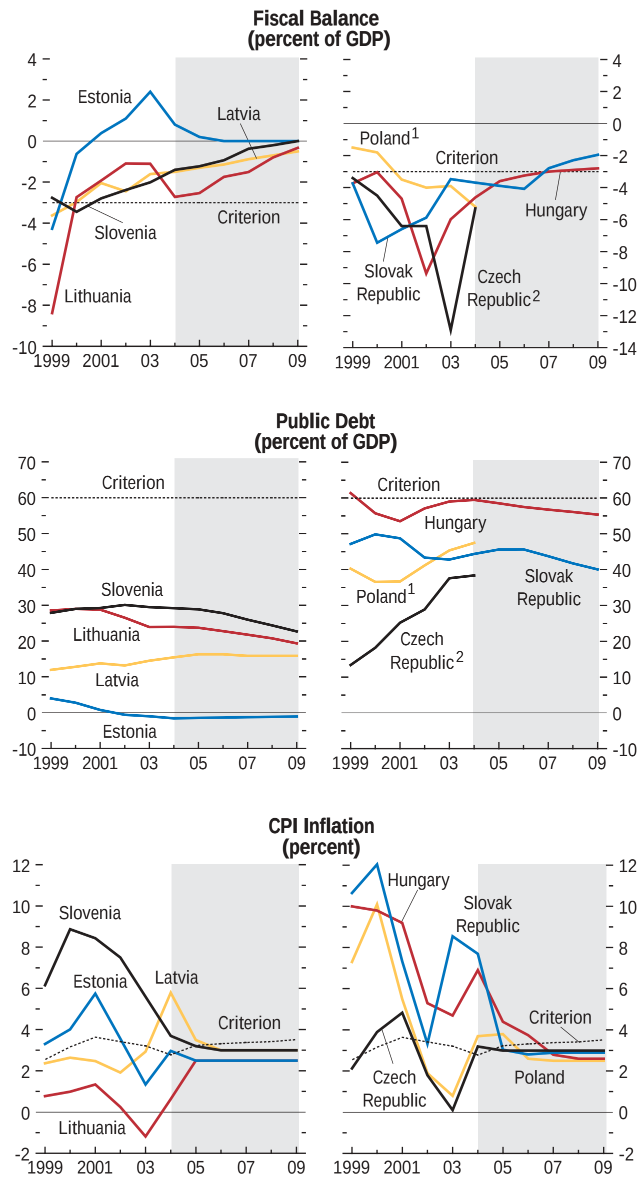
Turning to individual countries, Poland has continued to experience a strong recovery, underpinned by the substantial easing of monetary policy over the past two years. Since early 2004, inflation and inflation expectations have picked up sharply, prompting a 125-basis-point increase in interest rates since late June. The external current account deficit is moderate, with export growth boosted by the depreciation of the zloty. Despite the favorable short-run outlook, investment and employment growth have remained moderate, and financial markets are still concerned about fundamental impediments to growth. Notably, since 1999 four successive finance ministers have failed to rein in the rising fiscal deficit, and a further substantial increase is projected in 2004. While recent parliamentary approval of the modification of indexation of pension benefits—an important part of the Hausner medium-term fiscal consolidation plan—is a step forward, without substantial further measures fiscal deficits will remain very high for the remainder of the decade. With unemployment still close to 20 percent, labor market reform—focused on improving employability of low-skilled workers—is a central priority.

In Hungary, GDP growth is also picking up after last year's slowdown, underpinned by strong growth of exports and investment, accompanied by a significant upturn in inflation (now among the highest in central Europe). Foreign exchange markets have stabilized following the turbulence at end-2003, but interest rates are still high and the twin fiscal and current account deficits remain significant vulnerabilities. Looking forward, decisive and credible fiscal adjustment will be a key challenge for the new government, both to reduce external vulnerabilities and to stay on course for euro adoption.

Turning to the Czech Republic, activity is picking up more slowly than in the rest of central Europe, underpinned by exports and export-related investment. With rising inflation and increasing signs of cost push pressures, the Czech National Bank has appropriately raised interest rates by 50 basis points since June; looking forward, monetary policy will likely need to be tightened further, with the pace and timing depending on the strength of the recovery as well as on exchange rate developments. On the fiscal side, the cash general government deficit is expected to increase to about 6 percent of GDP,

Figure 1.16. How Close Are the New EU Members to the Convergence Criteria for EMU Membership?

The Baltic countries and Slovenia meet—or are very close to—Maastrich fiscal and inflation targets; most central European countries have considerably further to go.



Sources: National authorities; and IMF staff estimates.

[1]European System of Accounts (ESA95) definition with pension funds inside general government. If pension funds are excluded from general government, an issue that is presently under discussion with EUROSTAT, the deficit in 2004 would be 1.5 percent of GDP higher, and debt 4.1 percent of GDP higher.

[2]For 2003, 5.9 percentage points of the deficit were due to the inclusion of a guarantee that was partially called. The 2004 deficit and debt reflect the authorities' projections.

Box 1.4. Regional Trade Agreements and Integration: The Experience with NAFTA

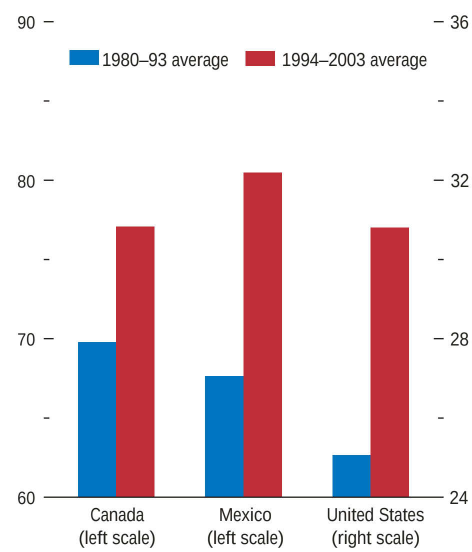
Ten years ago, Canada, Mexico, and the United States launched the North American Free Trade Agreement (NAFTA). This agreement was a milestone in several respects. It created the world's largest free trade area. Its coverage was more comprehensive than in most other regional trade agreements, ranging from merchandise trade to issues related to investment, services, labor markets, environment, and settlement of trade disputes. Finally, it was the first comprehensive free trade agreement between advanced and developing economies. This box briefly reviews the effects of the agreement on trade and financial flows; on business cycle linkages; and on the productivity dynamics in Canada and Mexico, drawing on recent research.[1]

The creation of NAFTA was followed by a sharp acceleration in trade flows among member countries, especially to and from Mexico, leading to an increase in intra-NAFTA relative to extra-NAFTA trade (see the figure).[2] During the recent downturn, however, some of these increases were partially reversed. Perhaps more significantly, the composition of trade flows also changed, as vertical specialization (the amount of imported goods embodied in exports), intra-industry, and intrafirm trade among the NAFTA partners increased substantially. Factors other than NAFTA also contributed to the increased trade integration among member countries, including Mexico's unilateral reduction of tariffs following its entry into GATT in 1986 and the sharp depreciation of the Mexican peso in 1994 (Krueger, 1999). While it is difficult to isolate empirically the effects of NAFTA on member countries' trade patterns, given other shocks during this period that may have affected trade flows, most studies conclude that the agreement played a major role in the growth of trade in the region. For Mexico, it has been estimated that between one-fourth and one-half of the increase in exports to the United States can be attributed to the country's preferential access under NAFTA (Romalis, 2002; Agama and McDaniel, 2002; and Wall, 2003).

Intraregional foreign direct investment flows to Mexico rose substantially after the inception of NAFTA. Cuevas, Messmacher, and Werner (2002) and Waldkirch (2003) estimate that NAFTA induced a 40–70 percent increase in the volume of foreign direct investment flows into Mexico, which was partly related to the increase in vertical trade and partly to the signaling

NAFTA and Trade Integration in North America

(Trade with NAFTA partners as a percent of total trade)[1]



Sources: IMF, *Direction of Trade Statistics;* and IMF staff calculations.
[1]Total trade is sum of merchandise exports and imports.

Note: The main author of this box is M. Ayhan Kose.

[1]For detailed reviews of the impact of the agreement on Mexico and Canada, see Kose, Meredith, and Towe (2004) and Cardarelli and Kose (2004), and the references therein.

[2]To date, most studies, including Krueger (1999, 2000), and Lederman, Maloney, and Serven (2003), concluded that NAFTA was not a trade-diverting agreement—that is, the expansion of trade was not at the expense of other countries. However, Romalis (2002) found some evidence of substantial trade diversion.

effects associated with the agreement—signaling Mexico's commitment to liberalization and reform programs. However, NAFTA had no discernible impact on foreign direct investment flows between Canada and the United States (Globerman and Shapiro, 2003).

Increased trade and financial linkages led to an increase in the synchronicity of business cycles among member countries. Cross-country correlations of major macroeconomic aggregates rose, although in some cases, especially for correlations between the United States and Canada, the statistical significance of the increases remains subject to debate (e.g., Doyle and Faust, 2003). The increased synchronicity could reflect the greater role of regional shocks compared with country-specific idiosyncratic shocks since the inception of NAFTA. This, in turn, likely reflects the increase in vertical specialization and intra-industry trade among the member countries, which leads to the transmission of shocks along the production chain. Indeed, some recent studies have found that the share of output fluctuations explained by regional shocks increased while the role of country-specific, idiosyncratic shocks decreased (e.g., Kose, Otrok, and Whiteman, 2003; Bordo and Helbling, 2003; and Helbling and Bayoumi, 2003). Moreover, since regional shocks were less volatile than idiosyncratic shocks in Mexico, cyclical fluctuations in the country became more moderate in size.

Despite the increased importance of regional shocks in business cycle linkages among NAFTA members, country-specific shocks continue to play an important role, given that interindustry trade and differences in industrial structure remain considerable. As a result, cycles can diverge, as happened, for example, during the most recent downturn, when Canada experienced a shallower slowdown and a relatively stronger recovery than the United States. This has been partly ascribed to Canada's smaller information, communication, and technology sector.

NAFTA also appears to have boosted member countries' productivity growth over the past decade. The speed of convergence of total factor productivity among NAFTA partners accelerated after the inception of NAFTA (Easterly, Fiess, and Lederman, 2003). In addition, Lopez-Cordova (2002) and Schiff and Wang (2003) estimate that NAFTA increased the level of total factor productivity in Mexico by 5½–10 percent.

In sum, NAFTA led to significant increases in trade and financial integration in North America, with, so far, little evidence of trade diversion. Moreover, the agreement helped to boost welfare in member countries by accelerating productivity growth and reducing output volatility. Looking forward, additional gains could be derived from further deepening economic linkages. Currently, trade and investment flows are restricted by differences in regulatory frameworks, security procedures, and rules-of-origin requirements. As an illustration of the potential efficiency gains from deeper economic integration, Ghosh and Rao (2004) find that the removal of rules-of-origin requirements and the harmonization of external tariffs—which has been under discussion among NAFTA member countries—could raise Mexico's GDP by more than 5 percent and Canada's GDP by as much as 1¼ percent.

in excess of the government's target. To restore the credibility of the 2004–06 deficit reduction plan, it is essential for the new government to bring forward the adjustment now planned for 2006, and strengthen the fiscal framework for future years. In the Slovak Republic, GDP growth remains solid with buoyant exports supported increasingly by a revival in domestic demand. Fiscal consolidation appears on track and core inflation is low, although headline inflation will remain high through end-2004. Monetary policy has been steadily eased in response to the strength of the koruna.

In the Baltic countries, output growth remains very strong, supported by robust export performance and increased domestic demand—

underpinned inter alia by transfers from the European Union. Macroeconomic policies are well aligned with the euro area, with all three countries expected to meet the Maastricht fiscal criteria in 2004 (although inflation in Latvia is relatively high, partly due to one-off factors, including oil). Relatively flexible economies and the previous history of fixed exchange rates should facilitate a smooth transition to EMU. However, with current account deficits very high and potential risks of increased capital inflows and overheating in the run-up to EMU, further efforts to raise public savings along with continued strengthening of bank supervision would be prudent. Slovenia was also well placed to join ERM2, despite inflation significantly above the EU average.

In both Bulgaria and Romania, growth of output and domestic demand has remained robust, underpinned by rapid credit growth and accompanied by continued high external current account deficits. To restrain external vulnerabilities, both countries need to press ahead with fiscal consolidation; wage restraint in the state-owned sector; measures to moderate private credit growth and strengthen banking supervision; and, in Romania, energy price adjustments. There is also substantial room to improve the business environment, including through accelerated privatization, labor market reform, and strengthening governance. Growth in the Balkans has been solid, aided by buoyant exports, but external vulnerabilities remain a serious concern (especially in Bosnia and Herzegovina, Croatia, and Serbia and Montenegro), underscoring the need for further fiscal consolidation. With poverty widespread, most countries—especially the post-conflict states—face enormous challenges in establishing a political, macroeconomic, and institutional environment conducive to private sector–led growth.

In Turkey, GDP growth is projected to exceed the authorities' 5 percent target in 2004, underpinned by buoyant domestic demand; along with higher oil prices, this has contributed to a further widening in the external current account deficit. To date, the deficit has been relatively comfortably financed, but mainly with short-term flows; looking forward, the recent depreciation of the lira, together with buoyant tourism receipts, should lead to a significant current account improvement in 2005. Nonetheless, the widening deficit—as well as the financial turbulence in April/May—serves as a reminder of Turkey's continued economic vulnerabilities, especially in a period of rising global interest rates and oil price instability, underscoring the need for policy discipline. On the monetary side, performance has been strong, with inflation now reduced to single digits—the lowest in more than 30 years; however, the lagged impact of higher oil prices and lira depreciation will need to be closely monitored. Higher-than-expected growth is leading to an overperformance of budget revenues and a better fiscal performance than targeted in 2004. Given the widening of the current account, it will be critical to hold the line on expenditures, and—given Turkey's high domestic debt—maintain a 6½ percent primary surplus in 2005 and beyond. On the structural side, the key issues remain to implement the newly designed strategy to restructure and privatize state banks; adopt comprehensive new banking legislation; assure a smooth transition to limited deposit insurance; and regain momentum in privatization following recent setbacks.

Commonwealth of Independent States: Maintaining Stability During a Commodity Boom

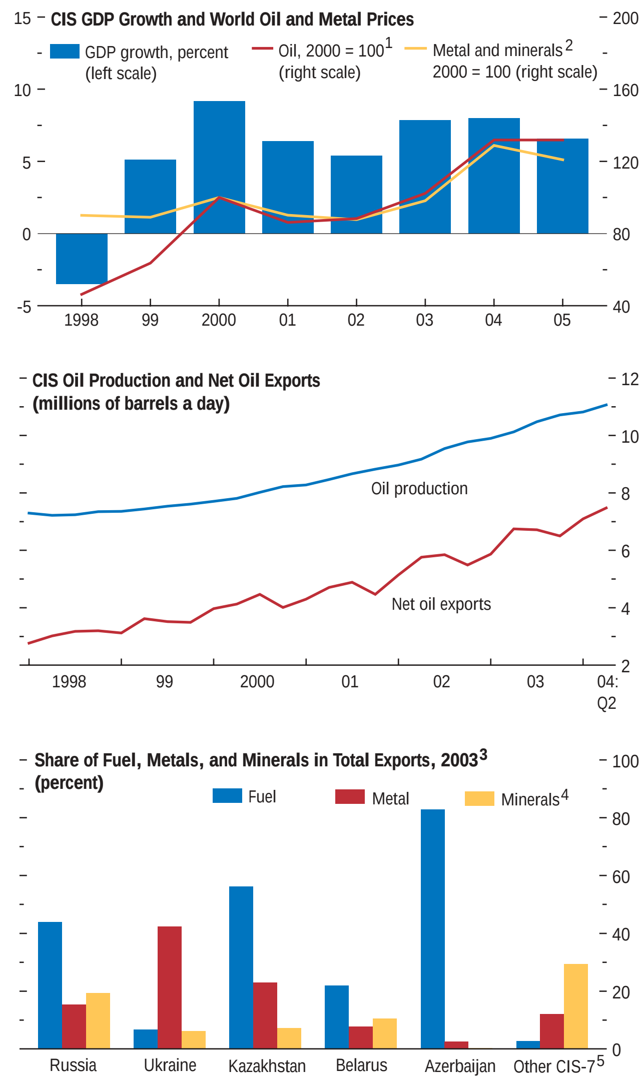
Sharply higher than expected world prices and demand for crude oil and metals have added to the already strong growth momentum in the CIS region, with economic activity expanding rapidly in the first half of 2004 (Figure 1.17). Buoyant export growth has increasingly been supported by strong domestic demand, with production in most manufacturing sectors and construction rising strongly. The latter reflects in part the spillover from the external stimulus, including the massive oil and gas sector expansion (which has boosted investment in related sectors such as transportation and infrastructure), but also strong wage growth and favorable liquidity conditions.

Given the stronger-than-expected current growth momentum, and with oil and metals prices projected to remain high for longer, short-term prospects are considerably more favorable than anticipated in the April 2004 *World Economic Outlook*. Regional GDP growth is now projected to remain at 8 percent in 2004 and to moderate to 6.6 percent in 2005, as consumption and investment growth slows to more sustainable levels (Table 1.9). Near-term risks appear broadly balanced, with movements in oil prices—in either direction—having a critical impact on the outlook. While domestic demand could continue to surprise on the upside, a slowdown in commodity demand in China could adversely affect a number of countries, especially metals producers. Prudential risks associated with continued rapid credit growth are also a serious concern. Continued discretionary government interference contributes to uncertainty regarding governance and property rights and, as the example of the Yukos affair illustrates, remains a deterrent to investor confidence in the region.

Despite continued rapid money and credit growth—and rising producer prices for intermediate goods and raw materials since late 2003—inflationary pressures have not so far intensified. In part, this reflects the fact that liquidity increases have been absorbed by rising money demand, reflecting rapid remonetization, strong income growth, and improved confidence. Nonetheless, the combination of very rapid growth and booming commodity prices will increasingly lead to overheating and inflationary pressures, most immediately in Russia, where some sectors are already close to capacity limits. To avoid exacerbating such pressures, it will be important to resist pressures to relax fiscal policies—including to spend all or a portion of the windfall gains from commodity prices—even when fiscal positions are in surplus. Monetary policy will also need to tighten, particularly

Figure 1.17. CIS: Riding on the Crest of a Global Commodity Boom

Rising world prices and demand for crude oil and metals have strongly boosted growth while the massive oil and gas sector expansion has added to the momentum. As a result, growth has become dependent on commodity market developments.



Sources: International Energy Agency, *Monthly Oil Market Report;* OPEC, *Monthly Oil Market Report;* United Nations Commodity Trade database; and IMF staff calculations.
[1]Simple average of U.K. Brent, Dubai, and West Texas Intermediate spot prices.
[2]Simple average of copper, aluminum, iron ore, tin, nickel, zinc, lead, and uranium prices.
[3]Data for Ukraine are as of 2002.
[4]Includes mineral products, precious stones, and precious metals.
[5]Export-weighted average of Armenia, Georgia, Kyrgyz Republic, and Moldova.

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 States	**5.4**	**7.9**	**8.0**	**6.6**	**13.8**	**12.0**	**9.9**	**8.7**	**7.0**	**6.4**	**8.3**	**6.2**
Russia	4.7	7.3	7.3	6.6	15.8	13.7	10.3	8.9	8.9	8.3	9.9	7.8
Ukraine	5.3	9.4	12.5	6.0	0.8	5.2	8.3	8.1	7.5	5.8	10.2	4.1
Kazakhstan	9.8	9.2	9.0	8.5	5.9	6.4	6.8	6.7	–3.5	–0.2	2.1	–0.7
Belarus	5.0	6.8	6.4	5.5	42.6	28.4	19.5	17.4	–2.6	–2.9	–3.6	–3.5
CIS-7	**6.4**	**7.2**	**6.0**	**6.2**	**17.7**	**8.6**	**7.8**	**6.7**	**–4.5**	**–7.2**	**–6.8**	**–3.4**
Armenia	12.9	13.9	7.0	6.0	1.1	4.8	3.0	3.0	–6.6	–7.1	–5.9	–5.2
Azerbaijan	10.6	11.2	9.1	11.4	2.8	2.2	5.3	5.0	–12.3	–28.3	–24.2	–8.1
Georgia	5.5	11.1	8.5	6.0	5.6	4.8	5.8	4.8	–6.0	–7.5	–8.1	–8.4
Kyrgyz Republic	—	6.7	5.5	4.9	2.1	3.1	4.5	4.6	–2.2	–2.3	–3.7	–5.7
Moldova	7.8	6.3	5.0	4.0	5.3	11.7	10.7	5.8	–6.0	–9.3	–6.6	–6.3
Tajikistan	9.1	10.2	10.0	8.0	12.2	16.4	7.2	5.7	–2.7	–1.3	–2.2	–2.5
Uzbekistan	3.1	1.5	2.5	2.5	44.3	14.8	11.8	10.5	1.2	8.9	8.2	5.5
Memorandum												
Net energy exporters[3]	5.4	7.6	7.3	6.7	15.5	12.8	9.9	8.6	7.6	7.1	8.8	6.9
Net energy importers[4]	5.5	9.1	10.9	5.9	7.1	8.9	9.7	9.0	3.4	2.1	4.9	1.1

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Includes Azerbaijan, Kazakhstan, Russia, Turkmenistan, and Uzbekistan.
[4]Includes Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Ukraine.

where inflation remains relatively high, accompanied in those countries that continue to experience large external surpluses by greater upward exchange rate flexibility.

Over the medium term, the dependence of many countries on commodity market developments remains a key vulnerability. A good part of the recent boost to growth has reflected temporary factors, including oil and other commodity prices above their long-term averages, and while more persistent than expected earlier, they are nevertheless unlikely to sustain growth at recent high rates. Thus, increased sectoral diversification is needed and, despite encouraging signs that investment outside the energy sector is picking up in Russia and Ukraine, much remains to be done to improve the investment climate and fully develop the institutions and structures for market-based economies, including regulatory frameworks for natural monopolies and competition and effective and transparent public institutions. Progress in this domain has been limited in recent years; a notable exception is the improvement in governance and transparency in Armenia. It will therefore be essential for countries in the region to take advantage of the expansion and press ahead with the reforms needed to improve medium-term prospects.

Turning to individual countries, economic activity in Russia has remained buoyant, while the external position has continued to strengthen with soaring oil exports. With labor markets tightening and growing indications that some sectors are approaching capacity limits, there is a danger that macroeconomic policies could become procyclical. With core inflation entrenched at 10–11 percent, monetary policy needs to focus on decisive disinflation, supported by more exchange rate flexibility. Fiscal policy, in turn, should avoid adding further stimulus, implying additional measures beyond those set out in the 2005 draft budget; pressures to spend a proportion of oil revenues once the cap on accumulation in the oil stabilization fund is reached should also be resisted. The central bank's prompt intervention to restore depositor confidence after some runs on private banks was welcome, but the incident underscores the need for the more determined enforcement of prudential regulations and for sharpening the instruments available to address banking sector problems—including to limit moral hazard related to the extension of interim deposit insurance to all banks after the runs. Regrettably, many structural reforms that would foster economic diversification by improving investment climate and governance have stalled, including reform of natural monopolies and public sector reforms addressing the still-excessive government influence in the economy.

In Ukraine, GDP growth has increased further after accelerating sharply in 2003 despite a poor grain harvest, owing to strong domestic demand and booming exports—particularly of metals and related manufacturing products. Fiscal policy remained appropriately prudent through the first half of 2004, while monetary policy has recently been tightened to contain inflation and credit risks, although this needs to be supported by greater exchange rate flexibility. Progress has been made in reforming the tax system (Box 1.5) and in addressing banking sector risks and vulnerabilities after several years of high credit growth, including through increased capital requirements, but further measures are needed, including restrictions on connected lending and strengthened supervision. In Kazakhstan, economic activity has been booming with the expansion of the oil and gas sector, and medium-term prospects remain favorable, with continued large-scale investment in that sector and enhanced regional market access. With fiscal policy turning more expansionary in 2004 because of welcome increases in social spending, a tightening of monetary policy accompanied by some greater exchange rate flexibility is needed.

On the back of the strong regional growth momentum, economic activity in the low-income CIS-7 countries has generally expanded rapidly, although lagging reformers, including Uzbekistan, have gained considerably less. Higher oil and gas prices benefit Azerbaijan and Uzbekistan, which are net energy exporters. As in other regions, the adverse effect on net energy importers has been partly offset by increases in other commodity prices—including cotton (Tajikistan), aluminum (Tajikistan), and gold (Armenia and the Kyrgyz Republic). Nevertheless, external current account deficits have begun to widen in net energy importers in 2003, a concern given very high external debt—except for Armenia—and vulnerability to external shocks. This underscores the need to sustain fiscal discipline and raise the effectiveness of public institutions—including through better revenue mobilization and expenditure rationalization to improve the delivery of high-priority public services and investment—accompanied by additional assistance from the international community.

Africa: Can Improved Economic Performance Be Sustained?

Real GDP growth in sub-Saharan Africa is projected to rise to 4¾ percent in 2004 and 5¾ percent in 2005, and—while some individual countries continue to face serious problems, with the humanitarian catastrophe in western Sudan of particular concern—the outlook is better than it has been for some time (Table 1.10). Underlying the pickup in growth are improving macroeconomic stability; the global expansion, notably through higher demand for commodities at higher prices; easing external debt burdens through the Heavily Indebted Poor Country (HIPC) Initiative; and somewhat better access to industrial country markets. In addition, growth this year has been boosted by a variety of country-specific developments, including large increases in oil production (in Angola, Chad, and Equatorial Guinea), recoveries of agricultural output from the drought-affected depressed levels of 2003 (in Ethiopia, Malawi, and Rwanda), and improved security situations (Burundi and Central African Republic).

Although higher oil prices are hurting oil importers, the general rise in global commodity prices is projected to have a positive net impact on the trade balances of many countries this

Box 1.5. Bringing Small Entrepreneurs into the Formal Economy

In almost all cases of successful economic development, small-scale entrepreneurs have played a prominent role. In parts of east Asia over the past 40 years, for example, investments by entrepreneurs have resulted in a dynamic small-scale business sector that not only provides suppliers and subcontractors for larger firms but also exports, contests markets, and in a few important cases produces the next generation of large firms. In contrast, in many developing countries, entrepreneurs stay small and "underground" to avoid the costs associated with operating officially. For these countries, sustained economic development requires that the small-scale private sector be brought into the formal economy—that is, that entrepreneurs register their businesses and pay taxes.

In transition economies there has been a divergence with regard to small business. One group of countries, especially in central and eastern Europe and the Baltics, initially gave firms complete freedom and secure property rights. As a result, after 1989, legal small enterprises in these countries swiftly accounted for 50–60 percent of GDP, which is similar to the average for advanced economies. In complete contrast, other postcommunist countries quickly found themselves with numerous entrepreneurs who stayed in the shadow economy to avoid onerous regulation, prohibitive taxation, and the associated corruption. Because these firms operated largely underground, they lacked a political voice. The interests of large firms predominated in the form of tax breaks, special credits, and one-off deals in the judicial system. No one spoke up for lower barriers to entry, for transparency in the fiscal system, or for the fair adjudication of contract disputes. The politics of this situation were largely self-perpetuating because no one with political representation or power wanted change.

In the past decade, two mainstream approaches emerged to entice entrepreneurs out from underground: regulatory reform and improved access to credit. Following the first approach, the World Bank now has an extensive set of recommendations intended to lower the regulatory cost of entry into the formal sector. In particular, countries are encouraged to reduce the time needed to obtain business permits. A second approach follows the work of Hernando de Soto in Peru. It focuses on improving access to credit for small entrepreneurs by making sure they have legal title over their real estate. Both approaches are sensible, and have helped change attitudes toward small-scale entrepreneurs, but the measurable effects so far around the world have been limited.

A third approach is presumptive taxation, meaning simplified taxes for small firms that are designed to reduce the administrative burden and the scope for discretion (and therefore corruption) on the part of tax inspectors. This system has been tried in various parts of the world, and—if properly implemented—is a way to improve tax compliance. Some countries in the Commonwealth of Independent States (CIS) have recently introduced presumptive taxation for small business.[1] For example, this has been the approach in Ukraine since 1998 (Barbone and Sanchez, 2003). After multiple failures to simplify regulations and reduce taxes during the mid-1990s, a presidential decree simply changed the basis of taxation for small firms. Specifically, it offered small firms the choice of paying a single low flat tax that replaced many, but not all, taxes. The rules changed slightly over time, but in 2003 small incorporated businesses could choose between a 5 percent turnover tax with an obligation to pay value-added tax (VAT), and a 10 percent tax with a VAT exemption. This reduced effective tax rates and greatly simplified tax administration for legally registered small

Note: The main authors of this box are Anders Åslund and Simon Johnson.

[1]Strictly speaking, this was a reintroduction. Ironically, given that the overall economic system was not at all favorable to entrepreneurs, a low fixed tax or "patent" fee for small entrepreneurs was present in some parts of the Soviet Union and eastern Europe under communism.

firms. The main significance of the presumptive taxation in this case, however, was that it relieved entrepreneurs from costly visits by tax inspectors.

In terms of direct economic impact, the quantifiable effects of the Ukrainian presumptive tax are significant. The number of registered small and medium-sized enterprises rose by 10 percent in 2000 alone, and the presumptive tax helped reduce the size of the shadow economy by perhaps 11–14 percentage points of GDP during 1999 and 2000 (Thiessen, 2001, 2003). Along with subsequent modest reductions in business licensing requirements and improved access to credit, these tax changes helped launch Ukraine into a period of strong economic growth. Despite the increased business registrations, there was some small loss of revenue associated with the switch to presumptive taxation—that is, there is no sign of favorable supply-side revenue effects being greater than the direct revenue loss. However, the switch to presumptive taxation and other (more costly in terms of revenue) tax cuts did not compromise macroeconomic stabilization because government spending declined by 8 percent of GDP from 1997 to 1999.

Further effects of presumptive taxation and the concomitant growth of the official small business sector are evident at the level of national economic policymaking. In particular, both the executive and the legislature now pay closer attention to the interests of the small-scale private sector. The causality is hard to establish, but this is a complete change in attitude from the situation of the mid-1990s. As entrepreneurs increased their investments in the formal sector, they definitely obtained more political voice, legitimacy, and power collectively. It also became harder to expropriate any of them individually.

There are definite disadvantages to a presumptive tax of any kind. Numerous categories—by separate types of business—introduce room for bureaucratic discretion and haggling. If the simplified tax is very low, as in some parts of the CIS, it operates as a pure tax concession or loophole, which is neither fair nor a good way to build the tax base. Even in the best case, there is obvious scope for rearranging the assets of larger firms so that they appear to be those of smaller firms; this is particularly a problem with high eligibility thresholds, as in Ukraine. It is also not a good idea to permanently create an advantage to being small—firms should want to grow if possible. So ideally a presumptive system should be temporary, until entrepreneurs feel the full advantages of operating in the formal sector, but experience around the world indicates there is a tendency toward permanence in any advantages granted to small business.

Economic development requires improvement in institutions, that is, in the laws, rules, and practices that govern property rights for a broad cross-section of society. When a firm operates unofficially, the entrepreneur does not have secure property rights. Effectively, a government needs to offer property rights in return for tax payments and compliance with regulations. But if taxes are high and regulations too costly—or if registered businesses are much more vulnerable to corruption—operating in the official sector is not attractive. Entrepreneurs can still do business but they invest less and stay small. The political representation of these firms is weak because they are not legal. This difficult economic and political situation exists in many poor countries.

Presumptive taxation can help break an economic and political logjam, as it did in Ukraine. Tax reform of this kind is not a panacea, but under some circumstances it is consistent with broader economic reforms that build a large legal tax-paying entrepreneurial class with legitimate political interests. Reducing regulations and improving access to credit are also helpful. The message from Ukraine confirms what we have learned from other parts of the world in the past 20 years. Macroeconomic stabilization is necessary but not generally sufficient for economic growth. Sustaining growth requires finding ways to offer more secure property rights to a large number of entrepreneurs.

Table 1.10. 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**	**4.3**	**4.5**	**5.4**	**9.7**	**10.3**	**8.4**	**8.1**	**–1.5**	**–0.1**	**0.4**	**0.7**
Maghreb	**3.3**	**6.2**	**4.2**	**4.4**	**2.1**	**2.2**	**4.0**	**3.4**	**4.5**	**7.0**	**6.1**	**6.8**
Algeria	4.0	6.8	4.5	4.4	1.4	2.6	5.4	4.5	7.8	13.4	13.1	15.2
Morocco	3.2	5.5	3.0	4.0	2.8	1.2	2.0	2.0	4.1	3.1	0.2	–1.3
Tunisia	1.7	5.6	5.6	5.0	2.8	2.8	3.4	2.7	–3.5	–2.9	–2.8	–3.0
Sub-Sahara	**3.6**	**3.7**	**4.6**	**5.8**	**12.1**	**12.9**	**9.9**	**9.6**	**–3.5**	**–2.4**	**–1.4**	**–1.2**
Horn of Africa[3]	**4.1**	**2.0**	**8.6**	**6.8**	**1.3**	**10.5**	**7.7**	**5.7**	**–8.4**	**–7.2**	**–6.0**	**–6.1**
Ethiopia	1.6	–3.9	11.6	5.7	–7.2	15.1	9.6	5.4	–5.7	–4.7	–3.8	–8.5
Sudan	6.0	6.0	6.6	7.6	8.3	7.7	6.5	6.0	–9.6	–8.2	–6.8	–4.8
Great Lakes[4]	**4.8**	**4.1**	**5.2**	**5.8**	**8.3**	**8.3**	**5.5**	**4.2**	**–3.0**	**–2.9**	**–5.3**	**–7.0**
Congo, Dem. Rep. of	3.5	5.6	6.3	7.0	25.3	12.8	5.0	5.0	–2.8	0.6	–3.0	–5.9
Kenya	1.0	1.6	2.3	3.6	2.0	9.8	8.1	4.0	—	–2.5	–7.7	–8.3
Tanzania	7.2	7.1	6.3	6.5	4.6	4.5	4.3	4.0	–3.8	–2.4	–5.2	–6.2
Uganda	6.8	4.7	5.7	6.0	5.7	5.1	3.5	3.5	–6.0	–5.9	–1.2	–5.3
Southern Africa[5]	**2.3**	**2.8**	**4.8**	**6.7**	**44.2**	**54.3**	**44.6**	**38.4**	**–2.9**	**–3.1**	**1.0**	**2.6**
Angola	14.4	3.4	11.2	15.5	108.9	98.3	56.1	16.5	–1.4	–4.9	9.2	14.5
Zimbabwe	–11.1	–9.3	–5.2	1.8	140.0	431.7	350.0	450.0	–2.6	–4.4	–7.1	–10.9
West and Central Africa[6]	**3.6**	**6.7**	**5.4**	**7.9**	**8.4**	**9.5**	**8.3**	**6.5**	**–6.9**	**–2.8**	**—**	**0.5**
Ghana	4.5	5.2	5.2	5.0	14.8	26.7	10.8	6.0	0.5	1.7	0.3	–1.0
Nigeria	1.5	10.7	4.0	5.9	13.7	14.4	15.8	11.4	–11.1	–2.8	2.9	1.7
CFA franc zone[7]	**4.4**	**4.6**	**6.8**	**10.7**	**4.0**	**1.5**	**1.5**	**2.7**	**–4.3**	**–2.9**	**–1.9**	**0.5**
Cameroon[8]	6.5	4.5	4.8	5.1	6.3	0.6	0.8	1.9	–7.0	–2.5	–2.1	–2.3
Côte d'Ivoire	–1.6	–2.8	1.7	4.3	3.1	3.3	1.5	2.0	6.1	3.6	–0.2	1.4
South Africa	**3.6**	**1.9**	**2.6**	**3.3**	**9.2**	**5.8**	**2.6**	**5.7**	**0.6**	**–0.8**	**–2.0**	**–2.1**
Memorandum												
Oil importers	3.2	3.1	4.3	4.5	8.9	9.6	7.2	8.2	–1.8	–1.9	–2.9	–3.3
Oil exporters	4.5	8.0	5.2	8.3	12.3	12.6	12.6	7.8	–0.7	4.8	8.6	10.2

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Includes Djibouti.
[4]Includes Burundi and Rwanda.
[5]Includes Botswana, Comoros, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Rep. of, Namibia, Seychelles, Swaziland, and Zambia.
[6]Includes Cape Verde, The Gambia, Guinea, Mauritania, São Tomé and Príncipe, Sierra Leone, and CFA franc zone.
[7]Includes Benin, Burkina Faso, Central African Republic, Chad, Congo, Rep. of, Equatorial Guinea, Gabon, Guinea-Bissau, Mali, Niger, Senegal, and Togo.
[8]The percent changes in 2002 are calculated over a period of 18 months, reflecting a change in the fiscal year cycle (from July–June to January–December).

year (Figure 1.18). The countries with the largest net gains are mostly oil exporters, followed by countries with substantial gains from higher prices of metal ores. For the majority of countries, gains from higher-priced nonfuel commodity exports are roughly equivalent to losses from higher-priced oil imports, though a few countries face substantial net losses, reflecting mainly higher oil import bills and—for Côte d'Ivoire—lower cocoa prices. A hard landing in China would pose a risk to many countries, as the general increase in nonfuel commodity prices has owed much to the surge in growth there.

While the increases in commodity prices are welcome, the windfall gains will need to be managed carefully to avoid boom-bust cycles that can result from price volatility. Africa's own experience shows that when prices are high, fiscal revenues tend to increase, often leading to an increase in government expenditures, which boosts aggregate demand. When prices subse-

Figure 1.18. Sub-Saharan Africa: Net Impact of Commodity Price Changes on Trade Balances[1]
(Percent of GDP)

Higher commodity prices are projected to have a positive net impact on the trade balances of many countries this year. The countries with the largest net gains are mostly oil exporters, followed by exporters of metals. For the majority of countries, gains from higher-priced nonfuel commodity exports are roughly equivalent to losses from higher-priced oil imports, though a few—mainly small—countries face substantial net losses.

Source: IMF staff estimates.
[1]Change in prices between 2003 and 2004. Assumes unchanged trade volumes.

quently fall, fiscal revenues decline, resulting in a decrease in government spending or an unsustainable increase in government debt, both of which tend to undermine macroeconomic stability and discourage private sector activity. Given the volatility of commodity prices, fiscal policy should aim to accumulate precautionary savings when prices and thus fiscal revenues are high. To ensure that the benefits of higher commodity prices are well used, fiscal institutions need to be strengthened.

Looking ahead, it is crucial to build on the achievements that have been made and lay the foundation for sustained strong growth. On present policies, per capita growth is projected to fall back to about 2 percent in the medium term, far short of what is needed to meet the Millennium Development Goals. Thus, it is essential not only to entrench macroeconomic stability but also to further reduce government involvement in the economy, promote private investment, develop infrastructure, and deepen institutional reforms. As discussed in Box 1.6, several countries in Africa have achieved governance levels that compare favorably with countries outside of Africa, and these could serve as examples for other countries in the region. In this regard, it is encouraging that 23 countries have already joined the African Peer Review Mechanism, which was launched through the New Partnership for Africa's Development and will peer-review economic and political governance. To mitigate the impact of the HIV/AIDS pandemic, an effective strategy will be critical, including strengthening health care systems, expanding prevention programs, and increasing the provision of life-prolonging antiretroviral therapy. The international community has a key role to play in Africa's development, including through lower restrictions on developing country exports, lower subsidies for agricultural products, higher aid flows, and continued debt relief.

Turning to individual countries, growth in South Africa is projected to rise to 2½ percent in 2004 and 3¼ percent in 2005, underpinned by low interest rates and a mildly expansionary fiscal stance. The appreciation of the rand since the end of 2001 has helped to reduce inflation to about the middle of the target band of 3–6 percent, allowing a significant reduction in short-term interest rates. However, the strength of domestic demand, the recent pickup in money supply growth, and wage settlements that have exceeded productivity gains are giving rise to inflationary pressures, which will likely require an increase in policy interest rates over the coming year. While fiscal policy has generally been prudent over the past few years, resulting in a decline in public sector debt, the projected increase in the government deficit to 3.1 percent of GDP in 2004/05 is now at the upper limit of what is desirable to avoid placing undue pressure on long-term interest rates. Any further rise in social spending will need to be funded through increased tax revenue or cuts in lower priority expenditures. With the unemployment rate at 28 percent, it is imperative to remove rigidities in the labor market and provide skills training for unemployed workers.

In Nigeria, real GDP growth is projected to slow to 4–6 percent in 2004–05, as the boom in oil production in 2003 wanes. While the overall fiscal balance is being boosted by windfall oil revenues, the non-oil deficit is large and rising. The government's new economic team has already made some progress in strengthening the federal budget position by cutting nonpriority outlays, while increasing spending on education, health, and infrastructure. To increase savings from the oil windfall, the federal and state governments need to agree on a prudent fiscal rule, and the Fiscal Responsibility Bill needs to be enacted. To support disinflation, the central bank should allow interest rates to rise, absorb excess liquidity, and allow greater exchange rate flexibility. Looking further ahead, the central bank's independence needs to be strengthened and the soundness of the banking system needs to be improved. Other structural reform priorities include privatization, trade liberalization, unification of the foreign exchange market, and civil service reform. Nigeria is participating in the Extractive Industry Transparency

Initiative—an international initiative to improve the transparency of payments by companies to governments and of the use of these revenues by governments—and has established an Economic and Financial Crimes Commission.

Elsewhere in sub-Saharan Africa, the economic outlook has generally improved, but further efforts are needed to ensure sustainable growth. In the Horn of Africa, the rebound in economic activity in Ethiopia is largely due to the return of normal weather conditions, and structural reforms need to be accelerated to enhance the investment climate, while in Sudan oil production is rising and a peace agreement has ended the rebellion in the south, but the armed conflict in the west has led to a humanitarian crisis. In the Great Lakes region, the projected increase in real GDP growth in the Democratic Republic of Congo partly reflects progress toward effective reunification, but the security situation in the eastern part of the country remains fragile. In southern Africa, real GDP growth in Angola is projected to accelerate to 11 percent, mainly reflecting increasing oil output, but urgent action is needed to establish sustainable fiscal and external positions, while in Zimbabwe the economy is in sharp decline, with the disorderly land reform reducing agricultural production and concerns about governance discouraging investment and promoting capital flight and emigration. In the CFA franc zone, it is key to restore political stability in Côte d'Ivoire to improve economic prospects.

In north Africa, real GDP growth in Algeria is projected to remain relatively strong in 2004–05, but expansionary fiscal and monetary policies are fueling inflationary pressures. To preserve macroeconomic stability, government spending needs to be de-linked from oil revenues to put fiscal policy firmly on a sustainable path. With unemployment of about 23 percent, it is also essential to initiate the privatization of state-owned banks and further modernize financial intermediation, decrease the role of government in the economy, and reduce labor taxes and the bureaucratic burden on private sector activity. Similarly, the short-term outlooks in Morocco and Tunisia are relatively favorable, but early and vigorous policy action is needed to accelerate underlying growth, reduce high unemployment rates, and cut public debt. The priorities are fiscal consolidation and structural reforms, including trade liberalization, improvements in the business environment, and financial sector reform.

Middle East: Fiscal Consolidation Challenges Ahead

In the Middle East, higher oil production and prices boosted growth in 2003 but, with oil production now close to capacity, the pace of economic expansion has begun to taper off (Figure 1.19). GDP growth in the region is now projected to decline by 1 percentage point to about 5 percent in 2004–05, reflecting a combination of lower growth in the oil sector and, in both oil exporters and the Mashreq, a substantial pickup in non-oil growth (Table 1.11). The latter is predicated on the global upturn, including in Europe, and reform prospects, especially renewed efforts at trade liberalization (including free trade agreements with the European Union and preparations for WTO membership). While most countries in the region have benefited from higher oil prices, they remain exposed to medium-term oil price volatility, especially if windfall gains from above-average oil revenues are not used to accumulate adequate buffer stock savings. Another key concern is the still-fragile security situation.

Looking forward, fiscal consolidation remains a priority in most countries, although the urgency and extent of problems differ. In some non-oil-exporting countries—most seriously Lebanon but also other parts of the Mashreq—public debt burdens are high, and need to be reduced for medium-term sustainability (see the September 2003 *World Economic Outlook*). In contrast, most oil-exporting countries have generally low public debt burdens and are currently running budget surpluses, as substantial shares of the large, oil-related revenue windfalls have been

Box 1.6. Governance Challenges and Progress in Sub-Saharan Africa

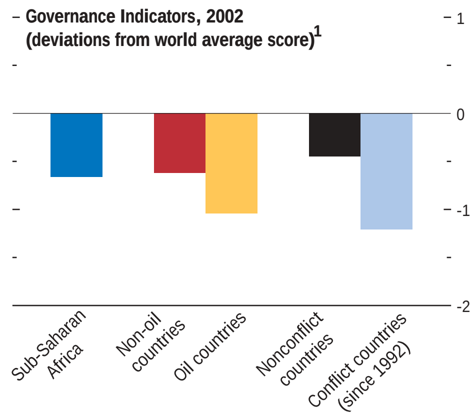
A record of poor governance in sub-Saharan Africa has hindered stronger economic growth and poverty reduction, but there are also important exceptions and related challenges being addressed more forcefully across the continent. The focus on good governance—quality of public institutions, transparency, accountability, and control of corruption—has intensified in Africa in recent years with the growing recognition of its critical role for progress toward the Millennium Development Goals (see Mauro, 1997; Kaufmann, Kraay, and Zoido-Lobatón, 1999; Acemoglu, Johnson, and Robinson, 2001; Subramanian and Roy, 2001; and the April 2003 *World Economic Outlook*). Available evidence, even if subject to statistical weaknesses, consistently points to a weak starting point for the region as a whole. For example, the World Bank's governance index places only five countries in the region above the world average.

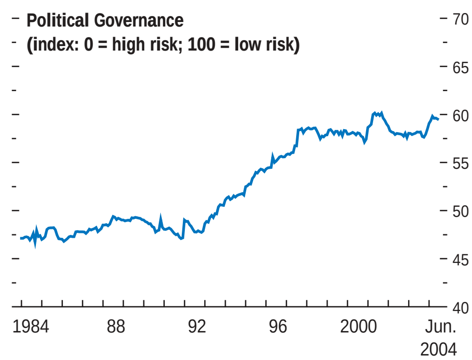
At the same time, important differences in the quality of governance exist between countries in sub-Saharan Africa (see figure, top panel). Governance in oil-producing countries has been noticeably weaker—probably attributable to relatively large rents, which often are conducive to corruption and an institutional emphasis on preserving the powers of a small elite (see Katz and others, 2004; and Sala-i-Martin and Subramanian, 2003). Conflict is typically associated with a widespread breakdown of governance, and no other region in the world has been more affected by armed conflicts than sub-Saharan Africa.

Several countries in Africa have achieved governance levels that compare, at least in some areas, quite favorably with other countries, and these could serve as important examples for the region (see also Box 1.5 in the April 2004 *World Economic Outlook*). For example, in South Africa, the institutional framework for macroeconomic policies emphasizes transparency and accountability, the financial sector is well regulated and supervised, and well-defined standards for corporate governance are generally in line with international best practice. Superior economic performance and financial stability in Mauritius have been underpinned by a tradition of good governance, including respect for the law and property rights, a culture of transparency and participatory politics, and an implicit social contract among government, firms, and labor. Comparatively strong legal rights have also fostered development in Namibia in the past, while Botswana's public finance management has been characterized by transparent institutional

Note: The main authors of this box are Milan Cuc and Thomas Krueger.

Sub-Saharan Africa: Selected Governance Indicators





Sources: World Bank; *International Country Risk Guide;* and IMF staff calculations.

[1]A negative number indicates a score below the world average. The scores are normalized with a standard deviation of 1.

arrangements for budget formulation and implementation (including for key aspects related to its extractive industry), and by a rule-based approach to fiscal policy.

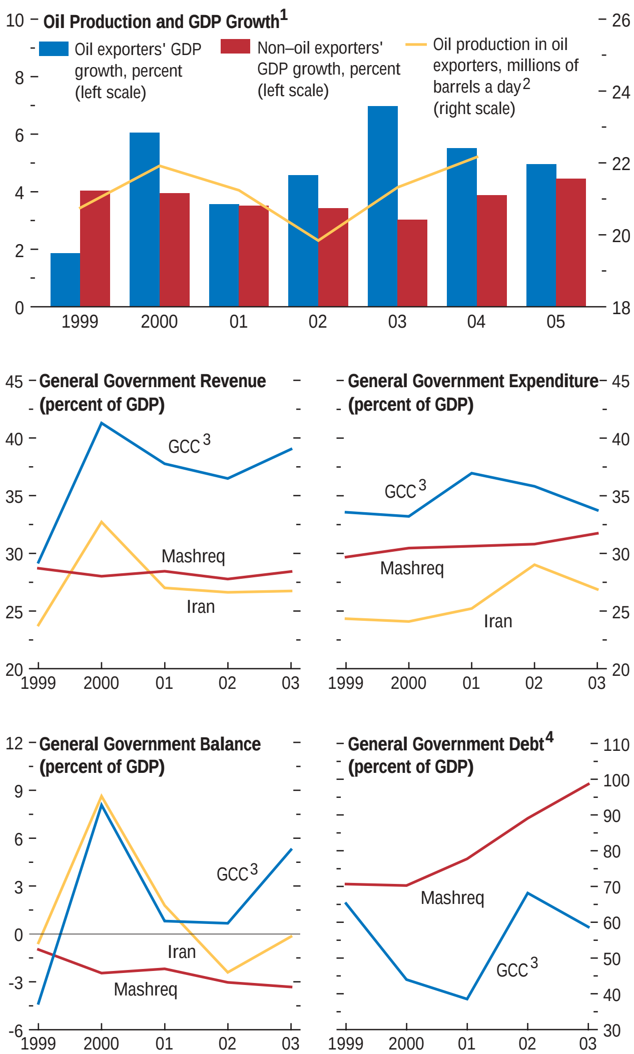
The challenge is to ensure that these successes spread more broadly across countries in sub-Saharan Africa—with important progress, especially on the political front, already secured over the past two decades (see figure, lower panel). Even so, progress has been uneven, and in many cases formalistic—focusing on legal arrangements without providing adequate resources and lacking frequently political support to actually implement the necessary steps. Moreover, armed conflicts quickly reversed earlier gains and led to a general deterioration in the rule of law in some countries (for example, in Côte d'Ivoire and Liberia).

Several important initiatives—both at national and international levels—are under way to secure improvements in governance. With some elements of governance clearly costly, such as increasing transparency or expanding the judiciary, resource limitations and capacity constraints point to an important role for international support in improving governance in sub-Saharan Africa. Indeed, fundamental progress will require concerted efforts at three levels.

- *Homegrown domestic efforts*. The key task here is to set up the institutional underpinnings for good governance, as well as to move more decisively beyond formalistic applications to actual implementation. Within the public sector, there remains room in many countries to limit official discretion, improve accountability, and strengthen monitoring and oversight—with the regional success stories noted above offering valuable lessons. Property rights and the rule of law will also be indispensable if the hoped-for dynamism in private sector activity is to be achieved. Steps taken within a broad-based participatory process, as is increasingly the case across the continent in the context of a broader poverty reduction strategy, can be particularly effective.
- *Multilateral African initiatives*. The New Partnership for Africa's Development (NEPAD) is a clear expression of Africa's determination to tackle governance problems. One of its central pillars is the African Peer Review Mechanism (APRM), covering several key governance areas. A more determined approach is now needed to turn this vision into reality: while 23 countries had joined the APRM by early July, only three (Ghana, Mauritius, and Rwanda) had entered the preliminary stage of the reviews. With conflict countries presenting particular governance challenges, African peacekeeping initiatives are also noteworthy.
- *Other international efforts*. The international financial institutions have taken a number of initiatives to promote greater transparency and accountability in member countries. The IMF has taken the lead in work on standards and codes in the fiscal and statistical areas and, jointly with the World Bank and the Bank for International Settlements, in the promotion of standards and codes in the monetary and banking areas. The IMF–World Bank Financial Sector Assessment Programs also aim to strengthen transparency and governance in the financial sector. Future steps could target specific revenue transparency issues facing oil-producing countries (or countries with other extractive industries), where governance problems are particularly severe (see above). This is also envisaged by the Extractive Industries Transparency Initiative (EITI), launched by the United Kingdom in 2003. Several African countries, including Equatorial Guinea, Ghana, São Tomé and Príncípe, Gabon, and Republic of Congo, are participating or have announced their intention to participate in the EITI. More efforts are also needed in developed countries that are often party to governance problems in the developing world, including in Africa. The OECD's Convention on Combating Bribery, for example, is an expression of the desire of developed countries to play their part in tackling international business corruption. Effectiveness of this initiative will now depend on how it is enforced under the signatories' national legal frameworks.

Figure 1.19. Middle East: Resisting Pressure to Spend Higher Oil Revenue

Most oil exporters are currently running budget surpluses, as substantial shares of the large, oil-related revenue windfalls have been saved. In contrast, budget deficits have widened in some countries in the Mashreq.



Sources: International Energy Agency, *Monthly Oil Market Report;* and IMF staff calculations.

[1]See Table 1.10 for country compositions of oil exporters and non–oil exporters.
[2]Average of January–June 2004.
[3]The Cooperation Council of the Arab States of the Gulf (GCC) includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates.
[4]Data for Bahrain, Iran, Jordan, and Kuwait are not available.

saved. However, budget deficits could reemerge, as oil prices are expected to decline, highlighting the vulnerability of fiscal positions to oil market developments. Accordingly, expenditure ratios need to be aligned with oil revenue based on average prices while at the same time saving some oil wealth for future generations. In addition, in Bahrain, Oman, and Yemen, other revenue sources need to be developed, as oil production will be declining.

Creating the environment for a sustained increase in medium-term growth is the second policy priority, given generally high unemployment rates and a rapidly growing labor force. Specific priorities vary, depending on differences in the origins of low per capita growth, as discussed in Chapter II of the September 2003 *World Economic Outlook.* In the countries of the Cooperation Council of the Arab States of the Gulf (GCC)—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—the priority is to reduce the role of government in the economy, including the large share of public sector employment and associated high wages and benefits, which distort incentives against private sector employment. (The related expenditure reductions would also help in medium-term fiscal consolidation.) In the other countries of the region, oil exporters and non-oil countries alike, priorities are the strengthening of institutions, including the rule of law and the capacity of public institutions, and further trade liberalization.

Turning to individual countries, growth in Iran has remained stronger than in other major oil-exporting countries in the region, owing to a larger and buoyant non-oil sector. This has partly reflected expansionary macroeconomic policies—including procyclical spending of oil revenue—but also recent reforms, including trade liberalization and exchange rate reform, though efforts to support private sector development and to strengthen the banking sector need to be intensified. Inflation has been in the range of 15–16 percent, well above the average in the region, and the external current account has weakened despite higher oil prices due to strong

Table 1.11. 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	**4.3**	**6.0**	**5.1**	**4.8**	**7.5**	**8.0**	**9.2**	**8.7**	**4.5**	**8.1**	**12.7**	**12.5**
Oil exporters[3]	**4.6**	**7.0**	**5.5**	**5.0**	**9.5**	**9.6**	**10.7**	**9.9**	**5.7**	**9.6**	**14.9**	**14.8**
Iran, I.R. of	7.5	6.6	6.6	5.2	15.8	15.6	15.6	15.0	3.1	1.5	3.4	1.6
Saudi Arabia	0.1	7.2	3.6	3.9	–0.6	0.5	2.5	0.8	6.2	13.5	19.5	20.1
United Arab Emirates	1.9	7.0	3.6	4.5	3.1	2.8	3.4	2.1	4.9	8.5	14.2	16.9
Kuwait	–0.4	10.1	2.8	2.3	1.4	1.2	1.7	1.6	12.1	18.1	28.8	29.6
Mashreq	**3.4**	**3.0**	**3.9**	**4.5**	**2.0**	**3.4**	**4.9**	**5.0**	**—**	**1.1**	**1.1**	**0.3**
Egypt	3.2	3.1	3.7	4.5	2.4	3.2	5.2	5.7	0.7	2.4	3.2	1.8
Syrian Arab Republic	4.2	2.6	3.6	4.0	0.6	5.0	5.0	4.5	6.7	3.5	3.3	3.3
Jordan	5.0	3.2	5.5	5.5	1.8	2.3	3.5	1.8	4.5	11.2	5.6	1.8
Lebanon	2.0	3.0	5.0	4.0	1.8	1.3	3.0	2.0	–13.8	–13.1	–12.2	–10.0
Memorandum												
Israel	–0.7	1.3	3.6	3.5	5.7	0.7	–0.3	1.4	–1.6	0.1	–0.5	–0.1

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

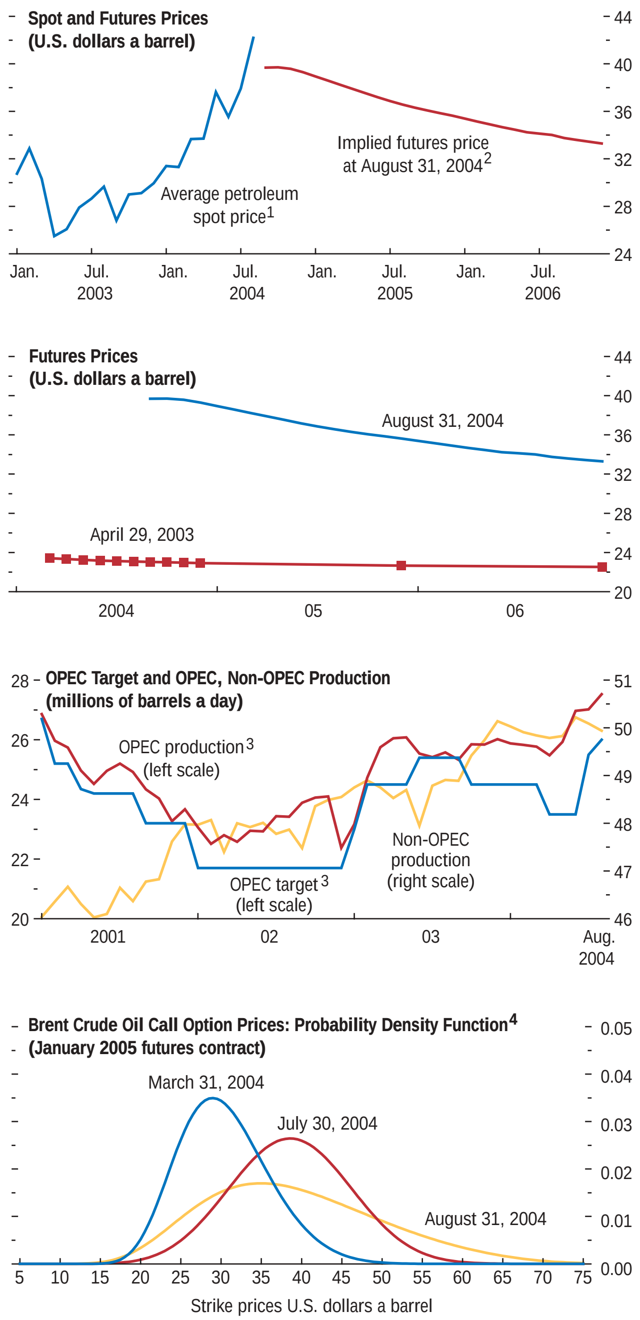
import growth. To lower the vulnerability to oil price reversals and reduce inflation to single digit levels, monetary and fiscal policies need to be tightened.

In Iraq, oil production and exports have generally stayed close to prewar levels, with some temporary disruptions owing to continued difficult security conditions. A number of indicators suggest that economic activity has begun to recover—at a slower than initially expected pace—but unemployment and underemployment remain pervasive. Broad consumer prices appear to have stabilized and the nominal exchange rate of the dinar against the U.S. dollar has remained steady since early 2004. Looking forward, policy priorities for the new interim government must be the reconstruction of the country's infrastructure, the maintenance of macroeconomic stability, and, most important, capacity building to develop institutions that can support a market-based economy.

In Egypt, a moderate, export-driven recovery has begun to take hold, reflecting the global upturn and the earlier depreciation of the pound. The latter, in conjunction with higher commodity prices and monetary policy easing, has led to some pickup in inflation, especially at the wholesale price level, where administered prices play less of a role. With steadily increasing net public debt, on course to rise above 70 percent of GDP by end-2005, fiscal consolidation efforts need to be stepped up. Renewed efforts at exchange rate unification and greater rate flexibility remain a priority, given that the dual exchange rate regime—with a de facto inflexible exchange rate—is an impediment to private sector development.

Elsewhere in the Mashreq, economic activity has picked up in Jordan, owing to surging exports and a rebound in domestic demand. Strengthened revenue administration has helped to improve budget balances, although further measures are needed for sustained debt reduction. In Lebanon, growth has similarly picked up, led by strong export, tourism, and construction activities. However, financial vulnerabilities associated with the very high level of public debt, the banking system's exposure to rollover risks in the deposit base, and large capital inflows remain high and, along with correspondingly high real interest rates, weigh on domestic demand. A favorable external environment and a high level of international reserves help to cushion the vulnerabilities in

Figure 1.20. Oil Prices, Futures, and Production



Sources: International Energy Agency; Bloomberg Financial, LP; and IMF staff calculations.
[1]Average petroleum spot price of West Texas Intermediate, U.K. Brent, and Dubai Fateh crude.
[2]Five-day weighted average of NYMEX Light Sweet Crude, IPE Dated Brent, and implied Dubai Fateh.
[3]Excluding Iraq.
[4]Call options are European style options for an option to buy (call) International Petroleum Exchange Brent Contract for January 2005 delivery.

the near term but lasting improvement requires continued fiscal consolidation and structural reforms.

In Israel, the recovery in economic activity has gathered pace, driven by the global upturn, especially in information technology spending, and private consumption. Despite some recent upward creep, core inflation and inflation expectations have remained in the Bank of Israel's target range of 1–3 percent. With a still-substantial output gap and a welcome renewed emphasis on fiscal consolidation, monetary policy has appropriately been relaxed to support recovery. In the West Bank and Gaza, the modest recovery that began in 2003 has continued but output remains some 30 percent below the level reached in 1999, the year before renewed conflict began. Without a lasting improvement in the security situation, general economic conditions will remain depressed.

Appendix 1.1. Commodity Markets

The main authors of this appendix are Kalpana Kochhar and Sam Ouliaris, with support from Hussein Allidina and Paul Nicholson.

Building on the robust increase in commodity prices during the last quarter of 2003, the index of overall primary commodity prices increased by about 27 percent in both U.S. dollar and SDR terms during the first eight months of 2004. The increase can be attributed to sizable movements in energy, raw materials, and metals prices, reflecting a surge in global demand—particularly in Asia. In energy markets, a series of geopolitical events raised concerns about the adequacy and stability of the supply of crude oil, especially with the seasonal pickup in demand approaching. Semiconductor markets consolidated their gains of late 2003 and early 2004.

Crude Oil

The main developments in oil markets during 2004 have been the rise in crude oil prices to record nominal highs, and higher price volatility.

Average[11] oil prices rose substantially during the first eight months of 2004, surpassing the record nominal highs set during the Iraqi invasion of Kuwait in 1990 (Figure 1.20). While OPEC's decision to increase official quotas by 2 million barrels a day (mbd) in July and a further 0.5 mbd in August helped to lower average prices markedly to about US$33 by mid-June, subsequent tensions in oil-exporting nations—particularly Iraq, Nigeria, Russia, and Venezuela—pushed average prices to a new record high of US$44.71 on August 19. Average prices fell to US$38.13 by early September as these tensions eased, but have since turned up once more, reflecting renewed supply concerns in Russia and an unexpected decline in U.S. inventories.

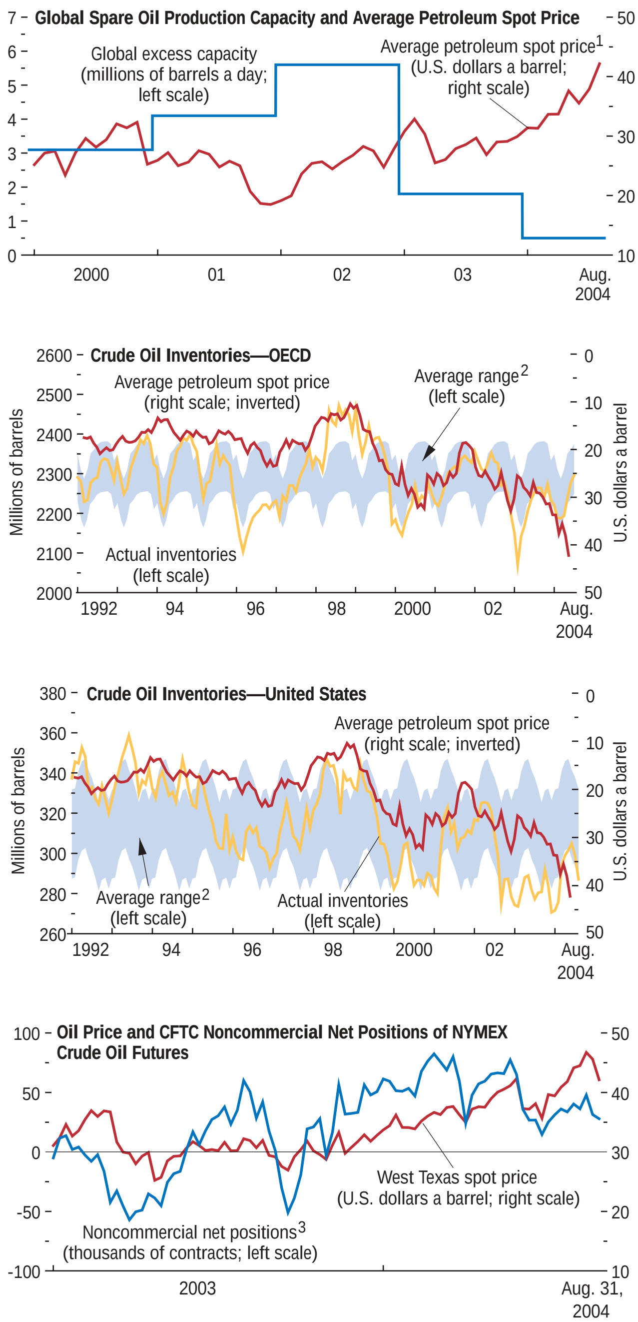
Looking ahead, futures markets suggest that oil prices will remain high for the remainder of 2004 and 2005. Higher prices are corroborated by options data on futures contracts, which reveal a steady rise—since March 2004—in the median strike price for the January 2005 Brent contract. Moreover, the range of strike prices has recently widened, especially at the upper end, suggesting greater uncertainty about the strike price and higher odds of a large price hike relative to existing levels (Figure 1.20). Finally, as of mid-September, future oil prices as far forward as 2010 were uniformly above US$30.

The surge in spot prices has been largely unanticipated—futures markets at the end of September 2003 indicated a spot price of about US$24.90 for September 2004 delivery—and appears to have reflected a number of factors.

- *Perhaps most important, as the global economic recovery has taken hold over the past year, the fact that both the level and growth in the global demand for oil have consistently outpaced expectations.* Despite significantly higher oil prices, the International Energy Agency's (IEA) latest projections envisage oil demand to increase by 3.2 percent in 2004, compared with a July 2003 forecast of only 1.3 percent. This projected increase represents the fastest annual increase in oil demand since 1980, reflecting sizable increases in demand from China, North America, and other non-OECD countries (Brazil and India in particular). The IEA expects Asia to be the principal region of growth, predicting that Chinese oil demand in particular will expand by about 15 percent in 2004—accounting for one-third of total growth in global demand in 2004. This compares with a previously projected increase for China—released in July 2003—of about 5 percent.
- *On the supply side, OPEC's February announcement of lower output targets together with disappointing growth in non-OPEC production.* While OPEC-10 members (OPEC excluding Iraq) actually kept production well above official quotas, the announcement of quota reductions from April 1 surprised the market—raising fears of actual production cuts—and was followed by large increases in oil prices. Moreover, oil production in Venezuela remains below prestrike levels, while production in Iraq—where ongoing security issues as well as aging infrastructure are complicating the task of maintaining production—has been slow to recover to prewar levels. Recent declines in U.S. and U.K. production have also limited the growth in global supply. The net result has been a sizable and somewhat unanticipated increase in the call on OPEC at a time when oil demand is rising rapidly.
- *Very low levels of spare global oil production capacity, raising concerns that the global production system will not be able to cope with an unanticipated, short-term supply shock.* The unexpected surge in oil prices prompted OPEC-10 to announce on June 10 an immediate increase in actual production by 0.8 mbd and a gradual increase in

[11]Unless noted otherwise, all subsequent references to the oil price, which is meant to reflect the global price of oil, are to the equally weighted average petroleum spot price (APSP) of three different grades of oil, namely, West Texas, Brent, and Dubai crude. The APSP is necessarily different from the price of any of these individual crudes, usually falling between the West Texas and Dubai crude prices. While the three crude oil prices move together over time, the APSP is likely to be a better estimate of global cost of oil since the world depends on a variety of crude oils for its energy.

Figure 1.21. OPEC Spare Capacity, Commercial Oil Inventories, and Speculative Activity



Sources: Commodity Futures Trading Commission (CFTC); Bloomberg Financial, LP; U.S. Department of Energy; International Energy Agency; and IMF staff calculations.

[1]Average petroleum spot price of West Texas Intermediate, U.K. Brent, and Dubai Fateh crude.

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

[3]Noncommercial net position is calculated by subtracting the short position from long positions.

official quotas to 26 mbd (effective August 1)—thereby legitimizing OPEC-10's actual end-May production levels. While this decision helped to reduce prices from the record highs recorded in early June, spare global oil production capacity is now extremely low compared with the projected growth in overall demand for 2004 and 2005. According to the IEA, OPEC-10's actual production averaged around 27.5 mbd in August 2004 and its excess capacity fell to about 0.3 mbd—less than 1 percent of global demand—compared with 5.5 mbd in July 2002 (prior to supply disruptions in Venezuela) (Figure 1.21). On September 15, OPEC decided to increase official quotas by a further 1 mbd to 27 mbd effective November 1, thereby raising quotas nearer to actual (and capacity) production levels.

A number of additional factors have also put upward pressure on oil futures prices in recent months.

- *Commercial inventories of crude oil in the OECD, though rising in recent months, remain low by historical standards—especially in the United States.* While low inventories reflect the underlying strength of global demand, and persistent backwardation in the futures market discourages inventory rebuilding, existing inventories may be too low for the normal draw that occurs in the final quarter of 2004, when the northern hemisphere enters the heating season.
- *Product markets are tighter*. Though the level of gasoline inventories measured in terms of the number of days of consumption is close to its long-run trend, strong demand for gasoline and a lack of refinery flexibility in the United States led to higher gasoline prices and gasoline crack spreads from May to July. Gasoline futures peaked at US$61.74 a barrel (US$1.47 a gallon) in May, more than US$12 a barrel above the previous peak set in 2003. More generally, though the efficiency of existing refineries has improved, global refining capacity has not kept pace with crude oil output in recent years, limiting the ability of producers to satisfy surging demand (including inventory needs). These pressures are likely to become especially

acute toward the end of 2004, as the northern hemisphere approaches its winter season.

- *Tight inventories in the context of greater geopolitical uncertainty have encouraged speculative activity in futures markets*. Speculators built a large net long position during the first half of 2004, placing further upward pressure on futures prices and increasing the sensitivity of the market to a sudden reversal in expectations. While causality is difficult to assess, net noncommercial long positions unwound as crude oil prices eased from then record highs in the first half of June.[12] Using first differences, the correlation between the net noncommercial long positions and average crude oil prices since the beginning of 2003 is about 0.6.
- *Geopolitical concerns in the Middle East have raised questions about the stability of supply, both in the short and long term*. Recent terrorist attacks in Iraq and Saudi Arabia in particular have heightened such concerns, although similar attacks in the past have not always been associated with oil price increases.
- *There is continued uncertainty regarding the status of the Russian oil firm OAS Yukos and its ability to continue to produce and sell crude oil.* The Yukos affair began last October when the Russian government made a claim for key production facilities and cash accounts of OAS Yukos as payment for US$3.4 billion in back taxes from 2000. The affair has raised concerns about the reliability of oil supplies from Russia, which recently surpassed Saudi Arabia as the world's largest producer of oil. Yukos currently produces about 2 percent of daily world oil supplies, and exports about 10 percent of its output to China.

As the *World Economic Outlook* went to press, futures markets implied an average crude oil price of US$37.66 in 2004, and $39.17 in 2005 (somewhat above the World Economic Outlook baseline). In addition, longer-term futures remain significantly higher than summer 2003 levels, reflecting expectations of a structural increase in global demand relative to supply, ongoing concerns about potential long-term disruptions to crude oil supply from the Middle East, and the likelihood of slower growth in oil production from non-OPEC countries.

While proven reserves remain plentiful, the key issue in the global oil market appears to be low excess capacity and the adequacy of existing capacity expansion projects relative to the potential increase in global demand. Today's limited spare capacity reflects in part stalled investment in capacity expansion projects by OPEC-11 members during the 1990s owing to persistently low real oil average oil prices during 1985–2000 (Figure 1.22). Existing capacity expansion projects appear limited even though futures markets suggest that crude oil prices will remain above the minimum levels needed to justify additional investment. Though productive capacity is expected to increase by approximately 1 mbd before the end of 2004 owing to expansion projects in Saudi Arabia, Kuwait, and United Arab Emirates, spare capacity is likely to remain tight because of a seasonal surge in demand during the second half of 2004. Moreover, trend growth in demand is expected to consume any additional capacity coming on stream in 2005, while growth in non-OPEC oil production may slow from its present highs. As such, the oil market is likely to remain dependent on all oil-exporting nations producing at close to maximum capacity, raising the likelihood of price spikes if productive capacity is compromised.

Nonenergy Commodity Prices

Following a marked increase in nonenergy commodity prices during the second half of 2003, nonenergy commodity prices experienced further but relatively modest gains during the first eight months of 2004. The slower increases coincided with attempts by China—a large consumer of nonenergy commodities—to cool the pace of its economic expansion, and moves by

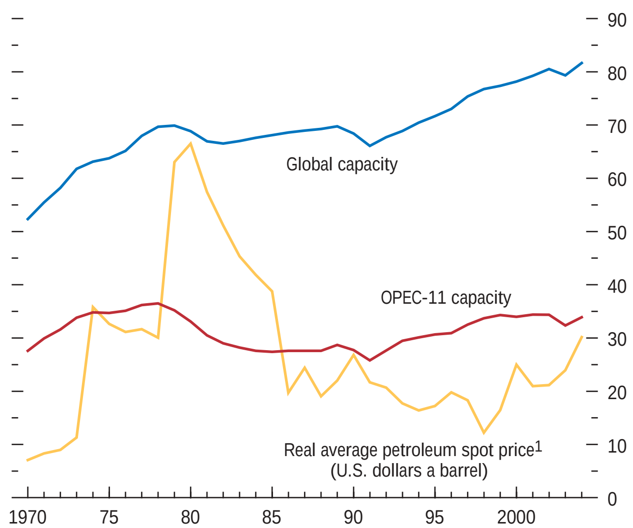
[12]The September 2004 *Global Financial Stability Report* reviews hedge fund activity in oil markets in greater detail.

Table 1.12. Commodity Consumption in Selected Countries[1]
(Percent of world consumption)

	China	United States	Japan	India
Wheat	17.2	5.5	1.0	11.8
Soybeans	16.0	24.7	2.1	2.7
Cotton	34.1	5.8	0.7	13.6
Copper	19.8	14.9	7.8	2.0
Aluminum	19.0	20.3	7.4	2.8
Steel	26.5	11.9	8.0	. . .
Petroleum	7.7	25.2	6.6	2.8

Sources: Commodity Research Bureau, U.S. Geological Survey, U.S. Department of Agriculture, International Cotton Advisory Committee, CRU International, International Energy Agency, U.N. Commodity Trade Statistics Database, World Bureau of Metal Statistics, and IMF staff estimates.
[1]Most recent estimates of consumption.

Figure 1.22. Global Production Capacity and Real Average Petroleum Spot Price
(Millions of barrels a day)



Sources: U.S. Department of Energy (Energy Information Agency); British Petroleum Review; and IMF staff calculations.
[1]Average petroleum spot price of West Texas Intermediate, U.K. Brent, and Dubai Fateh crude. Adjusted by the U.S. CPI with 1994 = 100.

the Federal Reserve to raise U.S. interest rates (Table 1.12). The IMF index of nonenergy commodity prices increased by 8 percent in both U.S. dollar and SDR terms since the start of 2004 (Table 1.13). Growth in the index has recently paused, owing to weakness in food prices in particular, reflecting the impact of favorable harvests. Additional downward pressure on prices has resulted from liquidation in speculative long positions as a number of commodities peaked at multiyear highs (Figure 1.23). Looking forward, nonenergy commodity prices are expected to remain flat or decline marginally in the coming months, but with upside potential toward the end of 2004 owing to depleted inventories (especially of metals) and a robust global economy.

Turning to specific components of the index, by the end of August the overall index of food prices had increased by 3 percent since the beginning of 2004. Rice prices, after a lackluster performance in 2003, increased by 28 percent as a disappointing harvest in China resulted in above-average imports. Relatively low global rice stocks have also supported prices. Maize prices continued their ascent from 2003, recording an increase of 10 percent during the first half of 2004. However, favorable harvests in the United States eventually caused prices to dip by 7 percent by end-August. After increasing to their highest level in over a decade, soybean prices have fallen by 21 percent as Chinese imports declined significantly and farmers in Brazil and

Table 1.13. Nonenergy Commodity Prices
(Percent change from December 2003 to August 2004)

	U.S. Dollar Terms	Contribution[1]	SDR Terms
Food	2.7	43.1	1.9
Beverages	5.2	3.0	5.4
Agricultural raw materials	9.0	21.4	9.2
Metals	15.3	32.5	15.5
Overall nonenergy	8.2	100.0	8.0

Sources: IMF, Primary Commodity Price Database; and IMF staff estimates.
[1]Contributions to change in overall nonenergy price index in U.S. dollar terms, in percent. Contributions to change in SDR terms are similar.

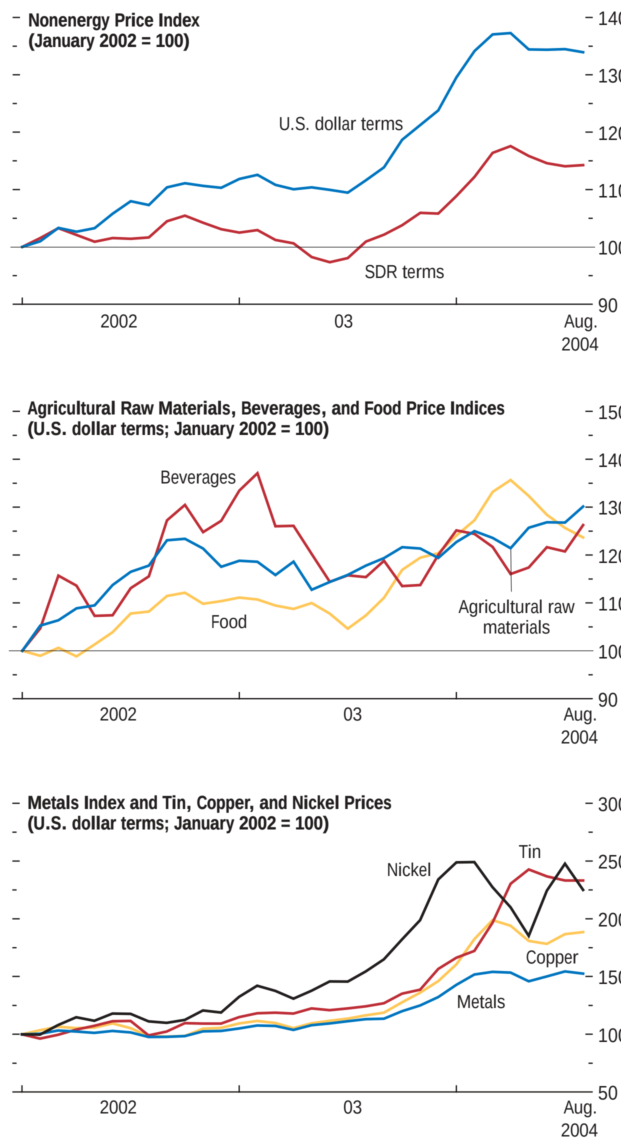
Argentina delivered a newly harvested crop. Favorable harvests in the United States also contributed to the recent move toward lower prices. Meat prices increased by a sizable 24 percent on strong demand reflecting the shift toward low-carbohydrate diets.

Beverage prices increased by 5 percent by end-August. Coffee prices increased by 8 percent, reaching a three-year high on speculation concerning adverse Brazilian weather conditions. However, coffee prices have since eased as the Brazilian concern proved unfounded. Fundamentals for coffee remain weak, as consumption remains static and global stockpiles are abundant. Cocoa prices, which fell sharply during 2003, increased by 5 percent on strong demand and reduced harvests in Côte d'Ivoire.

Agricultural raw materials prices increased by 9 percent, buoyed by growth in softwood lumber prices. As the trade dispute between Canada and the United States continues, softwood lumber prices have increased by over 40 percent on robust demand deriving from the U.S. housing market. Cotton prices declined considerably, falling by 27 percent on expectations of record harvests in the United States and China.

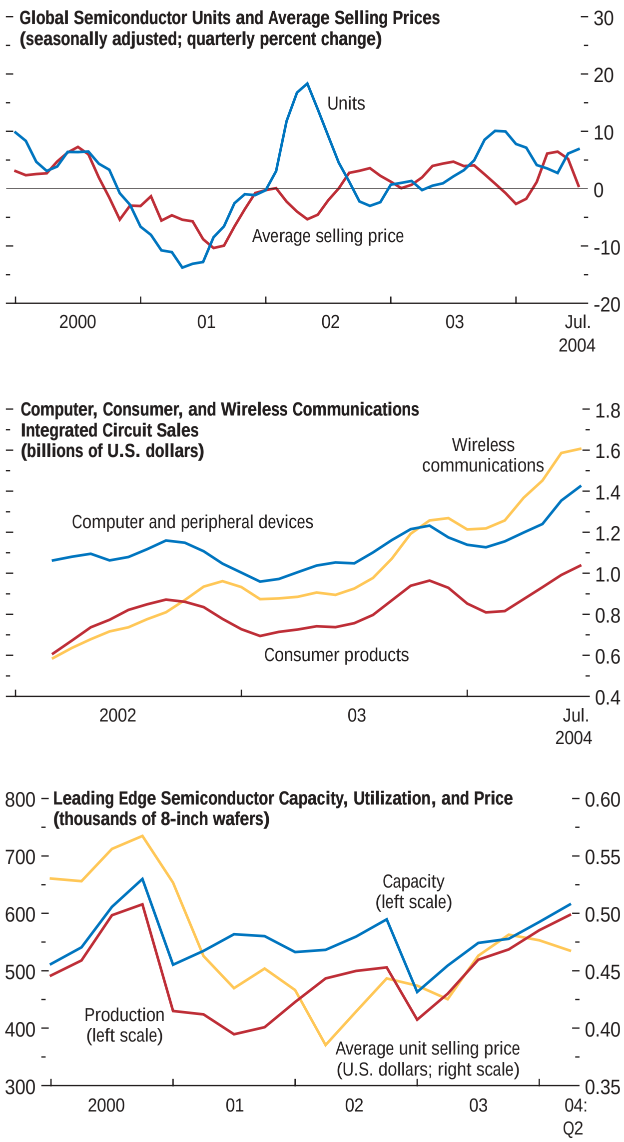
After surging to multiyear highs and recording growth of nearly 20 percent in the second half of 2003, metals prices increased by 15 percent through the end of August and their volatility remained high. Liquidation of speculative long positions resulted in prices easing markedly during the second quarter of 2004. Nickel prices led the decline, plunging by 21 percent through

Figure 1.23. Nonenergy Commodities



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

Figure 1.24. Semiconductor Market



Sources: World Semiconductor Trade Statistics; Semiconductor International Capacity Statistics; and IMF staff calculations.

May, owing to substitution, de-stocking, and higher production. In spite of this, nickel prices have recently rebounded and are now down from 2003 levels by only 4 percent. Nickel prices are expected to firm as inventories have fallen significantly, prompting renewed speculative interest. Copper prices increased by 29 percent on robust global demand and falling stocks. Tin prices have appreciated by 49 percent as supply tightness and strong demand have buoyed prices. Citing low metals inventories and the strong pace of growth in the global economy, market analysts are suggesting a second price peak in metals will occur later this year and into the beginning of next year.

Semiconductor Markets

Sales in semiconductor markets strengthened further during the first half of 2004, building on the strong recovery in 2003. Seasonally adjusted figures show 15 consecutive months of substantial growth in receipts—especially in the Asia-Pacific region excluding Japan. Moreover, sales for July are 15 percent higher than December 2003 levels, while unadjusted semiconductor receipts are 4 percent higher than corresponding sales in the boom year of 2000—confirming that the recovery has indeed taken hold. Analysts expect 2004 to be a very strong year for semiconductor sales. Much of the strength in receipts comes from unit sales rather than higher prices, while most of the volume can be attributed to surging demand for wireless goods in particular (Figure 1.24).

Capacity utilization in the leading-edge facilities is extremely tight—running at over 97 percent—owing to the surge in demand for wireless goods. While tight capacity had raised concerns that the market would not be able to cope with surging demand this year, average prices for the industry remain well below 2000 levels, and price rallies on spot markets caused by shortages for key integrated circuits have stalled or even reversed. However, given that some business and consumer technology purchasing indicators remain strong, prices are expected to increase in the third and fourth quarters—traditionally the strongest quarters for sales. Though 2004 is likely to be a good year for the semiconductor market, some analysts are expressing reservations about the market's prospects in 2005. Compared with the broader stock market, more companies in the technology sector are reporting earnings below expectations. Investment in capacity expansion is at a record high. In particular, global semiconductor equipment sales remain strong (the ratio of future orders to current shipments is 1.05, implying further increases in productive capacity). High levels of actual production are now outpacing demand, leading to an increase in inventory levels in key segments of the industry and forcing average selling prices down. Some market observers fear that the extra investment and the higher production that will result will lead to a large increase in inventories, placing further downward pressure on prices in the first quarter of 2005, when demand is at its seasonal low. Any inventory overhang and / or excess capacity could depress prices for the remainder of 2005.

Macroeconomic Impact of Higher Crude Oil Prices

Crude oil prices remain a key determinant of global economic prospects. Higher prices affect the global economy through a variety of channels.

- There is a transfer of income from oil consumers to oil producers. As oil producers have a lower propensity to consume than oil consumers on average, global demand falls.
- The cost of production of goods and services rises, possibly reducing profit margins. In the case of advanced countries, this supply-side effect, which was sizable during the 1970s, has fallen in the past three decades in line with their reduced dependency on oil. In contrast, for developing countries, which have not reduced their dependency on oil as much as industrial nations, the supply-side impact is likely to be relatively higher.
- Inflation rises by an amount that depends on the degree of monetary tightening associated with the oil price rise and the extent to which consumers and producers can offset the declines in incomes and profits, respectively.
- Associated movements in actual and anticipated economic activity, corporate earnings, inflation, and monetary policy affect equity and bond valuations, causing financial markets to react adversely to higher oil prices. The follow-on effects in terms of investor confidence and willingness to commit to longer-term capital projects may lower growth prospects further.
- Depending on the duration and extent of the price increases, the change in relative prices creates incentives for suppliers of energy to increase production and investment, and for oil consumers to move toward other sources of energy.

Table 1.14. Impact of a Permanent US$5 a Barrel Increase in Crude Oil Prices After One Year
(Percent of GDP)

	Real GDP	Inflation	Trade Balance
World GDP	–0.3	. . .	
Industrial Countries	–0.3	0.2	–0.1
United States	–0.4	0.3	–0.1
Euro area	–0.4	0.3	–0.1
Japan	–0.2	0.1	–0.2
Other	–0.2	0.1	0.1
Developing Countries			
Latin America	–0.1	0.6	0.0
Argentina	–0.2	0.1	0.1
Brazil	–0.2	1.0	–0.2
Chile	–0.2	1.0	–0.7
Mexico	—	0.1	0.2
Asia	–0.4	0.7	–0.5
China	–0.4	0.4	–0.3
India	–0.5	1.3	–0.6
Emerging Europe and Africa	0.1	0.3	0.2
Poland	–0.3	—	–0.4
Russia	0.7	—	1.8
South Africa	–0.4	1.2	–0.9
Turkey	–0.2	. . .	–0.3

Sources: IMF (2000), and IMF staff estimates.

Estimates of the impact of oil price shocks on the global economy, as reported in IMF (2000), suggest that a US$5 increase in oil prices would reduce global growth by about 0.3 percentage point after one year (Table 1.14). The overall response of a specific region or country differs

Table 1.15. Impact of Nominal Oil Price Hikes
(US$ unless otherwise stated)

	Oil Prices				Direct Impact on Net Trade Balance of Advanced Countries	
	Pre-hike[1]	Post-hike[2]	Change	Percent change	US$ billions	Percent of GDP
1973–74	3.3	11.6	8.3	252	–88	–2.6
1978–80	12.9	35.9	23.1	179	–232	–3.7
1989–90	17.9	28.3	10.4	58	–38	–0.2
1999–2000	18.0	28.2	10.3	57	–96	–0.4
2003–04	28.9	37.3	8.4	29	–107	–0.3

Source: IMF staff estimates.
[1]The average price in the first year of each episode.
[2]The average price in the last episode, except for 1990 and 2004. For 1990 it is the average price for the second half of the year. For 2004, the price is projected using futures market data.

depending on the relative importance of the (first four) short-run links between activity and oil prices indicated above, as well as the underlying flexibility of individual economies to absorb shocks (especially real wage rigidity). The estimated impact is higher in the United States and euro area—about 0.4 percentage point—largely because of their higher dependence on oil and, in the case of the euro area, rigidities in labor markets that limit the pace and extent of real wage adjustments. The impact on the group "other industrial countries" is smaller because the largest two members of this group—the United Kingdom and Canada—are net oil exporters. The negative impact on Japan at 0.2 percentage point is smaller than other industrial countries because of high efficiency in energy consumption and heavy reliance on nuclear power. For emerging market economies, the negative impact on Asia is the largest at 0.4 percentage point because of a larger presence of net-oil-importing nations in its aggregate economic activity. Africa and emerging Europe are less affected by the shock owing to the larger influence of net oil exporters. While oil exporters clearly stand to benefit from the direct impact of higher oil prices, lower domestic demand and substantial second-round effects cause overall activity to decline for some oil-exporting countries (e.g., Argentina)—see IMF (2000) for a detailed analysis.

Turning to the price level effects of higher oil prices, core inflation rises in all countries, with the magnitude depending in part on the extent of labor market rigidities. Inflation is higher by 0.3 percentage point in the United States and euro area, 0.6 percentage point in Latin America, and 0.7 percentage point in Asia. Asia tends to experience the largest increase in inflation because a rapid pass-through of oil price rises to domestic prices.[13]

As of mid-September 2004, futures prices implied an average 2004 oil price of around US$37 a barrel, or about US$8 (or 30 percent) a barrel higher than average 2003 levels. According to IMF (2000), this increase, if permanent, would be likely to reduce world output by approximately ½ percentage point after one year—a relatively small amount compared with the 4.3 percent World Economic Outlook global growth projection for 2005.[14] Moreover, the negative impact of the increase appears moderate when compared with the impact of four previous oil price spikes that have occurred since 1973 (Table 1.15). The estimated impact of the US$8 increase on the net trade balance for advanced

[13]While these price level and activity effects are calibrated for only a single year, it should be noted that the higher oil prices will also affect activity and inflation—both core and headline—in subsequent years.

[14]The World Economic Outlook global growth projection would likely be revised by less than 0.3 percentage point to the extent that higher oil prices reflect stronger activity than envisaged in the last set of projections.

Table 1.16. Movements in the IMF Commodity Price Index
(U.S. dollar terms, 1995 = 100)

	2003	2004[1]	Percent Change
All commodities and energy	119.7	148.8	24.3
Nonfuel commodities	82.1	95.9	16.8
Food	86.1	98.9	14.9
Beverages	66.5	65.0	–2.2
Agricultural	81.1	84.6	4.3
Raw materials			
Metals	80.4	105.6	31.3
Energy	160.6	206.4	28.5
Petroleum crude spot	167.9	216.5	29.0

Source: IMF staff estimates.
[1]Projected value for 2004.

Table 1.17. Trade Gains and Losses from Commodity Price Movements: Emerging Market and Developing Countries
(Percent of nominal GDP for 2003)

	Nonenergy[1]	Oil	Total
HIPC			
Oil exporters	0.35	6.14	6.48
Oil importers	0.80	–1.02	–0.22
CIS and Mongolia			
Oil exporters	0.79	3.35	4.14
Oil importers	0.19	–1.28	–1.09
Other emerging market countries			
Oil exporters	0.34	3.22	3.56
Oil importers	0.38	–0.53	–0.15
Overall impact	0.40	0.95	1.35
Oil exporters	0.40	3.32	3.72
Oil importers	0.40	–0.56	–0.16

Source: IMF staff estimates.
[1]Excludes impact of increases in non-oil commodity imports.

countries in 2004 is at about –0.3 percent of GDP, which is less than one-tenth of the average effect attributable to the two oil price shocks in the 1970s. The smaller impact reflects both the reduced dependency of industrial countries on crude oil compared with the 1970s and the significantly smaller percentage increase in nominal (and hence real) crude oil prices relative to the oil price shocks of the 1970s.

How Will Recent Commodity Price Changes Affect Emerging Markets and Developing Countries?

Though the share of primary commodities in global output has declined in recent decades, movements in commodity prices can still have a substantial impact on the global economy and individual countries. The impact of the recent broad-based run-up in commodity prices is therefore of interest, given that it was largely driven by strong global demand (Table 1.16). In particular, it would be useful to gauge the extent to which the impact of significantly higher oil prices on net oil-importing commodity producers is offset by the higher nonenergy commodity prices.

Movements in specific nonenergy prices can affect activity by raising the costs of production, though typically by a much smaller amount than oil prices because of their smaller share in global output. Even if the ultimate impact on global activity is relatively minor, a rise in nonenergy commodity prices will obviously cause a redistribution of income from net-importing to net-exporting nations. Given that many developing countries rely on only a few nonenergy commodities for the bulk of their export earnings and often have limited access to capital markets, a rise in nonenergy commodity prices may have a significant impact on their gross domestic product—one that could be transmitted to other developing countries via the normal channels of international trade.

The first-round effect of commodity price movements on individual countries can be approximated by the initial change in net export earnings without accounting for second-round effects (Table 1.17). This approach suggests that the projected increase in the average crude oil price in 2004 since 2003—namely, US$8 or 30 percent—will increase the import bill of emerging market and developing countries by approximately 0.6 percent (measured relative to nominal GDP for 2003). This negative impact, however, will be more than offset by the increase in oil revenue accruing to its oil-exporting members—about 3.3 percent of GDP. The overall oil-related net trade balance effect is estimated to be around 1 percent.

The negative impact of the oil price increase for net oil importers is of course tempered by the rise in nonenergy commodity prices. Indeed, for some oil-importing nations, the gains from movements in nonenergy commodity prices exceed the losses from higher crude oil prices. Emerging market economies and developing countries typically benefit from the increase in nonenergy commodity prices, reflecting in part their dependence on such commodities for export revenue. The overall gain in the net trade balance owing to nonenergy price movements, expressed as a percentage of nominal GDP for 2003, is estimated at 0.4 percent, leaving only a moderate net impact on emerging market economies and developing countries. While there are in fact overall losers—mainly some CIS and sub-Saharan African nations—their losses typically amount to less than 1 percent of nominal GDP.

A similar outcome arises for the "other emerging market" grouping of countries, which for the most part consists of exporters of nonenergy commodities. Relative to the HIPC and CIS-7 grouping, however, there will be a greater number of net losers, reflecting the dominance of the negative oil price impact on the trade balance. The list of countries with an overall loss of nominal GDP exceeding 1 percent is led by Cape Verde, which is a net importer of oil that derives little, if any, gains from the increase in nonenergy commodity prices.

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