CHAPTER I ECONOMIC PROSPECTS AND POLICY ISSUES

The expansion remains broadly on track, with global growth forecasts for 2005 and 2006 largely unchanged from the last *World Economic Outlook* (Table 1.1 and Figure 1.1), although risks are still slanted to the downside. Following a temporary slowdown in mid-2004, global GDP growth picked up through the first quarter of 2005, with robust services sector output more than offsetting slowing global growth in manufacturing and, latterly, trade. In the second quarter, however, in part reflecting the impact of higher oil prices, signs of a renewed "soft patch" emerged, with leading indicators turning downward and business confidence weakening in most major countries (Figure 1.2). While global manufacturing and trade are now strengthening, and leading indicators have picked up, the continuing rise in crude oil and refined product prices—latterly exacerbated by the catastrophic effects of Hurricane Katrina—is an increasingly important offset.

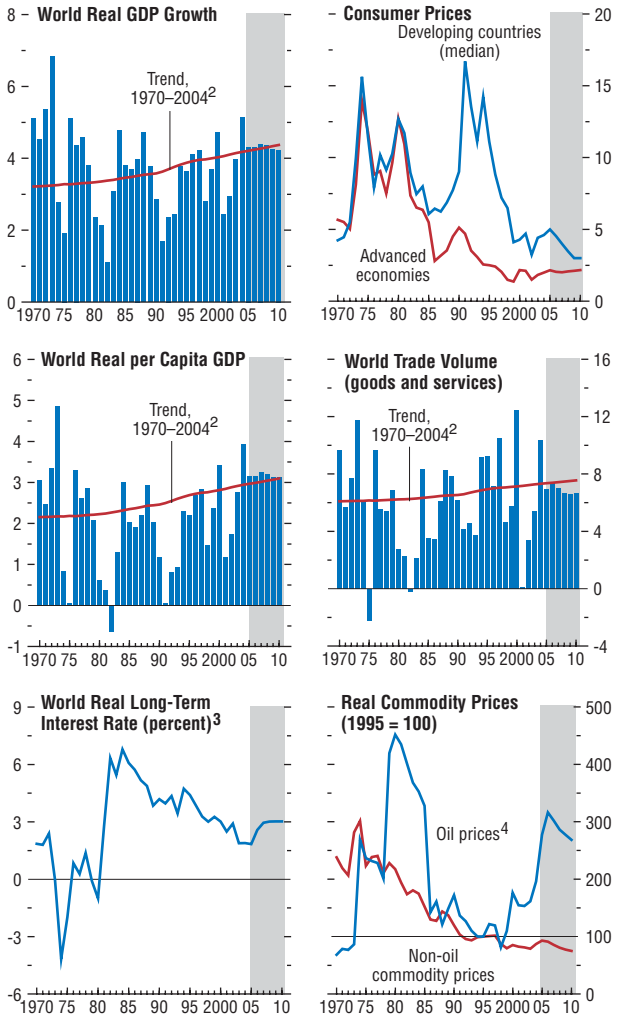
Within this broad picture, the regional differences highlighted in the April 2005 *World Economic Outlook* have become more marked:

- *Global current account imbalances—a key medium-term risk to the outlook—have increased yet again.* The U.S. current account deficit is now projected to rise to over 6 percent of GDP in 2005, 0.3 percent of GDP higher than projected in April, driven by higher oil prices and continued relatively strong domestic demand. On the surplus side, the key counterparts are Japan; China; the Middle East oil exporters, which as a result of soaring oil prices are now running a larger surplus in U.S. dollar terms than emerging Asia; the Commonwealth of Independent States; and some small industrial countries. Even so, capital inflows to the United States have remained strong, aided by robust private and official flows.

Figure 1.1. Global Indicators[1]

(Annual percent change unless otherwise noted)

Global growth is projected to be slightly above trend in 2005–06, while inflation remains moderate.



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

[2]Average growth rates for individual countries, aggregated using PPP 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 Fateh, and West Texas Intermediate crude oil.

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

(Annual percent change unless otherwise noted)

			Current Projections		Difference from April 2005 Projections	
	2003	2004	2005	2006	2005	2006
World output	**4.0**	**5.1**	**4.3**	**4.3**	**—**	**–0.1**
Advanced economies	1.9	3.3	2.5	2.7	–0.1	–0.3
United States	2.7	4.2	3.5	3.3	–0.2	–0.3
Euro area	0.7	2.0	1.2	1.8	–0.4	–0.5
Germany	–0.2	1.6	0.8	1.2	—	–0.7
France	0.9	2.0	1.5	1.8	–0.5	–0.4
Italy	0.3	1.2	—	1.4	–1.2	–0.6
Spain	2.9	3.1	3.2	3.0	0.5	0.1
Japan	1.4	2.7	2.0	2.0	1.2	—
United Kingdom	2.5	3.2	1.9	2.2	–0.7	–0.4
Canada	2.0	2.9	2.9	3.2	0.1	0.2
Other advanced economies	2.5	4.4	3.2	3.9	–0.2	—
Newly industrialized Asian economies	3.1	5.6	4.0	4.7	—	–0.1
Other emerging market and developing countries	6.5	7.3	6.4	6.1	0.1	0.1
Africa	4.6	5.3	4.5	5.9	–0.4	0.5
Sub-Sahara	4.1	5.4	4.8	5.9	–0.4	0.4
Central and eastern Europe	4.6	6.5	4.3	4.6	–0.2	0.1
Commonwealth of Independent States	7.9	8.4	6.0	5.7	–0.5	–0.2
Russia	7.3	7.2	5.5	5.3	–0.5	–0.3
Excluding Russia	9.2	11.0	7.1	6.8	–0.6	–0.2
Developing Asia	8.1	8.2	7.8	7.2	0.3	—
China	9.5	9.5	9.0	8.2	0.5	0.2
India	7.4	7.3	7.1	6.3	0.5	–0.1
ASEAN-4	5.4	5.8	4.9	5.4	–0.5	–0.4
Middle East	6.5	5.5	5.4	5.0	0.3	0.1
Western Hemisphere	2.2	5.6	4.1	3.8	—	0.1
Brazil	0.5	4.9	3.3	3.5	–0.4	—
Mexico	1.4	4.4	3.0	3.5	–0.8	0.3
Memorandum						
European Union	1.3	2.5	1.6	2.1	–0.4	–0.4
World growth based on market exchange rates	2.6	4.0	3.1	3.2	—	–0.2
World trade volume (goods and services)	**5.4**	**10.3**	**7.0**	**7.4**	**–0.5**	**–0.2**
Imports						
Advanced economies	4.1	8.8	5.4	5.8	–1.1	–0.5
Other emerging market and developing countries	11.1	16.4	13.5	11.9	1.5	0.9
Exports						
Advanced economies	3.1	8.3	5.0	6.3	–0.9	–0.5
Other emerging market and developing countries	10.8	14.5	10.4	10.3	0.4	0.6
Commodity prices (U.S. dollars)						
Oil[1]	15.8	30.7	43.6	13.9	20.5	19.8
Nonfuel (average based on world commodity export weights)	6.9	18.5	8.6	–2.1	4.7	3.0
Consumer prices						
Advanced economies	1.8	2.0	2.2	2.0	0.2	0.2
Other emerging market and developing countries	6.0	5.8	5.9	5.7	0.4	1.1
London interbank offered rate (percent)[2]						
On U.S. dollar deposits	1.2	1.8	3.6	4.5	0.3	0.4
On euro deposits	2.3	2.1	2.1	2.4	–0.2	–0.5
On Japanese yen deposits	0.1	0.1	0.1	0.2	–0.1	–0.2

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during July 8–August 5, 2005. See Statistical Appendix for details and groups and methodologies.

[1]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 $37.76 in 2004; the assumed price is $54.23 in 2005, and $61.75 in 2006.

[2]Six-month rate for the United States and Japan. Three-month rate for the euro area.

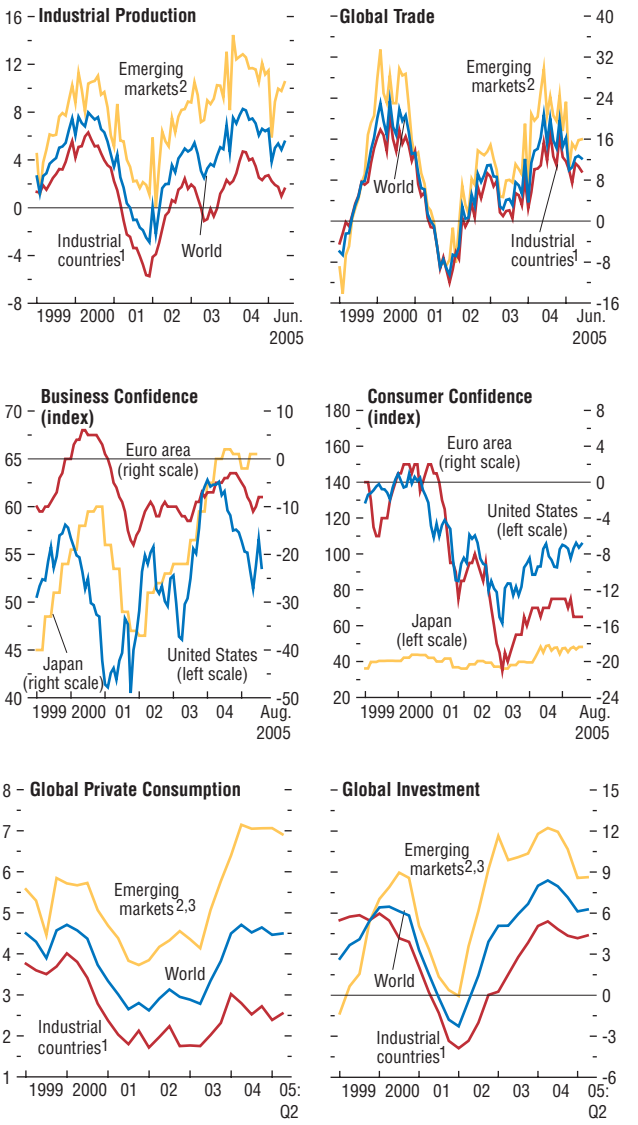
- *Associated with this, growth divergences across regions remain wide.* The expansion has continued to be led by the United States and China, where the growth momentum has remained robust. Growth projections for 2005 in most other regions have been marked downward—with the important exceptions of Japan and India—with the renewed weakness in the euro area of particular concern. Monetary policy stances are becoming correspondingly more differentiated: the Federal Reserve and the Bank of Canada have raised policy rates, the European Central Bank and the Bank of Japan have remained on hold, and the Bank of England and the Swedish Riksbank have reduced interest rates in recent months.
- *Despite the further rise in the U.S. current account deficit, the U.S. dollar appreciated modestly in trade-weighted terms during the first eight months of 2005* (Figure 1.3). Movements in industrial country currencies varied widely, with the Canadian dollar appreciating further and the yen and euro depreciating, the latter seemingly reflecting increasingly unfavorable short-term interest rate differentials and growing political uncertainties in Europe following the rejection of the European Union's constitution in France and the Netherlands. In emerging markets, bilateral exchange rate movements against the U.S. dollar were diverse, but—except in the ASEAN-4—trade-weighted exchange rates have generally appreciated, particularly in Latin America. Following the Chinese exchange reform on July 21, 2005—including a 2.1 percent revaluation, the adoption of a reference basket of currencies, and a 0.3 percent daily fluctuation range against the U.S. dollar—the renminbi has remained broadly unchanged against the U.S. dollar; movements in other regional currencies—bar the Indonesian rupiah, which came under significant pressure in late August—have generally been modest.

Oil prices have continued their ascent, hitting a new nominal high of some $65 a barrel in late August, before falling back somewhat thereafter (Appendix 1.1, "Recent Developments in

Figure 1.2. Current and Forward-Looking Indicators

(Percent change from a year ago unless otherwise noted)

Global industrial production and trade growth slowed during 2004, but show tentative signs of stabilizing.



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.

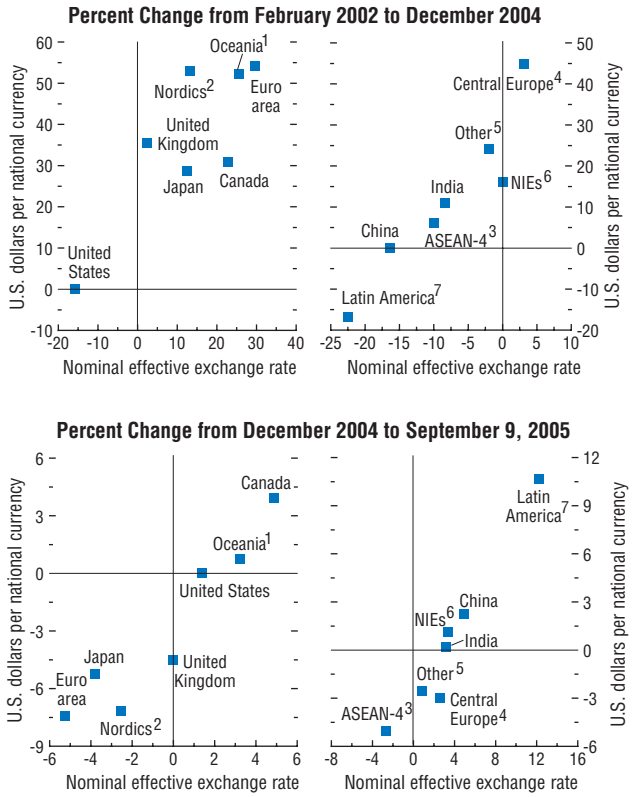
[1] Australia, Canada, Denmark, euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom, and the United States.

[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.

Figure 1.3. Global Exchange Rate Developments

After depreciating steadily since early 2002, the U.S. dollar has appreciated so far in 2005, offset primarily by a depreciation of the euro, pound sterling, and yen.



Sources: Bloomberg Financial Markets, 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, South Africa, and Turkey.
[6] Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.
[7] Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

Commodity Markets").[1] Despite the recent OPEC quota increase, markets remain concerned that the current very low spare production capacity will be insufficient to meet demand growth next winter, while short-term supply uncertainties have persisted, most recently as the result of the extensive damage to oil production and refining facilities in the Gulf Coast of the United States caused by Hurricane Katrina. While the impact of Hurricane Katrina on crude oil prices has been contained by releases from strategic reserves, as well as an offer by Saudi Arabia to boost crude production by 0.5 million barrels a day, shortages in refining capacity have added to pressures on refined product prices, particularly in the United States. More generally, while strong demand continues to play a key role in oil market developments, recent price pressures also appear to reflect growing concerns about future tightness in oil markets; consistent with this, long-run futures prices have moved increasingly closely with short-run spot prices, suggesting greater uncertainty about the stability of long-run market fundamentals.[2] Nonfuel commodity prices, which in aggregate remained stable during much of 2004, have since picked up in response to both strong demand—especially for metals—and supply disruptions, including bad weather. After weakening sharply in the second half of 2004, semiconductor revenues picked up in early 2005, particularly in the United States; correspondingly, industry analysts revised upwards their sales forecasts for 2005. However, the underlying strength of the upturn is still uncertain, and revenues have been declining recently.

Global headline inflation has picked up slightly in response to higher oil prices, but remains at moderate levels (Figure 1.4). Among the major industrial countries, core inflation

[1]The oil price used in the *World Economic Outlook* is the simple average of the spot prices of West Texas Intermediate, U.K. Brent, and Dubai crudes.

[2]See "Will the Oil Market Continue to Be Tight?" *World Economic Outlook*, April 2005, for a detailed discussion of factors affecting long-run oil demand and supply.

appears generally contained, inflationary expectations well-anchored, and wage increases moderate, although the impact of higher oil prices—and, in the United States, rising unit labor costs—will need to be carefully watched. Inflationary pressures have risen somewhat more in emerging markets, with forecasts for 2005 revised upward in most regions. With inflationary expectations in these countries generally less well anchored, the impact of oil price or other shocks is inevitably more pronounced; in addition, overheating pressures in some countries with large external surpluses are playing an increasing role.

Financial market conditions remain benign (Figure 1.5).[3] Long-run interest rates, while volatile, continue to be unusually low around the world; global equity markets have remained resilient, supported by strong corporate profits and increasingly solid balance sheets; and, apart from some rise in high yield spreads, credit spreads remain moderate. Emerging market financing conditions are very favorable (Figure 1.6), in part reflecting improved economic fundamentals and the increased presence of long-term investors, but also the continued search for yield; while net private capital inflows are projected to decline in 2005, this primarily reflects recycling of surpluses in oil producers (Table 1.2). Financial institutions' balance sheets appear relatively solid, although with long-run interest rates low and yield curves flattening, market participants have sought to boost returns through increasingly complex and leveraged strategies. Some of those trades resulted in material losses by a number of hedge funds when General Motors and Ford were downgraded, although the impact was relatively contained and the ensuing turbulence did not spill over into other markets.

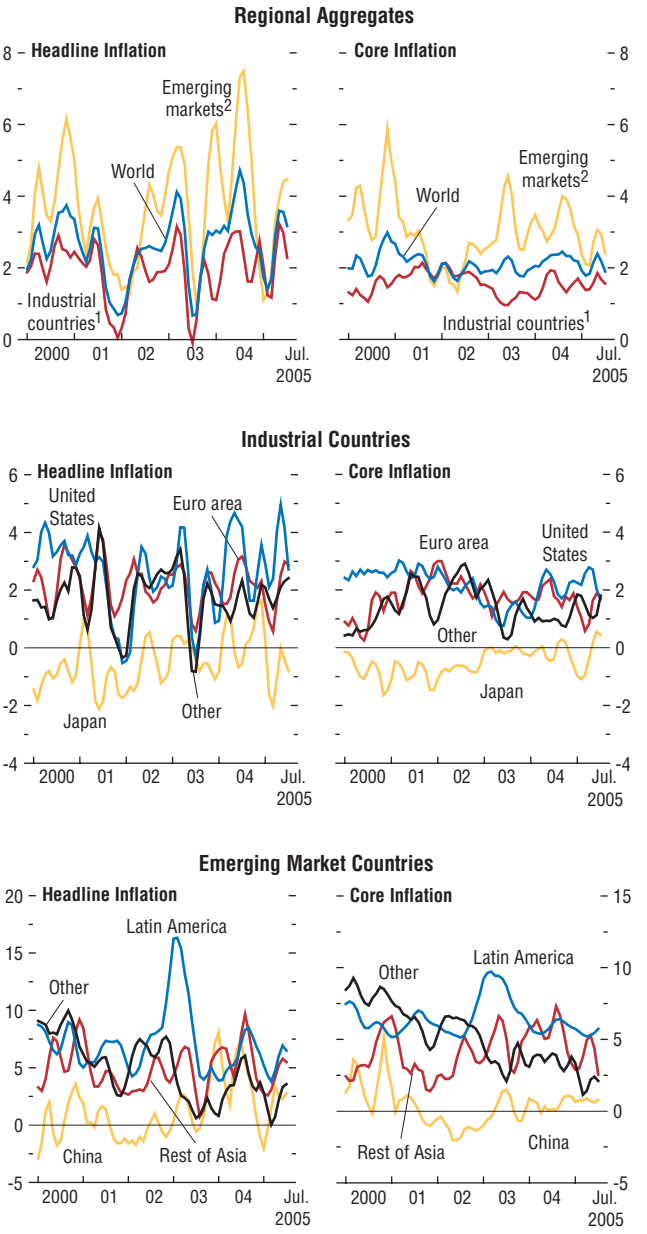
The low level of long-run interest rates across the globe remains, in the words of Federal Reserve Chairman Greenspan, a conundrum.

[3]See the September 2005 *Global Financial Stability Report* for a detailed discussion.

Figure 1.4. Global Inflation

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

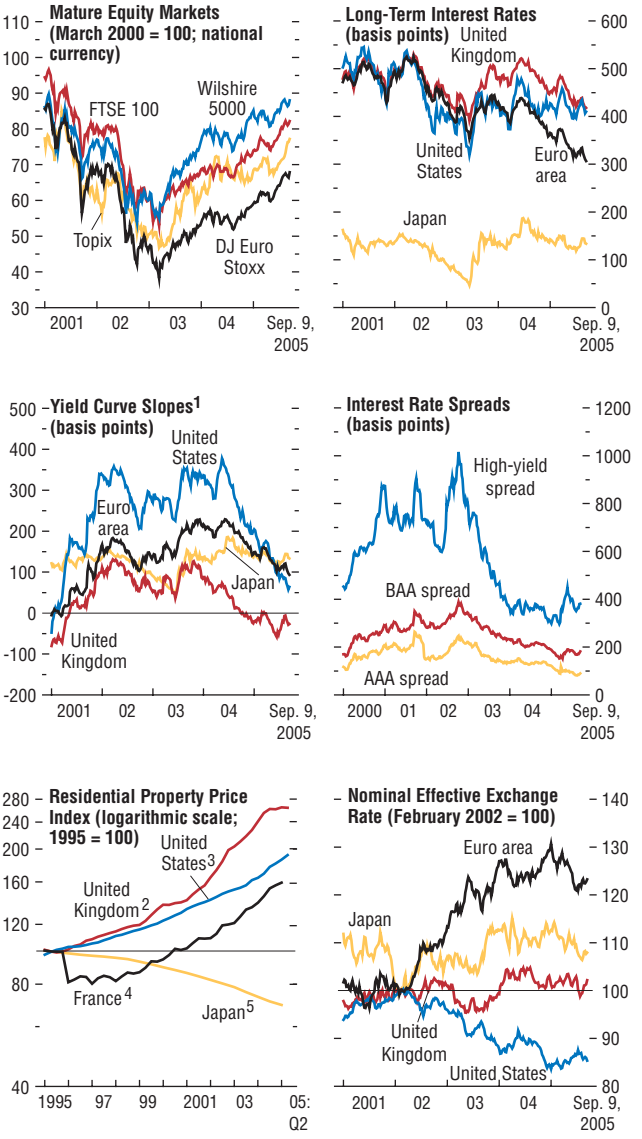
Headline inflation has risen with higher oil prices, along with some increase in core inflation in emerging markets.



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

Figure 1.5. Developments in Mature Financial Markets

Long-term interest rates have fallen back across the globe, accompanied by flattening yield curves.



Sources: Bloomberg Financial Markets, LP; Office of Federal Housing Enterprise Oversight; Japan Real Estate Institute; Halifax; National Institute for Statistics and Economic Studies; and IMF staff calculations.

[1] Ten-year government bond minus three-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] Housing price index: all homes.

[5] Urban land price index: average of nationwide residential areas.

While this partly reflects low and well-anchored inflationary expectations, real interest rates remain well below historical averages, a situation difficult to reconcile with economic fundamentals, including rising public debt. Given that low interest rates are a global phenomenon, the causes seem likely to be global in nature. While financial market factors are clearly contributing,[4] trends in actual and desired global saving and investment likely also play an important role (Chapter II, "Global Imbalances: A Saving and Investment Perspective"). One widely cited view (see Bernanke, 2005) is that the rise in saving in emerging markets has led to a global "savings glut," driving down global interest rates and—through its effects on asset prices—contributing to the steady fall in household saving in industrial countries. However, as can be seen from Figure 1.7, other factors have also been important. Beyond the deterioration in the fiscal positions in industrial countries, which has substantially reduced global savings since 2000, the rising surplus in the corporate sector in industrial countries is particularly striking. As a share of GDP, corporate profits in industrial countries are historically high, while private nonresidential investment is unusually low, suggesting that post-bubble corporate caution, excess capacity, or other structural and balance sheet constraints are—to varying extents—still at play. Similar trends can also be observed in many emerging markets, particularly in emerging Asia (except China, where corporate saving and investment have both risen sharply).

Correspondingly, corporate sector behavior—and in particular the disposition of record net surpluses—will be key for the global outlook in coming years. One scenario—broadly consistent with the World Economic Outlook baseline forecast—is that as balance sheet restructuring nears completion, and with corporate liquidity at unprecedented levels, both corporate invest-

[4] See the September 2005 *Global Financial Stability Report* for a discussion, including the increasing demand for duration by pension funds.

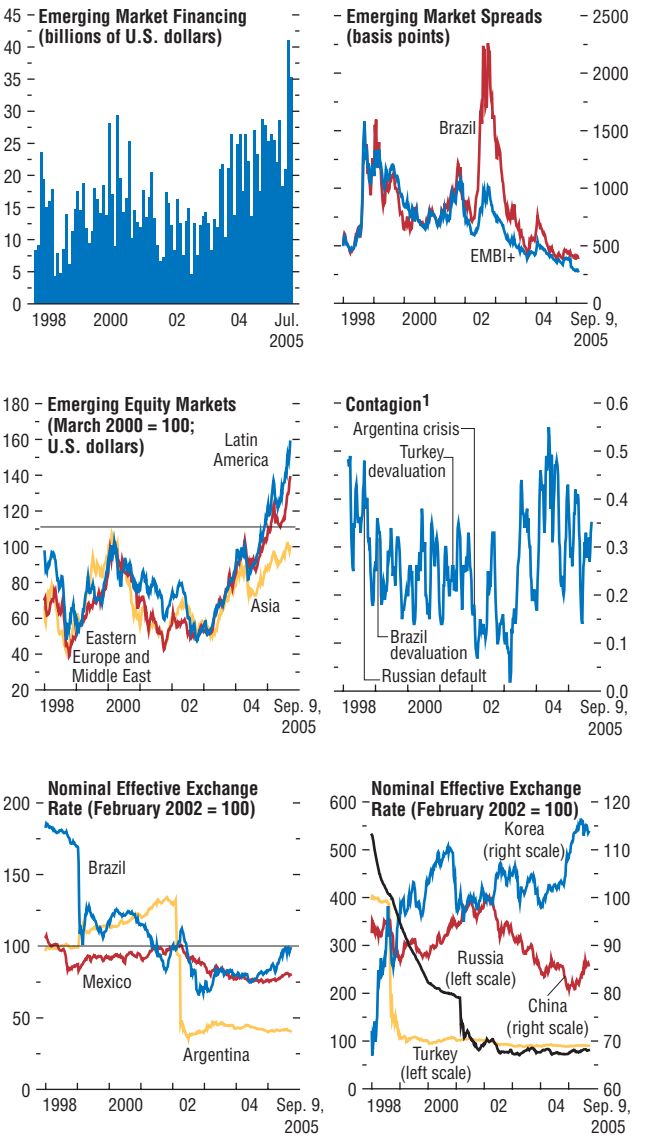
ment and wages will rise, accompanied by a corresponding increase in short- and long-term interest rates. While higher interest rates would adversely affect demand—particularly in countries where strong asset prices have been supporting consumption—this should be consistent with continued solid global growth. However, less benign scenarios are also possible. For example, with investment in some countries still constrained by structural and other impediments, the adjustment process may be asymmetric, possibly adding to global imbalances. Equally, strong corporate cash flow may be obscuring the inflationary and supply-side impact of recent shocks, notably higher oil prices and, in some countries, the adverse effect of exchange rate appreciation on margins. If that is the case, further adjustment may be needed as corporate profitability returns to more normal levels.

Against this background, global GDP growth is projected to average 4.3 percent in 2005 and 2006. Within this, global growth is expected to slow slightly through early 2006, picking up modestly thereafter (Figure 1.8) with the adverse impact of higher oil prices offset by still-accommodative macroeconomic policies (with only moderate tightening expected in major countries in 2006—Figure 1.9); benign financial market conditions, especially low long-run interest rates; and—as discussed above—increasingly solid corporate balance sheets. Looking across the key countries and regions:

- In *industrial countries,* GDP growth in the United States has eased moderately, but is projected to remain the highest in the G-7, underpinned by solid productivity growth; despite the appalling cost in life and property from Hurricane Katrina, the direct impact on GDP growth—as is generally the case for natural disasters—appears likely to be moderate (see below). The indirect effects—particularly as a result of higher gasoline prices—may be more of a concern; with household savings at record lows, this increases the risk of a sharp slowing in private consumption growth especially if the housing market, which is becoming increasingly richly valued, were to weaken. In

Figure 1.6. Emerging Market Financial Conditions

Emerging market financing conditions remain benign, with spreads at very low levels.



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

Table 1.2. Emerging Market and Developing Countries: Net Capital Flows[1]

(Billions of U.S. dollars)

	1994–96	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total											
Private capital flows, net[2]	156.4	191.7	76.2	86.0	74.3	66.2	68.2	158.2	232.0	132.9	53.8
Private direct investment, net	98.5	146.2	158.6	173.2	167.0	178.6	142.7	153.4	189.1	209.2	206.1
Private portfolio flows, net	65.0	60.8	42.6	69.5	21.0	−83.6	−87.6	−7.3	64.0	−28.6	−19.0
Other private capital flows, net	−7.0	−15.3	−125.0	−156.7	−113.7	−28.8	13.0	12.1	−21.1	−47.7	−133.3
Official flows, net	15.2	28.4	56.0	18.3	−52.1	−0.6	10.6	−61.7	−81.0	−137.1	−139.3
Change in reserves[3]	−97.3	−105.2	−34.8	−93.4	−113.2	−115.9	−185.7	−364.6	−517.4	−510.5	−506.8
Memorandum											
Current account[4]	−88.7	−82.6	−51.6	38.9	127.2	91.5	143.8	229.1	319.4	490.2	570.9
Africa											
Private capital flows, net[2]	2.0	7.9	7.9	10.1	−1.0	7.4	3.4	10.7	14.2	22.7	18.3
Private direct investment, net	2.3	7.7	6.6	9.4	8.0	22.3	14.7	14.6	13.9	19.5	17.8
Private portfolio flows, net	3.6	7.4	4.3	9.1	−1.8	−7.6	−0.9	0.1	6.3	5.5	6.3
Other private capital flows, net	−3.8	−7.3	−3.0	−8.4	−7.3	−7.2	−10.4	−4.1	−6.0	−2.2	−5.8
Official flows, net	2.8	−4.4	2.6	1.8	0.2	−1.9	1.8	2.8	—	−8.7	1.7
Change in reserves[3]	−4.7	−11.3	1.7	−2.8	−12.7	−12.4	−8.1	−19.4	−35.5	−38.6	−61.0
Central and eastern Europe											
Private capital flows, net[2]	12.3	20.2	27.3	36.7	39.0	11.8	55.8	48.1	58.0	72.3	58.6
Private direct investment, net	9.3	11.6	19.2	22.6	23.9	23.9	25.2	14.9	23.8	32.5	30.3
Private portfolio flows, net	4.0	5.4	−1.3	5.7	3.1	0.5	1.7	7.5	28.3	24.1	22.0
Other private capital flows, net	−1.0	3.2	9.4	8.4	12.0	−12.7	28.8	25.8	5.9	15.7	6.3
Official flows, net	0.4	−3.3	0.3	−2.6	1.6	5.6	−7.6	−5.4	−5.7	−5.7	−2.8
Change in reserves[3]	−14.2	−10.7	−9.5	−11.3	−2.8	7.4	−11.6	−11.7	−14.8	−17.0	−2.3
Commonwealth of Independent States[5]											
Private capital flows, net[2]	−0.8	19.9	6.4	−6.4	−12.9	−1.9	−9.5	16.5	9.4	−10.3	0.4
Private direct investment, net	3.2	5.9	5.3	4.2	2.4	4.6	4.0	5.3	13.4	8.6	8.5
Private portfolio flows, net	−7.7	17.6	7.7	−3.1	−6.1	−9.2	−8.2	−4.8	4.1	−16.2	−1.1
Other private capital flows, net	3.7	−3.6	−6.7	−7.5	−9.2	2.7	−5.3	16.0	−8.1	−2.6	−7.0
Official flows, net	9.2	8.7	10.0	0.1	−4.3	−4.5	−1.7	−5.1	−4.6	−5.2	−2.9
Change in reserves[3]	−3.2	−4.3	7.5	−2.7	−17.2	−11.3	−11.7	−33.8	−54.8	−80.7	−112.2
Emerging Asia[6]											
Private capital flows, net[2,7]	92.7	36.6	−49.9	11.8	7.5	14.7	21.0	62.0	132.9	84.6	34.1
Private direct investment, net	50.6	55.7	56.6	67.1	59.8	48.6	47.5	67.1	81.6	84.2	83.8
Private portfolio flows, net	25.3	6.8	8.7	55.8	20.1	−54.7	−60.2	4.9	25.8	−3.3	−1.4
Other private capital flows, net[7]	16.8	−26.0	−115.2	−111.1	−72.4	20.7	33.7	−10.0	25.4	3.8	−48.2
Official flows, net	−3.3	22.7	15.4	−0.3	−11.7	−11.3	5.2	−16.6	5.8	13.1	16.2
Change in reserves[3]	−48.7	−36.0	−52.9	−87.5	−52.5	−90.9	−149.9	−227.8	−342.7	−291.6	−234.9

the euro area, the tentative recovery in domestic demand in the second half of 2004 has slowed considerably. While incoming data are broadly consistent with a strengthening of activity in the second half of 2005, GDP growth forecasts for 2005 have been marked down, particularly for Italy; risks remain to the downside, given continued weak final domestic demand and the euro area's lack of domestic resilience to external shocks. In contrast, Japan's economy is regaining momentum, with GDP growth rising sharply in the first quarter of 2005 and recent data pointing to continued, if more sedate, expansion thereafter. GDP growth is now expected to average about 2 percent in both 2005 and 2006, with downside risks coming primarily from external factors.

- While growth prospects for *emerging market and developing countries* in aggregate have remained broadly unchanged, this disguises substantial changes in regional and individual forecasts, reflecting the impact of oil and other commodity price changes, exposure to global manufacturing and trade, as well as country-specific factors. In *emerging Asia*, GDP growth in China has continued to exceed expectations; with substantial liquidity remaining in

Table 1.2 *(concluded)*

	1994–96	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Middle East[8]											
Private capital flows, net[2]	4.2	7.4	13.7	−4.7	1.2	7.2	−2.8	2.4	7.5	−51.7	−66.2
Private direct investment, net	4.0	7.6	9.6	4.1	3.4	7.7	7.4	15.3	9.7	18.4	18.9
Private portfolio flows, net	−1.3	−6.8	−2.3	0.7	3.3	−3.5	−5.1	−5.9	9.7	−40.3	−48.7
Other private capital flows, net	1.5	6.6	6.5	−9.4	−5.4	2.9	−5.2	−7.0	−11.9	−29.8	−36.4
Official flows, net	4.7	−0.8	10.4	13.7	−30.7	−15.5	−7.6	−44.7	−71.1	−121.5	−141.8
Change in reserves[3]	−9.6	−16.5	8.8	−1.0	−29.5	−11.6	−3.3	−34.4	−45.9	−54.5	−76.5
Western Hemisphere											
Private capital flows, net[2]	46.1	99.7	70.8	38.5	40.5	27.0	0.4	18.5	9.9	15.2	8.5
Private direct investment, net	29.2	57.6	61.3	65.8	69.4	71.3	43.9	36.1	46.6	46.1	46.7
Private portfolio flows, net	41.1	30.3	25.6	1.3	2.4	−9.1	−14.9	−9.0	−10.3	1.7	4.0
Other private capital flows, net	−24.2	11.7	−16.1	−28.6	−31.3	−35.3	−28.7	−8.5	−26.4	−32.5	−42.2
Official flows, net	1.4	5.5	17.2	5.6	−7.2	27.0	20.6	7.3	−5.4	−9.1	−9.7
Change in reserves[3]	−16.9	−26.5	9.6	11.9	1.5	2.9	−1.0	−37.5	−23.7	−28.1	−19.8
Memorandum											
Fuel exporters											
Private capital flows, net[2]	−13.6	27.4	17.2	−22.3	−36.6	−9.7	−20.1	11.9	3.9	−76.6	−91.5
Nonfuel exporters											
Private capital flows, net[2]	170.0	164.3	59.1	108.3	110.9	75.8	88.3	146.4	228.1	209.5	145.3

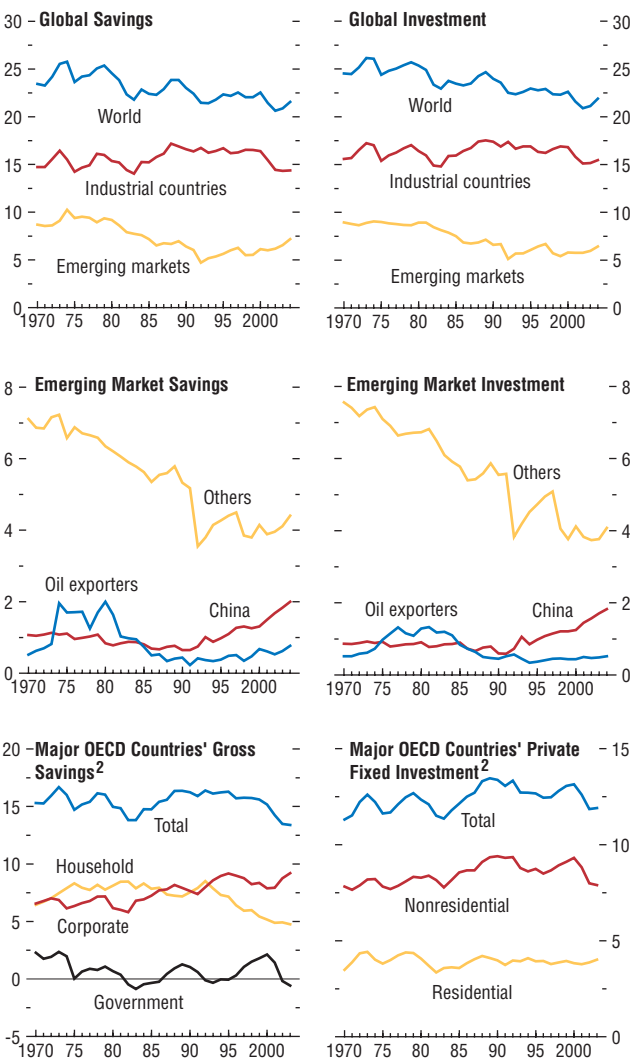
[1]Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing. In this table, Hong Kong SAR, Israel, Korea, Singapore, and Taiwan Province of China are included.
[2]Because of data limitations, "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 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$107 billion while other private capital flows net to the region amounted to US$35 billion.
[8]Includes Israel.

the banking system, risks of a rebound in credit and investment growth remain a concern. Growth in India has also remained robust with the continued expansion in services, including information technology, and accelerating industrial production. Elsewhere in the region, after a slow first quarter, GDP growth is projected to pick up in line with global manufacturing, although much will depend on the expected rebound in the information technology (IT) sector, as well as oil prices. After a strong rebound in 2004, GDP growth in *Latin America* has slowed, particularly in Brazil, where domestic demand fell back in early 2005 in response to monetary tightening to contain inflation, and political uncertainties in some countries are an increasing risk. Strong export growth and improved macroeconomic policy performance should help sustain the regional expansion going forward, while the widespread prefinancing of forthcoming debt repayments will help reduce the risk of financial market volatility in response to current political uncertainties and forthcoming elections. Rising oil production and prices have continued to support GDP growth in the *Middle East*, accompanied by dramatic improvements in external current account and fiscal positions. Despite strong domestic demand, inflation—outside Iran—has so far remained contained, but fiscal and structural policies will need to be carefully managed to ensure that higher oil revenues can be effectively absorbed. In Turkey, while GDP growth has slowed to a more sustainable pace, the current account deficit has widened further, underscoring the need for firm implementation of the authorities' economic program. Elsewhere, GDP growth in Russia has slowed since mid-2004, reflecting rising

Figure 1.7. Savings Glut or Investment Drought?[1]

(Percent of world GDP)

The rise in emerging market savings in recent years has been offset by falling industrial country savings, particularly by governments. Net corporate savings in industrial countries are unusually strong, owing to both buoyant profits and low investment.



Sources: OECD Analytical Database; OECD, *Economic Outlook;* and IMF staff calculations.

[1]Group composite ratios are sums of individual country data after conversion to U.S. dollars at the average market exchange rates over the sum of total GDP in U.S. dollars for the group.

[2]Excludes Denmark, Greece, Iceland, Ireland, Luxembourg, New Zealand, Norway, Portugal, and Switzerland from the WEO industrial country group because their data are not available.

capacity constraints and the adverse effect of the Yukos affair; growth in emerging Europe has also eased, with the key risks including high current account deficits—notably in Hungary—and strong credit growth.

- In the *poorest countries*, GDP growth in sub-Saharan Africa is forecast to moderate to 4.8 percent in 2005—0.4 percentage point lower than expected last April—partly reflecting a sharp slowdown in Nigeria as oil production nears capacity. Growth in oil-importing countries, while slowing, has so far held up surprisingly well, with the adverse impact of higher oil prices so far offset by stronger non-oil commodity prices, as well as the benefits of improved macroeconomic stability and ongoing structural reforms. Looking forward, the IMF staff projects GDP growth to rebound to 5.9 percent in 2006, led by surging growth in oil producers as new capacity comes on stream. However, with oil prices now increasing more rapidly than nonfuel commodities, downside risks for net oil importers have increased (Figure 1.10), and, as always, much will depend on the strength of policies, improved political stability, and favorable weather conditions.[5]

Looking forward, short-term risks remain slanted to the downside. Beyond geopolitical risks—underscored once again by the tragic events in London in July—there are three broad concerns:

- *High and volatile oil prices remain a significant global risk.* Since end-2004, spot oil prices have risen by over $20 a barrel; with the market very tight and long-run futures prices increasingly poorly grounded, a substantial further jump in oil prices cannot be ruled out (indeed, options markets suggest a 15 percent chance that West Texas crude could rise above $80 a barrel—see Appendix 1.1). To date, the impact of higher oil prices on global growth has been surprisingly moderate, in part reflecting the fact that

[5]In part reflecting these factors, fall *World Economic Outlooks* between 1990 and 2003 overestimated GDP growth in sub-Saharan Africa in the coming year by an average of 1.5 percentage points.

higher oil prices have owed much to strong global demand as well as relatively well-anchored inflationary expectations; however, it may also have reflected less benign factors, including the possibility that consumers have treated a significant portion of the oil shock as temporary, and—in some cases—a lack of pass-through to domestic prices.[6] With recent oil price increases owing less to demand pressures, further price increases could have a less benign impact, especially if they had a significant effect on consumer confidence and therefore spending. In addition, the impact on inflationary expectations could become much more marked, raising the risk of a sharp rise in interest rates, and adverse supply-side effects would be a much greater concern. The effect on countries and regions where domestic demand is already weak—notably the euro area—as well as on many oil-importing emerging market and developing countries could also be serious.[7]

- *Protectionist sentiment is rising, driven by global imbalances and growing fears of emerging market competition.* In the United States, a bill to impose across-the-board tariffs on China in the absence of an early revaluation in the renminbi gathered widespread Congressional support earlier this year; in the euro area, the recent withdrawal of the Services Directive was due in part to fears of "social dumping" from eastern Europe. The removal of quotas on textiles and clothing—despite being perhaps the most advertised move in trade history—has also triggered protectionist sentiments, including renewed restraints on exports from China, in many countries.
- *Financial market conditions could tighten significantly*, which is of particular concern if—as described above—the result of a jump in

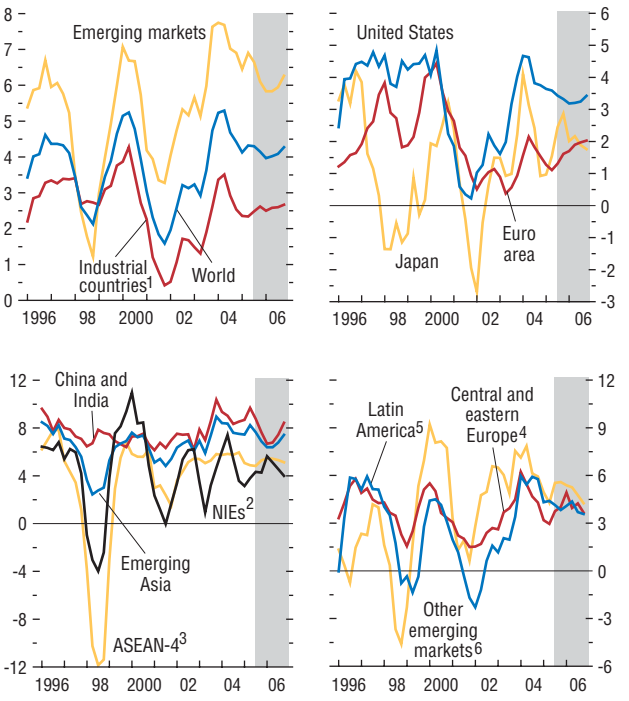
[6]A permanent 10 percent increase in crude oil prices is estimated to reduce global GDP by 0.1–0.15 percentage point over a year, assuming it is demand driven and there is only a limited impact on inflationary expectations (see Appendix 1.1, pp. 64–65, for a more detailed discussion).

[7]See IMF (2005b).

Figure 1.8. Global Outlook

(Real GDP; percent change from four quarters earlier)

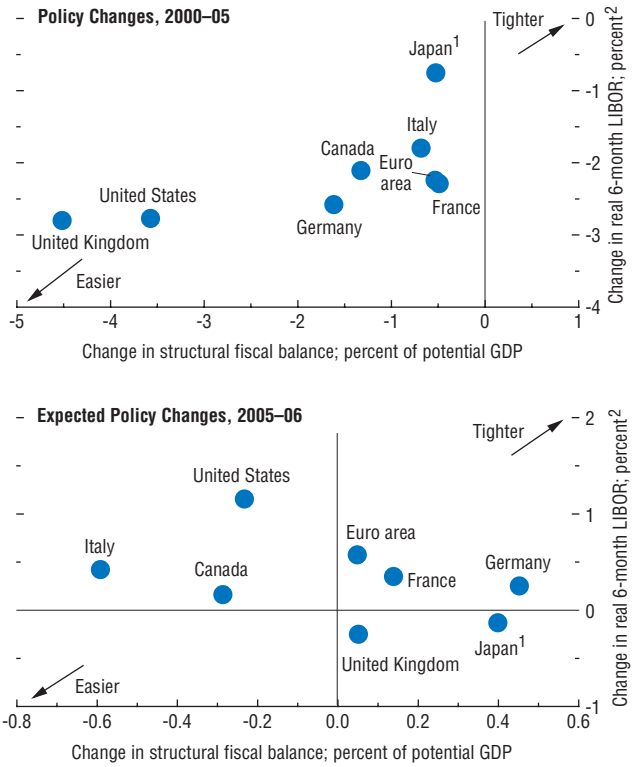
Global growth is expected to slow moderately through early 2006, picking up somewhat thereafter.



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 1.9. Fiscal and Monetary Policies in the Major Advanced Countries

Fiscal and monetary policies are expected to tighten modestly in 2006 in most G-7 countries.



Source: IMF staff estimates.
[1]For Japan, excludes bank support.
[2]Three-month rate for euro area, France, and Germany.

inflationary expectations, rather than a more gradual adjustment in savings and investment behavior. In such circumstances, the possibility of a simultaneous weakening of housing markets would be a particular concern; there could also be a significant impact on some emerging markets. As discussed in the IMF's September 2005 *Global Financial Stability Report*, risks related to increasingly complex arbitrage and leveraged investment strategies underscore the need for vigilance by supervisors and regulators.

Notwithstanding these risks, the short-term outlook remains generally solid, with the global economy having proved remarkably resilient to the shocks of the last several years. While this in part reflects fundamentals—including considerably improved monetary frameworks (Chapter IV, "Does Inflation Targeting Work in Emerging Markets?"), greater economic flexibility, improved financial system resilience, and reduced vulnerabilities in emerging markets—it also owes much to more transitory factors, not least the unusually low interest rates and the continued willingness of investors to finance large global imbalances. But looking forward, while there are clear positive factors—including the ongoing effects of the IT revolution—the longer-run foundations of the expansion seem considerably shakier. In particular, the recovery continues to depend unduly on developments in the United States and China—both of which face major adjustment challenges—and, as discussed below, limited progress has been made in addressing the major medium-term risks to the expansion.

Indeed, in some ways, recent developments have exacerbated the adjustment challenges ahead. While benign financial conditions have in many cases been used well—especially by emerging markets to restructure and prefinance debt—richly valued housing markets around the world could prove an uncomfortable legacy, especially since it takes longer for households to restore their balance sheets in a low-inflation environment. In addition, the rise in oil prices—with oil-producing countries becoming an increasingly large counterpart to the U.S. current account

deficit—will further complicate the resolution of global imbalances. Given the size of the increase in oil revenues relative to their economies, and the uncertainties as to how permanent they will prove, it will inevitably take a considerable time for them to adjust. In the short run, this may prove to be a factor sustaining current imbalances—especially if oil producers invest their surpluses in U.S. dollar–denominated assets—but with U.S. external liabilities rising further, this could come at the cost of a more serious problem in the longer term.

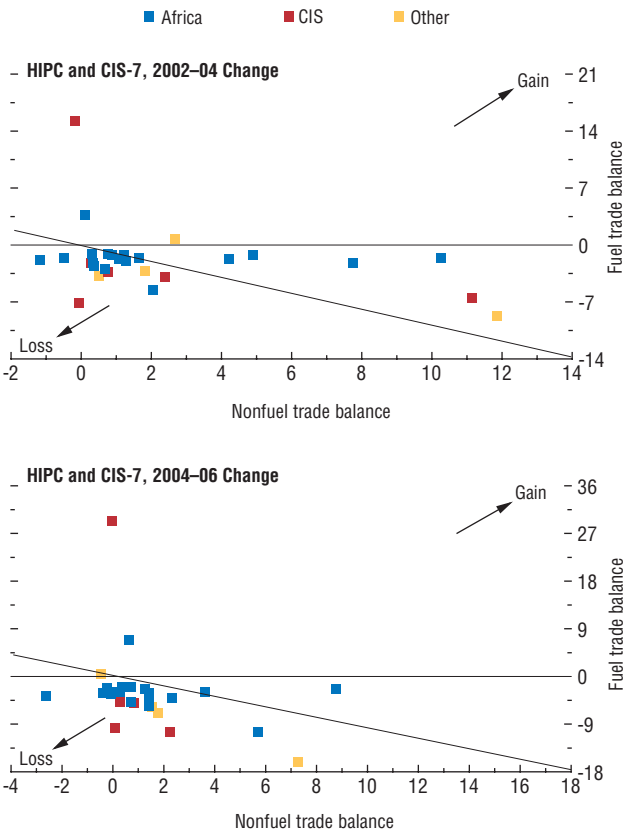
Turning to policies, short-run monetary requirements have become increasingly divergent, reflecting differing cyclical situations. In the United States, the present measured pace of tightening appears appropriate, although signs of rising labor market pressures will need to be carefully monitored; further tightening will also likely be needed in China, especially if signs of a rebound in investment growth strengthen, and will be aided by the greater scope for exchange rate flexibility as a result of recent reforms. In contrast, monetary policy has remained on hold in the euro area, and if incoming data confirm that inflationary pressures remain contained and the expected recovery fails to materialize, an interest rate cut should be considered; in Japan, the current accommodative stance remains appropriate and the quantitative easing policy should remain in place until deflation is unambiguously defeated. In cases where house price inflation remains robust, a combination of moral suasion and, if necessary, prudential measures could help limit potential risks; over the longer term, regulatory features—including those that potentially constrain supply—that may exacerbate price pressures also need to be addressed.

As indicated above, the key challenge remains to use the expansion to address underlying economic vulnerabilities and boost long-run growth:

- *The rising level of global imbalances, and their changing distribution, remains a central medium-term risk.* To date the adverse effects have been relatively limited, in part because—despite very large capital losses on U.S. dollar–denominated assets since the U.S. dollar

Figure 1.10. Trade Gains and Losses from Commodity Price Movements Relative to 2002[1]
(Percent of 2002 GDP)

Rising nonfuel commodity prices have only partly offset the losses from higher oil prices for many of the poorest countries.



Source: IMF staff estimates.
[1]The figure shows the impact of the projected rise in commodity prices between 2002–04 and 2004–06 relative to 2002 prices on nonfuel trade balance (horizontal axis) and fuel trade balance (vertical axis).

began to depreciate in early 2002—foreigners have continued to increase their holdings without demanding any interest rate premium.[8] While this benign situation could persist for some time, it will not continue forever; and finding out just when it might end is an experiment best not undertaken. As discussed in detail in Appendix 1.2, "How Will Global Imbalances Adjust?" a sharp decline in the demand for U.S. assets, combined with rising protectionist pressures, could well lead to a global recession; in contrast, concerted action to reduce imbalances could help forestall the risks of a disorderly adjustment, limit the size of external exposures and the attending risks, and sustain global growth during the adjustment process. Since the last *World Economic Outlook* was published in April, there has been some progress in implementing the policy strategy to address global imbalances. Notably, the fiscal outlook in the United States has improved, aided by a rebound in revenues (although emergency spending associated with Hurricane Katrina will add to the deficit in the short run); there have also been important further steps toward greater exchange rate flexibility in Asia, notably in China and Malaysia. However, there remains a considerable way to go. The projected fiscal adjustment in the United States over the medium run remains unambitious, and in Asia the scope for flexibility in the new exchange rates should be fully utilized; moreover, progress since April with financial reform in Asia, or further structural reforms to boost domestic demand and growth in Japan and the euro area, has been limited. Oil-exporting countries will also need to play their part, including by taking advantage of higher revenues to boost expenditures in areas where social returns are high (subject to cyclical considerations) and to accelerate growth-enhancing structural reforms;[9] over the medium term, real exchange rate appreciation may also be necessary. Even so, as noted above, adjustment in oil-exporting countries will take time, underscoring the need for other countries to make progress now.

- *Unsustainable medium-term fiscal positions remain a key risk.* Among the major industrial countries, fiscal deficits are expected to decline only modestly over the medium term (outside Canada, which remains in surplus), with rising public debt ratios in Japan, Italy, and Germany of particular concern (Table 1.3). In most countries, despite past reforms, fiscal pressures from aging populations remain a serious concern, especially for health care. Encouragingly, emerging market countries have improved their fiscal positions noticeably in recent years, although, in many, public debt is still well above sustainable levels (Box 1.1, "Is Public Debt in Emerging Markets Still Too High?").
- *More ambitious efforts are required to address constraints to long-run growth.* Despite some welcome progress, most countries and regions face significant structural challenges, including product and labor market reforms in the euro area and Japan; financial and corporate reform in much of emerging Asia; improving the investment climate in Latin America, the Commonwealth of Independent States, and the Middle East; and strengthening banking supervision in central and eastern Europe.
- *From a multilateral perspective, a successful outcome to the Doha Round remains critical to support global growth over the medium term.* To date, progress has been disappointing, and time is running out to reach agreement on an ambitious trade liberalization at the upcoming World Trade Organization (WTO) Ministerial meeting in Hong Kong SAR in December. Key issues that remain to be determined include modalities for eliminating export subsidies and tariff cuts on agricultural goods; nonagricultural tariffs, including the extent of cuts by

[8]See "Globalization and External Imbalances," Chapter III, *World Economic Outlook*, April 2005 for a detailed discussion.
[9]See "How Should Middle Eastern and Central Asian Oil Exporters Use Their Oil Revenues?" Box 1.6 in the April 2005 *World Economic Outlook* for a detailed discussion.

Table 1.3. Major Advanced Economies: General Government Fiscal Balances and Debt[1]

(Percent of GDP)

	1989–98	1999	2000	2001	2002	2003	2004	2005	2006	2010
Major advanced economies										
Actual balance	–3.5	–1.2	–0.2	–1.8	–4.1	–4.6	–4.1	–4.0	–4.1	–2.8
Output gap[2]	0.4	1.3	2.2	0.6	–0.8	–1.5	–0.8	–0.9	–0.8	—
Structural balance[2]	–3.5	–1.5	–1.4	–2.0	–3.7	–3.9	–3.7	–3.6	–3.6	–2.8
United States										
Actual balance	–3.4	0.6	1.3	–0.7	–4.0	–4.6	–4.0	–3.7	–3.9	–2.3
Output gap[2]	0.5	3.3	3.5	0.9	–0.9	–1.5	–0.8	–0.6	–0.6	—
Structural balance[2]	–3.4	–0.3	0.3	–0.8	–3.5	–3.8	–3.5	–3.2	–3.5	–2.3
Net debt	54.1	44.6	39.3	38.3	41.0	43.8	44.9	46.0	47.6	47.4
Gross debt	69.5	62.8	57.1	56.6	58.7	60.6	60.7	60.9	61.7	58.8
Euro area										
Actual balance	...	–1.3	–0.9	–1.8	–2.5	–2.8	–2.7	–3.0	–3.1	–2.0
Output gap[2]	...	0.3	1.8	1.4	0.2	–1.1	–1.0	–1.6	–1.6	—
Structural balance[2]	...	–1.6	–1.8	–2.4	–2.6	–2.5	–2.2	–2.3	–2.3	–1.9
Net debt	...	60.7	58.3	58.3	58.3	59.9	60.4	61.6	62.6	62.0
Gross debt	...	72.5	70.0	68.9	68.8	70.1	70.6	72.3	73.1	71.9
Germany[3]										
Actual balance	–2.4	–1.5	1.3	–2.8	–3.7	–4.0	–3.7	–3.9	–3.7	–3.2
Output gap[2]	1.3	0.1	1.7	1.5	0.2	–1.3	–1.0	–1.6	–1.7	—
Structural balance[2,4]	–2.7	–1.5	–1.7	–3.1	–3.5	–3.4	–3.2	–3.3	–2.9	–3.1
Net debt	37.3	53.5	51.5	52.1	54.3	57.7	59.9	63.1	65.6	70.7
Gross debt	48.8	59.6	58.7	57.9	59.6	62.8	64.5	67.7	70.1	74.7
France										
Actual balance	–3.7	–2.5	–1.5	–1.5	–3.1	–4.2	–3.7	–3.5	–3.9	–1.2
Output gap[2]	–1.0	–0.6	1.2	1.0	—	–1.4	–1.4	–2.0	–2.1	—
Structural balance[2,4]	–2.9	–2.2	–2.1	–2.1	–3.1	–3.4	–2.6	–2.6	–2.4	–1.2
Net debt	37.2	48.6	47.0	48.2	48.5	53.0	55.2	56.8	58.5	56.2
Gross debt	46.4	58.3	56.6	56.1	58.1	62.7	64.8	66.4	68.2	65.8
Italy										
Actual balance	–8.4	–1.7	–0.8	–3.2	–2.7	–3.2	–3.2	–4.3	–5.1	–4.4
Output gap[2]	–0.4	0.4	1.5	1.2	–0.2	–1.3	–1.3	–2.5	–2.3	—
Structural balance[2,4]	–8.3	–2.0	–2.7	–3.9	–3.5	–2.8	–2.9	–3.4	–4.0	–4.3
Net debt	106.6	109.2	105.6	105.5	103.1	103.1	103.0	105.5	107.1	111.7
Gross debt	112.7	115.5	111.3	110.9	108.3	106.8	106.6	109.3	110.9	115.6
Japan										
Actual balance	–1.9	–7.2	–7.5	–6.1	–7.9	–7.8	–7.2	–6.7	–6.2	–5.2
Excluding social security	–4.1	–8.3	–8.0	–6.2	–7.7	–7.9	–6.9	–6.3	–5.8	–4.8
Output gap[2]	0.9	–1.6	–0.3	–1.3	–2.5	–2.3	–0.9	–0.4	—	—
Structural balance[2,4]	–2.2	–6.6	–7.3	–5.5	–6.8	–6.9	–6.8	–6.6	–6.2	–5.2
Excluding social security	–4.3	–7.9	–7.9	–5.9	–7.1	–7.4	–6.8	–6.2	–5.8	–4.8
Net debt	23.3	53.8	59.3	64.5	71.5	76.0	82.1	88.3	93.3	106.7
Gross debt	85.6	131.1	139.3	148.8	158.4	164.7	169.2	174.4	177.8	182.1
United Kingdom										
Actual balance	–3.7	1.1	3.9	0.8	–1.5	–3.2	–3.0	–3.2	–3.4	–2.0
Output gap[2]	–0.2	–0.1	1.1	0.7	–0.1	–0.4	0.3	–0.3	–0.4	—
Structural balance[2,4]	–3.6	1.0	1.3	0.3	–1.7	–3.1	–3.0	–3.2	–3.2	–2.0
Net debt	38.1	40.0	34.2	32.7	32.7	34.5	36.4	37.9	40.2	43.9
Gross debt	43.7	44.6	41.6	38.4	37.9	39.3	41.1	42.5	44.8	48.5
Canada										
Actual balance	–5.1	1.6	2.9	0.7	–0.1	—	0.7	0.5	0.3	0.5
Output gap[2]	–0.3	0.6	1.9	0.3	0.3	–0.5	–0.4	–0.4	–0.1	—
Structural balance[2,4]	–4.8	1.3	2.0	0.4	–0.2	0.3	0.9	0.7	0.4	0.5
Net debt	78.9	75.4	65.3	60.2	57.9	51.4	46.8	43.9	41.3	32.1
Gross debt	110.5	111.6	101.5	100.3	97.4	91.9	87.9	83.0	78.4	62.6

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 the 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, in particular 0.5 percent of GDP for France in 2005.

Box 1.1. Is Public Debt in Emerging Markets Still Too High?

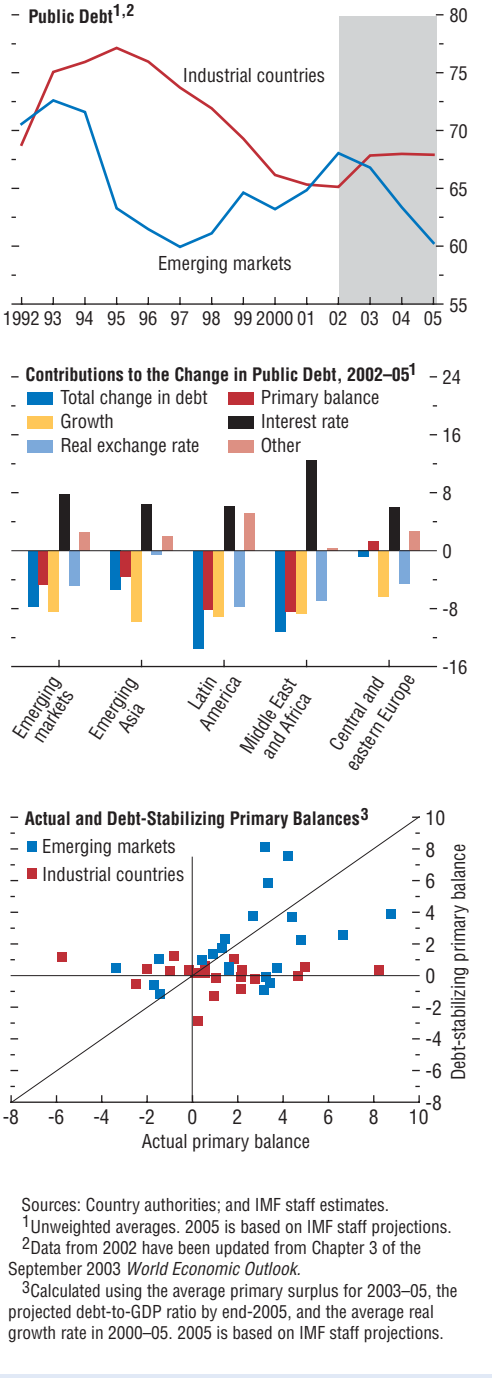
The September 2003 *World Economic Outlook* noted with concern the rising trend in public debt in emerging market economies. At that time, public debt was viewed as being too high in many emerging market economies—25–50 percent of GDP was seen as an appropriate level in that *World Economic Outlook*—and the steady increase in public debt since the mid-1990s had taken debt above the levels in industrial countries. This box provides an update of the situation.

Over the past two years, emerging market economies have made encouraging progress in reducing the vulnerabilities they face from high public debt levels. By the end of 2005, public debt ratios in emerging markets will likely have fallen by some 8 percentage points of GDP since 2002, to an average of about 60 percent of GDP (top panel in the figure).[1] In contrast, the average debt ratio in industrial countries is projected to have increased by almost 3 percentage points of GDP over the same period.[2]

Public debt ratios have fallen in most emerging market countries. In a 25-country sample, public debt ratios are projected to increase between 2002–05 in just 6 countries and to fall in the remaining 19. Public debt ratios have fallen most significantly in Latin America (an average decline of 13 percent of GDP, to about 52¼ percent of GDP by end-2005),[3] followed by the Middle East and Africa region (by 11 percent of GDP, to about 77¼ percent of GDP), and Asia

Emerging Market Debt

(Percent of GDP)



Sources: Country authorities; and IMF staff estimates.
[1]Unweighted averages. 2005 is based on IMF staff projections.
[2]Data from 2002 have been updated from Chapter 3 of the September 2003 *World Economic Outlook*.
[3]Calculated using the average primary surplus for 2003–05, the projected debt-to-GDP ratio by end-2005, and the average real growth rate in 2000–05. 2005 is based on IMF staff projections.

Note: The main authors of this box are María González and Davide Lombardo.

[1]This analysis is based on a sample of 25 emerging market countries, taken from an update of the databases used for Chapter III of the September 2003 *World Economic Outlook*. Only countries with continuous data from 1992 are used.

[2]The worsening appears to be led both by a slowdown in economic activity and a weakening of the fiscal stance in industrial countries. Between 1995–2002 and 2003–05, average growth in the industrial countries declined from nearly 3.1 to 2.3 percent, while their average primary surplus fell from about 2¼ percent of GDP to about 1 percent of GDP.

[3]The average decline in Latin America excluding Argentina is projected at about 6 percent of GDP.

(by 5 percent of GDP, to 58 percent of GDP). Only in the central and eastern European countries have public debt ratios increased (about 1 percent of GDP, to 53½ percent of GDP).

The structure of public debt has also improved. The share of foreign-currency-denominated debt in total public debt declined from about 55 percent at end-2002 to just under half by end-2005 (IMF staff estimate). This is the result of both real exchange rate appreciations in many countries during this period and improved public sector debt management. Countries have benefited from favorable global financial market conditions in recent years, which have seen spreads on emerging market debt decline to historic lows. The average implicit interest rate (calculated as the ratio of the interest bill over the total debt stock of the previous period) has fallen for emerging market economies by about 2 percentage points, most notably in the Middle East and Africa region.

What accounts for the 8 percent of GDP decline in emerging market public debt ratios between 2002 and 2005? Real GDP growth rates have been particularly strong by historical standards, contributing 8½ percent of GDP to the reduction of the average public debt stock (middle panel in the figure). At the same time, real exchange rate appreciations have contributed nearly 5 percent of GDP, and primary fiscal surpluses (reflecting a mix of adjustment and favorable cyclical effects), a further 5 percent of GDP. Countervailing factors have been the automatic debt increase resulting from positive real interest rates, increasing the average debt ratio by 7.8 percent of GDP, and residual factors (including the recognition of off-balance-sheet liabilities and the use of part of the fiscal surpluses to build up liquidity cushions rather than to reduce gross debt) accounting for an increase of some 2.6 percent of GDP. In some specific cases (as in Argentina and Ecuador), public debt ratios have been reduced through debt-restructuring operations.

While the regional trends have been broadly similar, some differences stand out. In the central and eastern European countries, primary fiscal deficits have added to the debt ratio. The effect of appreciating real exchange rates has been particularly strong in those regions (such as Latin America and Middle East and Africa) with relatively high shares of foreign-currency-denominated debt and in countries (such as Uruguay) that had experienced large exchange rate depreciations that have since been partially reversed.

Looking forward, emerging market economies should entrench and—in some cases—intensify their recent fiscal consolidation efforts. An average public debt ratio of 60 percent of GDP is still too high, and debt-related vulnerabilities need to be reduced further. Despite the recent progress, the average primary balance over 2002–05 for many countries has fallen short of what would have been needed to reduce or even stabilize the debt-to-GDP ratio under average historical values for real GDP growth and interest rates—arguably better proxies for their respective medium-term values than more recent observations—which underscores the need for further adjustment (see bottom panel in the figure).[4] Moreover, the recent decline in public debt has taken place in the face of an unusually favorable combination of circumstances—real exchange rate appreciation, historically-high growth rates, buoyant commodity prices, and an increase in financial market risk appetite. It will be key for emerging market countries to continue to take advantage of the current favorable circumstances, and to stay the course if and when growth slows down.

[4]The estimates suggest that the primary balance in those emerging market countries that remain below their debt-stabilizing level would need to increase on average by about 4½ percent of GDP to become sustainable according to this metric. (See Chapter III of the September 2003 *World Economic Outlook* for details on the concept of the debt-stabilizing primary balance.) For this exercise, the real interest rate on emerging market debt has been estimated as the U.S. long-term real interest rate plus the respective average EMBI spread for the 2000–05 period, with the exception of Ecuador (2005 spreads) and Argentina (average EMBI spread following the settlement of the debt exchange). For industrial countries, the real interest rate has been proxied by the inflation-adjusted yield on benchmark 10-year government bonds.

middle-income countries; and services, where progress has lagged substantially. In addition, as emphasized in past issues of the *World Economic Outlook*, the continuing risks and pressures in oil markets underscore the need to reduce obstacles to investment, including in refining; strengthen energy conservation; and improve transparency.

The improvement in growth prospects in many of the world's poorest countries has been an especially welcome development over the past few years. Beyond the continued robust expansions in China and India, which account for over half of the world's poor, the GDP growth rate in the Heavily Indebted Poor Countries (HIPC)—while still far too slow—has also risen to an average 5 percent in 2001–05, despite the adverse effects of the global slowdown and—in many cases—commodity prices during this period (Figure 1.10). As encouraging, there is renewed commitment in the international community to provide additional resources, reflected in the G-8 agreement at Gleneagles in July (which, along with other donor commitments, should raise official development assistance by $50 billion, and aid to Africa by $25 billion, by 2010); the European Union's undertaking to increase aid to the UN target of 0.7 percent of GNP by 2015; and proposals to cancel concessional multilateral debt of the heavily indebted poor countries.

The priorities now are twofold. First, the international community must follow through expeditiously on its commitments, and accompany this with an ambitious trade liberalization—particularly for agricultural products—under the Doha Round. Second, developing countries must move rapidly to put in place the policies needed for sustainable growth and poverty reduction. In this connection, a central challenge is to build sound, accountable, and transparent institutions, the theme of this edition of the *World Economic Outlook*. As discussed in Chapter III, "Building Institutions," a country's institutions—typically the product of its entire political, economic, and cultural history—can be quite persistent, but are not immutable. Over the past 30 years, many emerging and developing countries have made progress in improving their institutions, and this has generally been followed by stronger growth and higher investment. While there is no single road to success—and indeed efforts at "institutional engineering" may well prove counterproductive—the chapter identifies a variety of conditions under which good institutions appear most likely to flourish. Perhaps the most important of these—consistent with the view that good institutions are most likely to grow in an environment where rent-seeking is limited—is greater openness to the outside world, reinforcing the arguments for developing countries themselves to undertake ambitious liberalization under the Doha Round.

United States and Canada: Strong U.S. Growth, but Rising Housing Market Risks

In the United States, GDP growth remained strong in the first half of 2005, underpinned, as in 2004, by strong income growth and steady improvements in labor market conditions, supportive financial market conditions, and rising house prices. Incoming data—including manufacturing and services sector activity surveys, employment data, and retail sales—generally suggest the momentum of the expansion remains solid. However, the near-term outlook has been overshadowed by the devastating loss of life and property caused by Hurricane Katrina, which is almost certain to be the most expensive natural disaster in recent years. The immediate direct output effects of the disruption in production are likely to be modest, given the affected area's relatively small economic size, and will be increasingly offset by the stimulus from reconstruction involving significant government spending. However, given the area's importance in hydrocarbon production—with the initial refinery capacity shut down in the aftermath of Hurricane Katrina accounting for some 13 percent of national capacity—and as a national transportation hub, there could be larger indirect effects on consumption and fixed investment through temporarily higher

Table 1.4. Advanced Economies: Real GDP, Consumer Prices, and Unemployment
(Annual percent change and percent of labor force)

	Real GDP				Consumer Prices				Unemployment			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Advanced economies	**1.9**	**3.3**	**2.5**	**2.7**	**1.8**	**2.0**	**2.2**	**2.0**	**6.6**	**6.3**	**6.1**	**5.9**
United States	2.7	4.2	3.5	3.3	2.3	2.7	3.1	2.8	6.0	5.5	5.2	5.2
Euro area[1]	0.7	2.0	1.2	1.8	2.1	2.1	2.1	1.8	8.7	8.9	8.7	8.4
Germany	−0.2	1.6	0.8	1.2	1.0	1.8	1.7	1.7	9.6	9.2	9.5	9.3
France	0.9	2.0	1.5	1.8	2.2	2.3	1.9	1.8	9.5	9.7	9.8	9.6
Italy	0.3	1.2	—	1.4	2.8	2.3	2.1	2.0	8.7	8.5	8.1	7.8
Spain	2.9	3.1	3.2	3.0	3.1	3.1	3.2	3.0	11.5	11.0	9.1	8.0
Netherlands[2]	−0.1	1.7	0.7	2.0	2.2	1.4	1.4	−2.6	3.7	4.6	5.0	4.5
Belgium	1.3	2.7	1.2	2.0	1.5	1.9	2.3	1.9	7.9	7.8	7.9	8.0
Austria	1.4	2.4	1.9	2.2	1.3	2.0	2.0	1.8	4.3	4.8	5.0	4.7
Finland	2.4	3.6	1.8	3.2	1.3	0.1	1.0	1.5	9.0	8.8	8.0	7.8
Greece	4.7	4.2	3.2	2.9	3.4	3.1	3.5	3.3	9.7	10.5	10.5	10.5
Portugal	−1.1	1.0	0.5	1.2	3.3	2.5	2.3	2.5	6.3	6.7	7.4	7.7
Ireland	4.4	4.5	5.0	4.9	4.0	2.3	2.3	2.5	4.7	4.5	4.2	4.0
Luxembourg	2.4	4.4	3.1	3.2	2.0	2.2	2.4	2.7	3.8	4.4	4.8	5.2
Japan	1.4	2.7	2.0	2.0	−0.2	—	−0.4	−0.1	5.3	4.7	4.3	4.1
United Kingdom[1]	2.5	3.2	1.9	2.2	1.4	1.3	2.0	1.9	5.0	4.8	4.7	4.8
Canada	2.0	2.9	2.9	3.2	2.7	1.8	2.2	2.5	7.6	7.2	6.8	6.7
Korea	3.1	4.6	3.8	5.0	3.5	3.6	2.8	2.9	3.6	3.5	3.6	3.3
Australia	3.3	3.2	2.2	3.2	2.8	2.3	2.6	2.7	6.0	5.5	5.1	5.1
Taiwan Province of China	3.3	5.7	3.4	4.3	−0.3	1.6	2.0	1.8	5.0	4.4	4.3	4.2
Sweden	1.5	3.6	2.6	2.8	2.3	1.1	0.8	1.8	4.9	5.5	5.2	4.9
Switzerland	−0.4	1.7	0.8	1.8	0.6	0.8	1.3	1.4	3.4	3.5	3.7	3.7
Hong Kong SAR	3.2	8.1	6.3	4.5	−2.6	−0.4	1.0	1.3	7.9	6.8	5.7	4.6
Denmark	0.7	2.4	2.2	2.1	2.1	1.2	1.7	1.8	5.8	6.0	5.6	5.5
Norway	0.4	2.9	3.1	3.3	2.5	0.4	1.4	2.1	4.5	4.5	4.2	4.0
Israel	1.7	4.4	4.2	3.9	0.7	−0.4	1.2	2.3	10.7	10.3	9.1	8.7
Singapore	1.4	8.4	3.9	4.5	0.5	1.7	0.7	1.7	4.7	4.0	3.6	3.4
New Zealand[3]	3.4	4.8	2.5	2.5	1.8	2.3	2.7	2.7	4.7	3.9	4.0	4.2
Cyprus	1.9	3.7	3.8	4.0	4.1	2.3	2.5	2.5	3.5	3.6	3.2	3.0
Iceland	4.2	5.2	5.8	4.9	2.1	3.2	3.4	3.5	3.4	3.1	2.3	1.7
Memorandum												
Major advanced economies	1.8	3.2	2.5	2.6	1.7	2.0	2.1	2.1	6.7	6.4	6.1	6.0
Newly industrialized Asian economies	3.1	5.6	4.0	4.7	1.5	2.4	2.2	2.3	4.4	4.1	4.0	3.7

[1]Based on Eurostat's harmonized index of consumer prices.
[2]In 2006, as a statistical effect, the introduction of a new health care system will lower Harmonized Index of Consumer Price (HICP) inflation by 4 percentage points (but only in that year) as private health expenditures drop out of the consumption basket; otherwise inflation would be positive.
[3]Consumer prices excluding interest rate components.

input prices, particularly for gasoline and other refined oil products.

Against this background, GDP growth is projected to be somewhat weaker than previously expected in the latter part of 2005, with private consumption affected by higher gasoline prices and population displacement. In 2006, growth is expected to return to trend, driven primarily by a pickup in fixed investment, reflecting firms' healthy balance sheets, strong profitability, and capital stocks that are below trend in some sectors (Table 1.4). With U.S. growth continuing to outstrip that of other large advanced economies in 2005–06 and, with higher oil prices, the current account deficit is projected to widen to over 6 percent of GDP in 2005 (Table 1.5). Looking forward, assuming no further real depreciation of the U.S. dollar and a moderate fiscal consolidation, the current account deficit would remain at this level through the rest of the decade, accompanied by a further substantial rise in U.S. external liabilities (Appendix 1.2). Within this, the steady deterioration of the investment income account—still surprisingly in surplus

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

	2003	2004	2005	2006
Advanced economies	**–0.8**	**–1.0**	**–1.3**	**–1.4**
United States	–4.7	–5.7	–6.1	–6.1
Euro area[1]	0.3	0.5	0.2	0.2
Germany	2.1	3.8	4.3	4.4
France	0.4	–0.4	–1.3	–1.5
Italy	–1.3	–0.9	–1.7	–1.4
Spain	–3.6	–5.3	–6.2	–6.9
Netherlands	2.8	3.3	4.9	5.3
Belgium	4.5	3.4	4.2	4.0
Austria	–0.5	0.6	—	–0.3
Finland	4.0	4.0	3.4	4.4
Greece	–5.6	–3.9	–3.9	–4.0
Portugal	–5.4	–7.5	–8.4	–7.7
Ireland	—	–0.8	–1.4	–1.8
Luxembourg	9.4	6.9	8.4	9.1
Japan	3.2	3.7	3.3	3.0
United Kingdom	–1.5	–2.0	–1.9	–1.8
Canada	1.5	2.2	1.5	1.7
Korea	2.0	4.1	2.0	1.5
Australia	–5.9	–6.4	–5.7	–5.0
Taiwan Province of China	10.2	6.1	4.3	4.6
Sweden	7.6	8.2	7.4	6.7
Switzerland	13.2	12.0	10.8	11.3
Hong Kong SAR	10.3	9.8	10.3	10.2
Denmark	3.3	2.5	1.9	2.2
Norway	12.8	13.5	18.3	21.4
Israel	0.7	1.3	1.7	1.3
Singapore	29.2	26.1	25.7	22.7
New Zealand	–4.2	–6.4	–7.4	–7.7
Cyprus	–3.4	–5.8	–4.0	–3.2
Iceland	–5.1	–8.5	–12.0	–11.4
Memorandum				
Major advanced economies	–1.5	–1.7	–2.1	–2.2
Euro area[2]	0.3	0.6	0.4	0.3
Newly industrialized Asian economies	7.4	7.2	5.5	5.0

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

(Box 1.2, "Why Is the U.S. International Income Account Still in the Black, and Will This Last?") will be an increasing headwind, with rising debt and higher interest rates likely to reduce the U.S. net income balance by about 1 percent of GDP in coming years.

Near-term risks to growth are mixed, albeit tilted to the downside. While business and consumer confidence remain healthy, the continuing rise in prices for oil and downstream petroleum products could have a larger negative impact on growth in the near term. Moreover, while productivity growth remains solid, a further slowdown could adversely affect capital inflows and add to cost pressures, increasing the risk of a jump in long-run interest rates. More generally, the very low level of household savings—closely linked to developments in the housing market—remains a significant concern. Since the late 1990s, house prices in the United States have risen rapidly, although with considerable variation across states. IMF staff estimates suggest that at least 18 states, accounting for more than 40 percent of U.S. GDP, are currently experiencing housing booms (Figure 1.11), and, by some measures, the implications for the national level are such that—for the first time since 1970—the national housing market is booming as well.[10] Rising prices have supported the increase in home mortgage borrowing from about 3 percent of GDP in 2000 to close to 8 percent of GDP in early 2005, with about one-third in the form of net equity extraction, which, in turn, has been underlying the household sectors' financing gap—the excess of household spending on residential investment and consumer durables over gross household savings. Moreover, a rising share of new mortgages is being financed in a riskier fashion, including through negative amortization and floating rate instruments.

While house price booms do not necessarily end in busts, recent house price increases have raised concerns that the market could be increasingly susceptible to a correction.[11] While high housing prices partly reflect underlying

[10]Booms are defined as the peak-to-peak increases or, alternatively, as the cumulative eight-quarter pre-peak increases in inflation-adjusted housing prices that exceed a threshold. The thresholds are based on the top quartiles of all increases in a sample of house prices in 14 industrial countries during 1970–2002 (see Chapter II, *World Economic Outlook,* April 2003, and Helbling and Terrones, 2003, for details). To assess current housing market conditions, house prices in 2005:Q2 were assumed to have reached a peak.
[11]See also Chapter I in IMF (2005c).

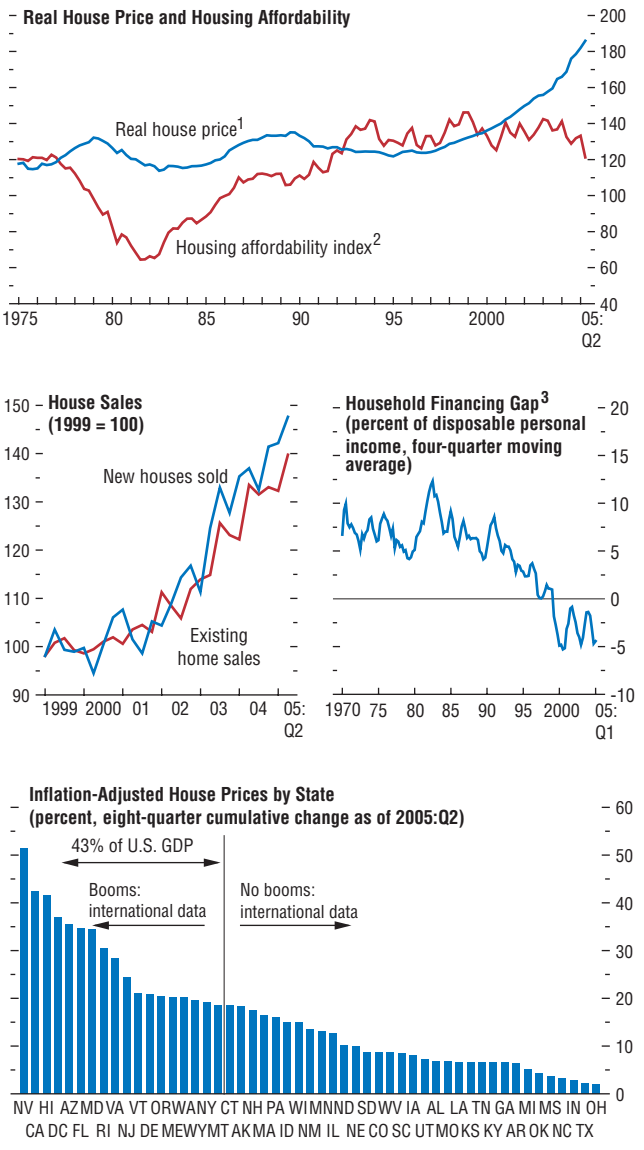
fundamentals—including increased incomes, wealth, and demographics—they also reflect the present very low level of interest rates, which is unlikely to be sustained. Moreover, the ratio of house prices to rents—equivalent to a price-earnings ratio for housing—has reached new highs. On the positive side, supervisory agencies recently issued guidance to promote sound risk management practices for home equity lending, and sound financial sector balance sheets and the broader distribution of real estate–related risks through asset securitization and other financial innovations have reduced financial market risks. However, the impact on the real economy could be more severe, with even a slowdown in house price inflation—prompted for example by higher interest rates (with variable-rate products constituting about one-third of new mortgages in 2004–05 compared with about one-fifth on average)—having the potential to significantly slow private consumption growth in the future.

While headline inflation has fluctuated around 3 percent in the first half of 2005, reflecting higher prices for oil and other raw materials, core inflation—as measured by the personal consumption expenditure deflator—has remained restrained, running at about 1.7 percent in the first half of the year. But with growth exceeding potential, and policy interest rates still below most estimates of neutral levels, the Federal Reserve has continued to raise policy rates steadily: looking forward, further measured withdrawal of monetary stimulus seems likely to be appropriate. However, as usual, much will depend on the incoming data, with the steady increase in unit labor costs, as well as higher oil prices, needing to be particularly carefully watched.

Against the background of a low national savings rate, a large current account deficit, and impending demographic pressures, fiscal consolidation remains a macroeconomic policy priority. Owing to strong revenue growth, the FY2004 unified budget deficit fell to 3.6 percent of GDP—over 1 percent of GDP lower than anticipated—and was expected to decrease

Figure 1.11. United States: House Prices and Household Demand

Rapid house price increases have supported growth in household expenditure and surging housing market transactions. Some 15–18 states are estimated to be experiencing a housing boom. Low interest rates have contributed to maintaining affordability, although leverage and riskier financing have also been on the rise.



Sources: Haver Analytics; and IMF staff calculations.

[1]Office of Federal Housing Enterprise Oversight house price index adjusted by the total CPI (1982–84 = 100).

[2]Index = 100 when median family income qualifies for an 80 percent mortgage on a median-priced existing single-family home. A rising index indicates more buyers can afford to enter the market.

[3]Net acquisition of financial assets by households minus net increase in their financial liabilities (equals gross household savings minus household capital expenditure).

Box 1.2. Why Is the U.S. International Income Account Still in the Black, and Will This Last?

The increase in the U.S. current account deficit in recent years has taken place mostly as a result of a widening of the goods and services trade balance. Somewhat surprisingly, the other main component of the current account—the income balance, which comprises returns on foreign assets and liabilities of U.S. residents—has remained in surplus. Indeed, net income flows have boosted the current account balance by about ¼ percent of GDP since 2000 even as the U.S. net foreign debt ratio has risen by about one-third, from some 15 percent of GDP to over 20 percent of GDP (see the figure).[1] Two questions follow from these developments. What explains the continuing surpluses on the income account, given large and growing U.S. net foreign liabilities? And is this remarkable performance likely to continue? To answer these questions, the income flows from debt holdings and foreign direct investment (FDI) are examined separately.

On the debt side, the fall in U.S. interest rates—reflecting accommodative monetary policies and low premiums on longer debt maturities—has largely offset the impact of the rise in U.S. net foreign debt liabilities. The latter accounts for almost all of the market rise in U.S. net foreign liabilities in recent years. The net positions for other types of holdings—foreign direct investment, portfolio equities, and "other" assets, mainly comprising bank loans—have remained broadly balanced.

Regarding FDI, there has been a consistent surplus of about 1 percent of GDP on associated incomes over the past 20 years even though holdings of *foreign direct investment* assets and liabilities are approximately balanced. This reflects yields on U.S. assets abroad that are much higher than those on foreign investment in the United States.[2] With no significant differences in returns on other types of international assets and liabilities, this surplus explains why the income account has remained in surplus over recent years despite the fact that the United States is a significant net debtor.[3]

Various explanations have been proposed for why rates of return on U.S. direct investment abroad remain almost twice as large as those on equivalent foreign inflows. The rate of return on U.S. investment abroad is similar to that achieved by domestic companies in the United States and other countries. Accordingly, the main issue seems to be the low rate of return on foreign investment in the United States, a somewhat surprising result given the widespread view that the United States is an attractive location for foreign ventures.

Structural factors play a role.[4] Foreign affiliates are slightly more concentrated in industries with low returns, tend to be less profitable when their market share is small, and have higher leverage, and new ventures have lower rates of return, presumably reflecting the initial costs of entering the U.S. market. Indeed, the maturation of earlier FDI may help explain the narrowing differentials in returns over recent years. In addition, yields on U.S. investment abroad may reflect a risk premium, given that about one-third of these investments are in emerging markets.

Note: The main authors of this box are Tamim Bayoumi, Kornélia Krajnyák, and Alejandro Justiniano.

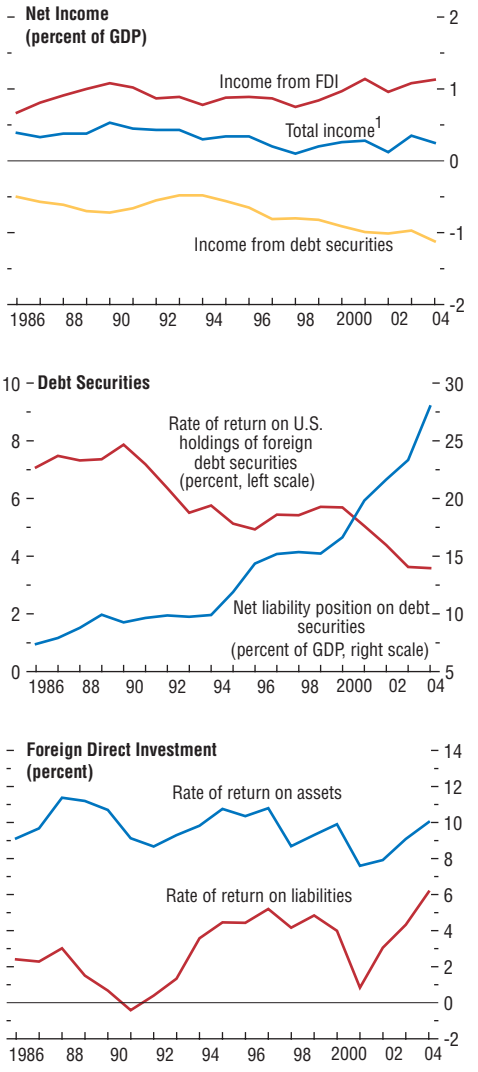
[1]Chapters 3 and 4 of IMF (2005c) discuss the deterioration of the U.S. trade balance and U.S. international investment position, respectively.

[2]Although the yields gap has narrowed over time, the impact on income flows has been offset by an increase in gross FDI assets and liabilities as a ratio to GDP.

[3]For completeness, a small surplus has been maintained over recent years on the income account for equity portfolio investment, reflecting both slightly higher rates of return and gross stock of assets compared to liabilities. Net flows on "other" investments have remained close to balanced.

[4]See Mataloni (2000), Grubert (1997), and references therein. For example, the rate of return on assets of FDI firms tended to be substantially lower than the industry average in motor vehicle production, rubber and plastic products, and electronic equipment over 1988–97.

Developments in the U.S. International Income Account



Sources: U.S. Bureau of Economic Analysis; and IMF, *Balance of Payments Statistics*.

[1]Includes FDI, debt, equity, and other flows.

The size of the difference in rates of return, however, has led researchers to ask whether mechanisms that transfer profits to the foreign host company also play a role in reducing observed yields on foreign affiliates in the United States. For example, foreign firms could buy U.S. subsidiaries to acquire new products or processes, whose profits may then be booked abroad. Indeed, royalties (and dividends) are less important in foreign affiliates' incomes than in those of domestically owned U.S. companies. In addition, transfer pricing of components may be used to move profits out of the United States for tax purposes. Rates of return tend to be lower for subsidiaries whose host companies are in low-tax jurisdictions and those that import and export larger amounts of components with their hosts. In addition, on a firm-by-firm basis, foreign subsidiaries in the United States have an unusual concentration of taxable profits around zero. However, these characteristics also tend to be true of firms with minority foreign stakes (25–50 percent) as opposed to fully foreign-owned firms—and thus may only explain a limited amount of the differential in yields.

Looking ahead, the support to the U.S. current account from income flows is likely to erode rapidly—indeed, the IMF staff projects that the U.S. international income position will move into deficit later this year. Rising global interest rates will raise the deficit on income flows from debt instruments, a trend reinforced by continuing increases in the net foreign liabilities from large U.S. current account deficits. With about equal contributions from interest rate and debt increases, this could reduce the net income balance of the United States by about 1 percent of GDP in coming years, putting downward pressure on the current account and exchange rate.

further to 2.7 percent of GDP in FY2005 prior to the emergency spending associated with Hurricane Katrina, which, according to budget requests to date, may amount to some 0.5 percent of GDP. That said, the strong revenue rebound may partly reflect the unwinding of

factors that depressed tax collections in the aftermath of the collapse of the equity bubble, and future fiscal receipts will probably grow more in line with corporate profits and income growth. And looking forward, the U.S. Administration's plan to reduce the unified budget deficit to below 2 percent of GDP by FY2009 remains both relatively unambitious, and—since it depends on unprecedented compression of discretionary nondefense spending, while not providing funding for operations in Iraq and Afghanistan beyond FY2006 or the reform of the Alternative Minimum Tax—subject to considerable risk.

Given the relatively favorable outlook, a bolder adjustment effort is warranted, with the aim of achieving broad budget balance—excluding social security—by 2010. Such an adjustment would require consideration of revenue measures, given the already very stringent spending discipline assumed in the U.S. Administration's proposals. Options include broadening the income tax base by curbing deductions, a national consumption tax, or an energy tax. The consolidation efforts would be supported by a legislated budget rule, with pay-as-you-go provisions for all expenditures, including tax expenditures. Recent steps to address the solvency of the Social Security system, including a proposal for slowing benefits growth, are welcome, and only relatively modest additional steps would be required to eliminate the system's underfunding, if implemented in a timely manner. However, Medicare outlays are on an explosive path, and urgent steps are needed to address the system's underfunding and to increase the efficiency of the U.S. health care system.

In Canada, real GDP growth has rebounded, driven primarily by strong consumption, which has been underpinned by robust employment gains—with unemployment reaching a 30-year low—strong wage increases, and rising house prices. Consumer price pressures have remained contained; core inflation remains below 2 percent. Nevertheless, with labor market conditions tightening and unit labor costs increasing, price developments need to be monitored carefully, and the Bank of Canada has appropriately resumed withdrawing monetary stimulus. Fiscal policy is expected to remain on a steady course, with the general government continuing to run a surplus of about ½ percent of GDP, and the net public debt ratio is projected to decline steadily in the coming years. If this prudence is sustained in the face of political demands for higher government spending, the country will be in a favorable position when the fiscal pressures arising from population aging begin to emerge. However, to ensure long-term fiscal sustainability with an aging population, prudent fiscal policies will need to be accompanied by reforms aimed at increasing the efficiency of health care systems and structural policies to boost productivity growth and economic flexibility.

Western Europe: The Recovery Continues to Struggle

The tentative expansion in the euro area has faltered once again. After showing signs of revival in the second half of 2004, final domestic demand has since slowed considerably; while GDP growth averaged about 1¼ percent in the first half of 2005, this primarily reflected a stronger contribution from net exports. On the political front, the rejection of the European Union (EU) constitution by France and the Netherlands, as well as the subsequent and acrimonious failure to agree on the EU budget, have so far had a limited effect on confidence, with the financial market impact limited to a small widening of spreads for high debt countries, and a moderate depreciation of the euro.

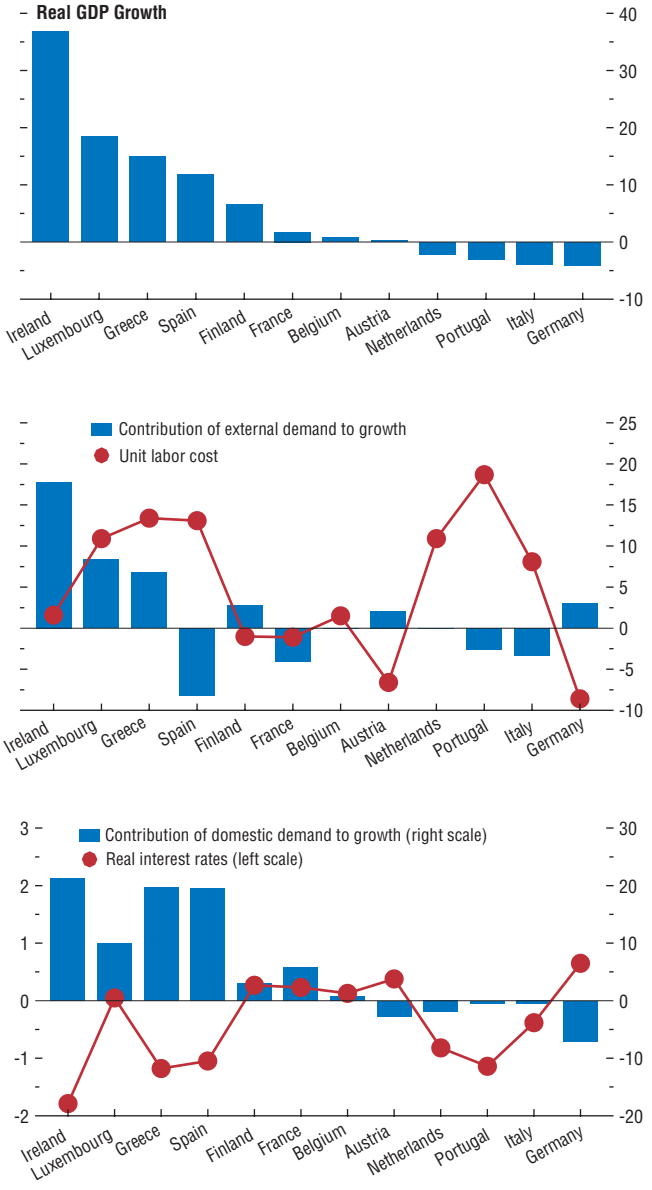
Looking forward, the outlook is highly uncertain. While confidence indicators remain subdued, incoming data—notably for exports and, more tentatively, manufacturing—have generally strengthened. Moreover, corporate balance sheets have continued to improve, with profitability continuing to rise, aided by prudent wage setting; employment has been more resilient than during past cycles (although

unemployment remains high); long-run interest rates are at historic lows; and solid global growth and recent euro depreciation should also be supportive. Against this background, the expansion is expected to gradually regain momentum in the second half of the year, with euro area GDP growth projected to average 1.2 percent in 2005, rising to 1.8 percent in 2006 (0.4 and 0.5 percentage point lower than projected last April). That said, the consistent overestimation of the strength of the expansion in the euro area in recent years, as well as the fact that corporations as yet show little sign of investing their now substantial profits, underscore the risks of a more extended period of weakness. Notably, the lack of internal dynamism makes the euro area particularly susceptible to external shocks, including higher oil prices, a renewed sharp appreciation of the euro, or a rebound in global interest rates. A number of country-specific risks also remain, including richly valued housing markets (Spain and Ireland) and high household debt-to-income ratios and a high concentration of bank lending in Portugal.

Economic performance across the euro area remains very diverse. Among the major countries, domestic demand in Spain and—except in the second quarter of 2005—France has been relatively strong, while net exports have subtracted from growth. In contrast, domestic demand in Germany, and to a lesser extent Italy, has been considerably weaker, although German GDP has increasingly been boosted by strong net exports (see Box 1.3, "What Explains Divergent External Sector Performance in the Euro Area?"). In fact, these developments are not especially unusual (Figure 1.12), and reflect a variety of factors, including differences in underlying productivity growth and in fiscal stances, as well as country-specific and other shocks. But they are also indicative of less benign factors, including rigidities in product and labor markets across the zone. Differences in competitiveness can take a considerable time to reverse, and—partly associated with that—inflation differentials can

Figure 1.12. Euro Area: Growth Divergences Since EMU
(Cumulative difference from euro area average in percent, 1999–2004)

The level and composition of growth have differed widely across euro area countries over the past five years. This has partly resulted from differences in inflation rates across the area, reflected in both real interest rates and unit labor costs.



Sources: OECD, *Economic Outlook;* and IMF staff calculations.

Box 1.3. What Explains Divergent External Sector Performance in the Euro Area?

Against the generally weak economic performance in the euro area in recent years, there have been striking divergences in the external sector contribution to growth among the three largest countries. In Germany, net exports have contributed strongly to growth, in fact exceeding the cumulative increase in GDP over 2001–04. In Italy, however, net exports have contributed negatively to real growth since 2002, whereas in France, the contribution of the external sector switched from being marginally positive in 2001–02 to appreciably negative in 2003–04.

These differences in the contribution of external demand to growth mask significant variations between countries in import and export growth dynamics, on the one hand, and in goods and services growth on the other (see the figure). To understand what has been driving this variation, IMF staff conducted an econometric exercise to identify the main determinants of imports and exports for each of the three major euro area countries.[1]

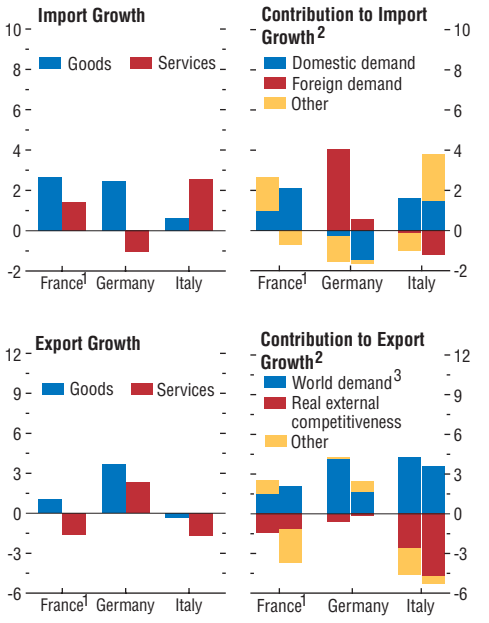
For imports, it is the relative import content of domestic and foreign demand that accounts for most of the difference in import growth between the three countries. In particular, the vigor of export growth explains most of the recent evolution of imports in Germany, likely reflecting an increase in the share of intermediary imports in the production of exported manufactured capital goods. Conversely, the resilience of Italian imports owes much to the stability of domestic consumption.

Nonetheless, most of the divergences in external sector performances originate from export growth dynamics. Uneven demand developments in the key trading partners of the major euro area countries are partly responsible. Since 2001, France has faced consistently lower effective foreign demand growth than Germany and Italy, reflecting weak domestic demand in the latter two economies. In addition, exporters in France and Italy are less geared toward fast-growing areas—such as emerging Asia and the United States—than their German counterparts. However, in the case of Italy, the strength of effective global demand has been insufficient to prevent a collapse of sales abroad. Tellingly, between 2001 and 2004 import demand in Italy's trade partners increased, on average, by 4 percent a year in real terms, whereas the volume of Italian exports has actually fallen.

Another source of disparity in export performances is the sectoral composition of

Accounting for Country Differences in Trade Growth

(Percent, average annualized growth rate, 2001–04)



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

[1]For France, "goods" refer to the manufacturing sector and "services" to the rest of the economy.

[2]The first stacked bar for each country refers to goods, and the second one to services.

[3]Calculated as a weighted average of trade partners' GDP.

Note: The main authors of this box are Celine Allard and Silvia Sgherri.

[1]Based on quarterly data from the 1980s, except for Germany, where the sample period starts only after reunification.

exports. Whereas Germany has traditionally specialized in the more dynamic sector of manufactured capital goods, France and Italy have been somewhat hampered by their concentration on consumer goods, which are more vulnerable to competitive pressures from emerging markets.

The most important factor explaining recent differences in export performance among euro area countries, however, is the divergence in price and cost competitiveness. In this respect, even if the euro area countries share the same currency, in real terms, their price position vis-à-vis trading partners has evolved very differently. Owing to wage moderation, tax cuts, and cost retrenchment, relatively low inflation has contributed to a limited appreciation of the real effective exchange rate in Germany, whereas higher average inflation has caused a slightly stronger appreciation in France. At the same time, Italy has experienced a steady deterioration in competitiveness—owing to plunging labor productivity and rising production costs—that has hobbled its export performance.

Because divergences in relative prices and costs have been blurred by different productivity developments, the external competitiveness channel has not been able, recently, to smooth cyclical differences across the major euro area countries. Conceptually, in the absence of independent monetary and exchange rate policies, countries facing weak cyclical positions are likely to experience lower inflation and enjoy an improvement in competitiveness relative to the other members of the union. However, this link is found to be quite tenuous. Member states with comparatively large positive output gaps in the late 1990s have managed to contain unit labor cost pressures, whereas those with comparatively lower cyclical pressures have registered large losses in competitiveness in the past few years. The most striking case is Italy. Here, the weakness of domestic demand has been coupled with a negative contribution of exports, which have been hampered by unit labor costs that have risen faster than those of the country's main European competitors. Thus, the stagnation of the Italian economy has not prevented a further deterioration in external sector performance.

In addition to productivity developments, another factor that appears to have dampened the effectiveness of the competitiveness adjustment mechanism among euro area countries is the behavior of exporters' margins. If margins are maintained in the face of a deterioration in competitiveness owing to unfavorable developments in productivity, export performance will suffer, with additional negative effects on growth. In Italy, for example, exporters appear to have responded to the appreciation of the euro by passing on to export prices a higher-than-average percentage of the increase in unit labor costs, to preserve profitability.

be very persistent.[12] This complicates national policymaking, including by exacerbating pressures in housing markets, particularly when the scope for offsetting policy action is limited. These rigidities also make area-wide monetary policy management more costly; if area-wide product and labor market competitiveness were brought to U.S. levels, the sacrifice ratio (the output cost of reducing inflation by 1 percentage point) would be reduced by one-third.[13]

Given the continued weakness of domestic demand, inflationary pressures in the euro area are easing. While headline inflation remains above 2 percent, in part reflecting the impact of higher oil prices, core inflation has slowed significantly, unit labor costs are essentially flat, and inflationary expectations remain reasonably well

[12]See, for instance, Ortega (2003) and European Central Bank (2005).

[13]See "Unemployment and Labor Market Institutions: Why Reforms Pay Off," Chapter IV the April 2003 *World Economic Outlook*.

anchored. Against this background, headline inflation is expected to fall back to an average 1.8 percent in 2006, broadly in line with the European Central Bank (ECB) target of close to but less than 2 percent. Past underestimation of inflation—in part due to unexpected increases in administered prices—and oil price risks provide some reason for caution, but overall excessive monetary tightness appears a greater risk than excessive monetary ease. If inflationary pressures remain restrained, and the expected recovery fails to materialize—or if the euro appreciates significantly—an interest rate cut should be considered.

On the fiscal side, the euro area deficit is projected to rise to 3 percent of GDP in 2005, with five countries—France, Germany, Greece, Italy, and Portugal—expected to exceed the 3 percent of GDP limit, in some cases by significant margins. With fiscal pressures from aging set to accelerate very shortly, most countries should ideally achieve a broadly balanced fiscal position by the end of the decade—requiring an average improvement in structural balances of about ½ percentage point of GDP annually—accompanied by further progress in pension and health reforms. The IMF staff's assessment of present budgetary policies, particularly in the largest countries, suggests they fall far short of meeting this requirement, with most showing little improvement or a deterioration in 2005–06; in particular, in Italy, significant—and as yet unidentified—adjustment will be required to reduce the general government deficit to the authorities' target of 3.8 percent of GDP in 2006. This will pose a key test of the revised Stability and Growth Pact procedures, and it will be important that the additional flexibility they allow is not used as an excuse to postpone adjustment altogether. Both the realism and public understanding of national Stability Plans could be improved if they were reviewed by independent fiscal councils and debated in parliaments.

In the United Kingdom, GDP growth has proved weaker than expected. Private consumption growth slowed sharply in the first half of 2005, in part reflecting higher interest rates, oil price increases, and the cooling—if still elevated—housing market; while export growth—which weakened sharply in the first quarter—is showing signs of recovery, business confidence has weakened. Correspondingly, GDP growth is now projected at 1.9 percent in 2005, 0.7 percentage point lower than expected in April, before recovering to 2.2 percent in 2006, with higher oil prices and weaker euro area growth key downside risks. While CPI inflation has risen above 2 percent, reflecting in part rising oil prices, core inflation remains moderate and private sector wage growth has eased. Against this background, the Bank of England appropriately reduced interest rates by 25 basis points in August; looking forward, future moves will depend on incoming data, especially with respect to domestic demand. With IMF staff projections suggesting no improvement in the fiscal deficit in 2005 or 2006, fiscal consolidation remains necessary to ensure that the golden rule is met over the next cycle.

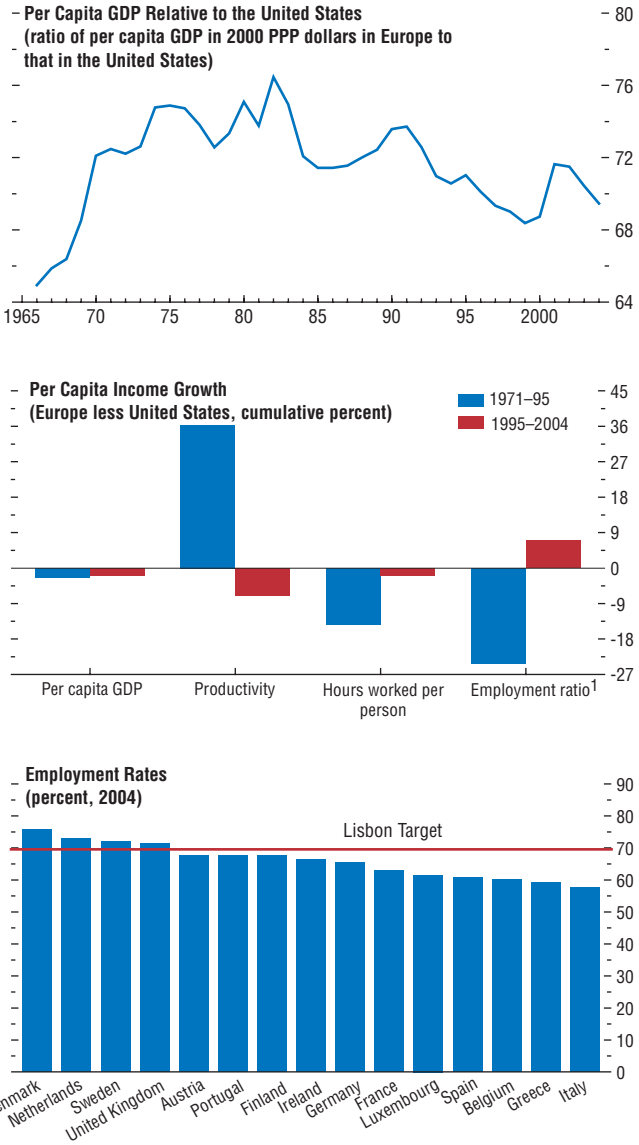
Following strong recoveries in 2004, performance in the Nordic countries has become more divergent. In Norway, high oil prices have supported strong GDP growth, prompting the Norges Bank to begin the tightening cycle; growth in Denmark is expected to remain broadly unchanged from 2004 at 2.2 percent, notwithstanding a temporary weakening of domestic demand in early 2005. The outlook in Sweden weakened markedly in the first quarter, accompanied by slowing demand growth in key European trading partners. While substantial fiscal stimulus in the pipeline will help support activity, the Riksbank cut interest rates by 50 basis points in late June. In Switzerland, the expansion has also weakened, reflecting the general slowdown in global manufacturing and weak euro area domestic demand; with inflation risks low, the Swiss National Bank has appropriately maintained a very accommodative monetary stance. Early elimination of the structural federal deficit and decisive reforms of pension and health systems remain key to addressing looming pressures from aging, along with competition-enhancing measures to boost low potential growth.

With Europe's per capita GDP having stagnated at about 70 percent of the level in the United States for the past 30 years, raising potential growth remains a central challenge. In this connection, a key issue in many countries is to raise labor utilization: apart from the direct economic and social benefits, this could also substantially improve the solvency of national pension systems. Since the mid-1990s, progress has clearly been made (Figure 1.13), and more recent reforms, such as Agenda 2010 in Germany, should lead to further improvements. But with many countries unlikely to achieve the Lisbon target of an employment rate of 70 percent by 2010, there is much further to go. Priorities vary across countries, but include minimum wages and greater flexibility in wage bargaining (France, Germany, and Italy); lowering tax wedges (Germany, Greece, Italy, the Netherlands, Spain); reforming employment protection (France, Greece, Italy, Portugal, Spain); reducing incentives for early retirement (Austria, Belgium, France, Germany, Greece); and reforms to social safety nets including—depending on the country—welfare, unemployment, or invalidity programs (Belgium, Germany, Greece, the Netherlands, Norway, and Spain). A further challenge will be to ensure sufficient demand for the rising supply of older—and lower-productivity—workers in the labor force, which could, inter alia, require reforms to systems of seniority pay.

Looking forward, a key question is how to accelerate the reform momentum. At the central level, priorities remain the completion of the internal market—a potentially important support for labor market reforms, although the recent rejection of the Services Directive was a setback—and further financial market integration. However, as stressed in the revised Lisbon Strategy, the key to further progress increasingly resides at the national level; with signs of growing reform fatigue, this will be a challenging task. In this context, in cases where structural reforms are expected to yield significant long-term fiscal benefits, short-term trade-offs with fiscal adjustment should not be ruled out. National

Figure 1.13. Europe: Why Has per Capita GDP Stagnated Relative to the United States?

Since 1970, strong European productivity growth has been offset by falling working hours and lower labor utilization. While these trends have partly reversed since 1995, low labor utilization remains a key concern, especially in continental Europe.



Sources: OECD, *Economic Outlook;* Eurostat; and IMF staff calculations.
[1]Includes differences in age structure of the population.

governments will need to make the case for reform more clearly, including—as the Kok (2004) report stresses—bringing out clearly the costs of failing to act; preparation of National Action Plans under the revised Lisbon Agenda, and their debate in parliament, will be an important step in that process.

Japan: A Strong Rebound, but Reforms Need to Continue

The Japanese economy expanded strongly in the first half of 2005, driven by a recovery in private final domestic demand. Robust private consumption was underpinned by a strengthening labor market—full-time employment is expanding for the first time in seven years and wage growth has turned positive—while business investment grew strongly as corporate profitability remained high. Net exports, however, contributed little to growth, marking a turnaround from earlier in the cycle when exports—particularly to China and the rest of emerging Asia—were the main growth engine.

Recent indicators suggest that the positive growth momentum seen in the first half of the year will continue. The recovery in wages and employment is continuing to support private consumption, the June Tankan survey showed business confidence increasing and firms revising upward their investment plans, and progress was made in reducing inventories in the second quarter. Export growth is also expected to rebound as the global economic environment remains supportive and the IT sector adjustment runs its course. Consequently, real GDP is now projected to expand by 2 percent in both 2005 and 2006. While domestic demand is recovering, there are downside risks to the outlook, particularly given the continued rise in oil prices and the possibility of renewed upward pressures on the yen in an environment of large global current account imbalances.

Considerable progress has been made in addressing weaknesses in the bank and corporate sectors in recent years, and this progress has put the economy in a better position to sustain an expansion. In particular, the Financial Services Agency has increased its regulatory pressure on banks, and in turn this has forced banks to deal more forcefully with their problem borrowers. As a consequence of these actions, and the cyclical recovery in the economy, nonperforming loans have fallen by more than one-half among the major banks (somewhat less for the regional banks), corporate debt levels have declined, excess capacity in the corporate sector has fallen, and the return on assets in the bank and corporate sectors has increased (Figure 1.14). Further, the coverage of deposit insurance was successfully scaled back at end-March 2005, evidence of solid public confidence in banking system stability.

This reform momentum in the bank and corporate sectors needs to be maintained. To this end, the government has announced a program to create a more efficient and flexible financial system ("The Program for Further Financial Reform"). Some of the key issues that will need to be addressed in the period ahead are as follows.

- The profitability of Japanese banks—which is low by international standards—needs to be increased and the banks' capital bases strengthened so they can better support growth. One component of raising profitability will be to increase interest margins, including by improving credit assessment processes and ensuring that loans, particularly to higher risk borrowers, are appropriately priced (see Bank of Japan, 2001, 2004).[14] This process will be aided by planned steps to improve risk management and tighten regulation using the Basel II Accord of the Basel Committee on Banking Supervision as the overarching framework. Recent large bank mergers have been

[14]Noninterest income of Japanese banks is also low compared with that of their U.S. counterparts (see Chapter II of the September 2005 *Global Financial Stability Report*).

undertaken with a view to raising profitability. The envisioned privatization of Japan Post will also help bank profitability if it eliminates the competitive advantages that this government-owned entity with huge bank and insurance businesses currently enjoys.

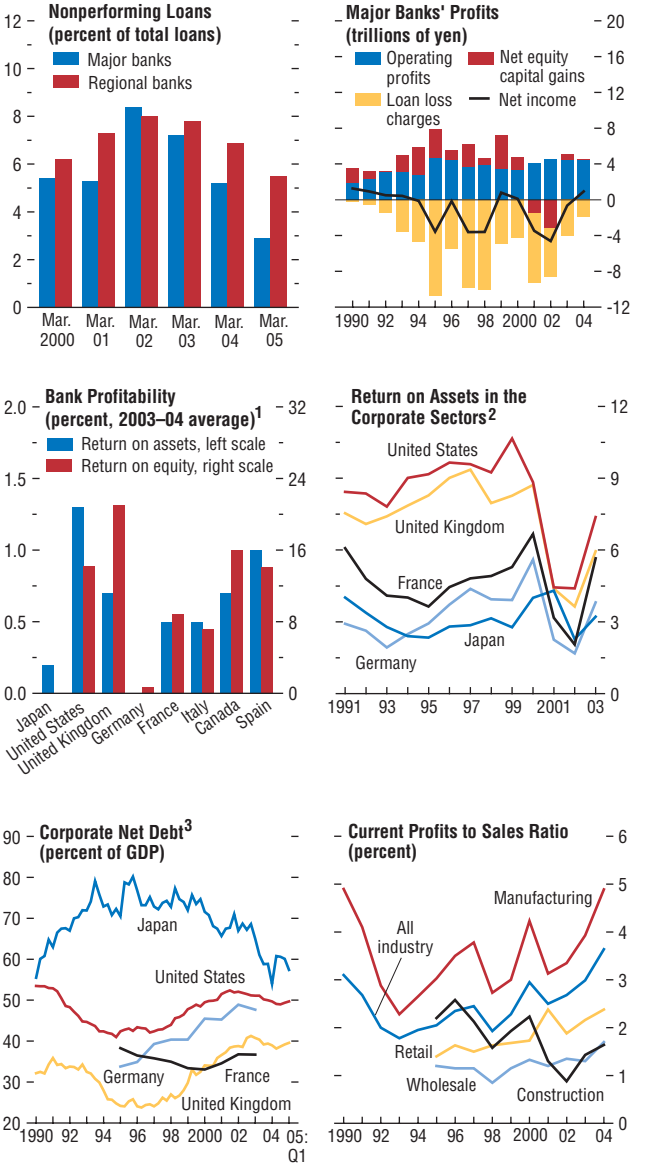
- The corporate sector needs to earn a higher rate of return on its assets, with reform particularly needed in the domestically oriented sectors of the economy. While the manufacturing sector has made significant strides in boosting profitability since the recession in 2001, much less progress has been made in the construction, retail, and wholesale sectors. Moreover, despite the considerable progress in deleveraging, corporate debt remains elevated in some sectors and further adjustment seems desirable.

As highlighted in the recent report by the expert committee of the Council on Economic and Fiscal Policy ("Japan's 21st Century Vision"), structural reforms are needed to raise productivity, allow the Japanese economy to reap the full benefits of globalization, and cope with ongoing population aging. Among the most important are steps to increase product market competition; improve flexibility in the labor market; encourage foreign direct investment, which remains very low by international standards; and reduce agricultural trade protection.

Mild deflation continues, with the core CPI declining by 0.2 percent (year-on-year) in July, and the GDP deflator falling by 0.9 percent (year-on-year) in the second quarter of the year. Land prices (residential and commercial) are also still declining, although at a slowing rate (and are actually now rising in central Tokyo). Until deflation is decisively beaten, it is important that the Bank of Japan maintain its very accommodative monetary policy stance. A premature end to the existing quantitative easing framework would endanger the progress that has been made in tackling deflation in recent years. Consideration needs to be given to how to guide expectations when inflation returns, and the announcement of an explicit medium-term inflation objective could be a useful

Figure 1.14. Japan: Indicators of Bank and Corporate Sector Financial Health

Considerable progress has been made in strengthening the bank and corporate sectors in Japan. International comparisons, however, suggest that more needs to be done to return these sectors to full strength.



Sources: National authorities; Financial Services Agency; Fitch Research; European Central Bank; Haver Analytics; CEIC Data Company Limited; and IMF staff calculations.
[1]2002–03 average for Germany, France, and Italy because 2004 data were not yet available.
[2]Percent, mean-weighted by market capitalization.
[3]Defined as financial liabilities less financial assets of the nonfinancial corporate sector.

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]			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Emerging Asia[3]	**7.5**	**7.9**	**7.3**	**6.9**	**2.4**	**4.0**	**3.9**	**4.4**	**4.3**	**4.1**	**3.7**	**3.4**
China	9.5	9.5	9.0	8.2	1.2	3.9	3.0	3.8	3.2	4.2	6.1	5.6
South Asia[4]	**7.1**	**7.1**	**7.0**	**6.3**	**3.9**	**4.3**	**4.7**	**5.6**	**1.3**	**–0.2**	**–1.9**	**–2.1**
India	7.4	7.3	7.1	6.3	3.8	3.8	3.9	5.1	1.2	–0.1	–1.8	–2.0
Pakistan	5.7	7.1	7.4	6.5	2.9	7.4	9.9	9.8	3.4	0.2	–1.7	–2.3
Bangladesh	5.8	5.8	5.7	6.0	5.4	6.1	6.2	5.8	0.2	–0.4	–1.5	–1.8
ASEAN-4	**5.4**	**5.8**	**4.9**	**5.4**	**4.1**	**4.5**	**6.4**	**5.1**	**5.5**	**4.4**	**2.2**	**2.4**
Indonesia	4.9	5.1	5.8	5.8	6.8	6.1	8.2	6.5	3.4	1.2	–0.4	0.7
Thailand	6.9	6.1	3.5	5.0	1.8	2.7	4.2	2.7	5.6	4.5	–2.5	–2.5
Philippines	4.5	6.0	4.7	4.8	3.5	6.0	8.2	7.5	1.8	2.7	2.1	1.9
Malaysia	5.4	7.1	5.5	6.0	1.1	1.4	3.0	2.5	12.9	12.6	13.5	12.4
Newly industrialized Asian economies	**3.1**	**5.6**	**4.0**	**4.7**	**1.5**	**2.4**	**2.2**	**2.3**	**7.4**	**7.2**	**5.5**	**5.0**
Korea	3.1	4.6	3.8	5.0	3.5	3.6	2.8	2.9	2.0	4.1	2.0	1.5
Taiwan Province of China	3.3	5.7	3.4	4.3	–0.3	1.6	2.0	1.8	10.2	6.1	4.3	4.6
Hong Kong SAR	3.2	8.1	6.3	4.5	–2.6	–0.4	1.0	1.3	10.3	9.8	10.3	10.2
Singapore	1.4	8.4	3.9	4.5	0.5	1.7	0.7	1.7	29.2	26.1	25.7	22.7

[1]In accordance with standard practice in the *World Economic Outlook,* movements in consumer prices are indicated as annual averages rather than as December/December changes, as is the practice in some countries.
[2]Percent of GDP.
[3]Consists of developing Asia, the newly industrialized Asian economies, and Mongolia.
[4]The country composition of this regional group is set out in Table F in the Statistical Appendix.

element of a post-deflation monetary policy framework.

Sustained fiscal consolidation is needed to reverse the ongoing rise in public debt and to make room for the pressures that population aging will place on the budget. Against this background, a further reduction in the budget deficit is envisaged during 2005–06, and the government has announced the goal of achieving primary budget balance (excluding social security) by the early 2010s, which would require a fiscal adjustment of about ½ percent of GDP a year. While welcome, this target may not, however, be sufficient to stabilize public debt over the medium term, and more ambitious fiscal consolidation—on the order of ¾ percentage point of GDP a year—is likely to be needed.[15] Such fiscal consolidation will be more easily maintained in an environment of sustained solid growth, again emphasizing the importance of continued structural reforms. Further, the government has announced few details of how it intends to achieve its fiscal objectives, and the early publication of a more concrete deficit reduction strategy would enhance the credibility of fiscal policy.

Emerging Asia and the Pacific: Balanced, Twin-Engined Growth Needed

In 2004, GDP growth in emerging Asia's economies rose to 7.9 percent, driven by vigorous exports and a marked pickup in domestic demand in late 2003 and early 2004, underpinned by supportive macroeconomic policies and financial market conditions (Table 1.6). However, from mid-2004, regional divergences increased markedly: while growth in China and India remained relatively robust, the expansion in much of the rest of the region slowed, reflecting the impact of higher oil prices and the IT sector correction. With conditions in the IT sec-

[15]See IMF (2005a)

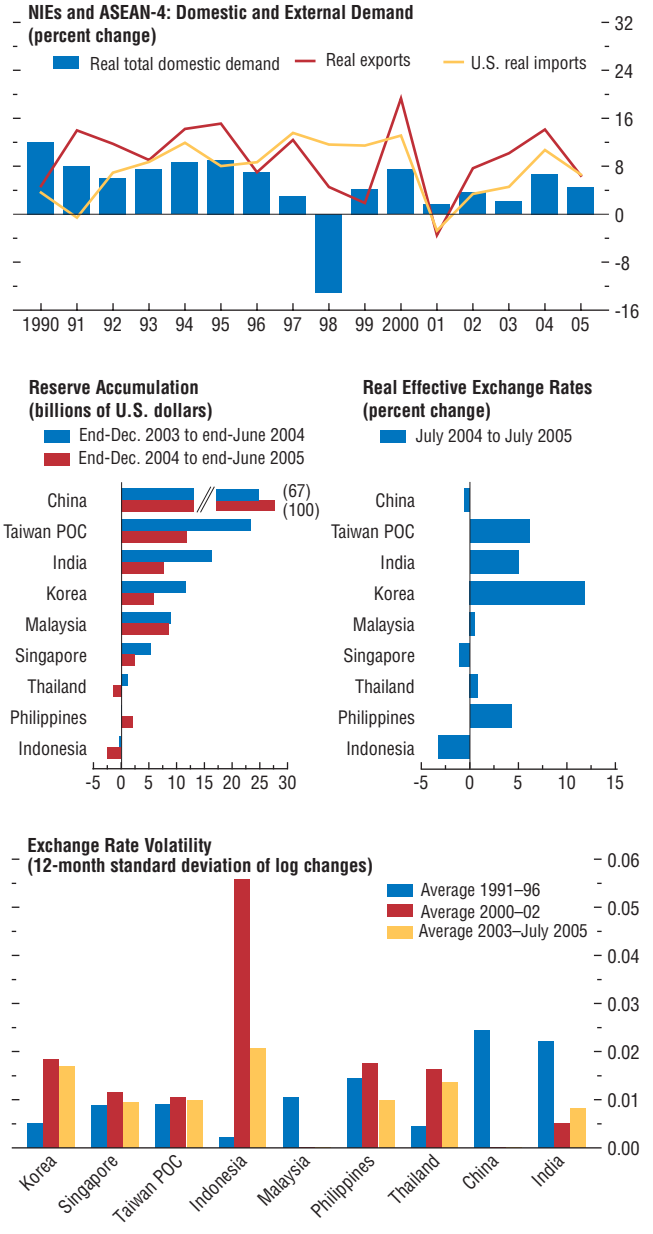
tor starting to improve, and recent data suggesting that industrial production and trade in the region are picking up, the expansion is expected to strengthen during the year, with regional GDP growth projected to average over 7 percent in 2005 and close to that in 2006. Regional inflation picked up in 2004, but—with some exceptions—remains well contained.

Within this broad picture, consistent with the assessment for the globe as a whole, risks are increasingly slanted to the downside. Persistently high oil prices will adversely affect activity, especially since a number of countries—including India, Indonesia, Malaysia, and Thailand—have yet to pass through the full effect of past increases to domestic prices, in some cases at substantial fiscal cost. More generally, much depends on the strength of the pickup in the IT sector as well as developments in the United States and, increasingly, China (Figure 1.15). Elsewhere in the region—with the exception of India, and to some extent Indonesia and Thailand—there are only modest signs of autonomous domestic demand-led growth. Consequently, the region has a particularly large stake in an orderly reduction of global imbalances and the avoidance of a pickup in protectionist pressures. Country-specific risks are also a concern, including in Indonesia, where excess liquidity and the rising budgetary cost of oil subsidies led to significant financial market pressures in late August, and in the Philippines, where, after several months of improving fundamentals, the recent political turmoil has raised concerns about the prospects for economic reforms and led to downward revisions to the ratings outlook.

On the external side, the regional current account surplus is projected to decline only modestly from 4.1 percent of GDP to 3.7 percent of GDP in 2005. This aggregate figure disguises sharply different trends across the region, with a marked increase in the current account surplus in China to over 6 percent of GDP offset by reductions—to varying degrees—elsewhere in the region (except in Hong Kong SAR and Malaysia). In China, this has reflected continued

Figure 1.15. Emerging Asia: Growth, Reserves, and Exchange Rate Flexibility

With little autonomous domestic demand in Asia, the outlook is closely linked to export growth. A shift toward domestic demand will need to be accompanied by nominal currency appreciation and greater exchange rate flexibility.



Sources: CEIC Data Company Limited; IMF, *International Financial Statistics;* and IMF staff calculations.

rapid growth in manufacturing exports—aided by the ending of textile quotas—along with a sharp slowdown in import growth, seemingly related to slowing demand for imported capital goods as well as import substitution in some sectors. Elsewhere, weaker current account positions reflect a variety of factors, including higher oil prices, slower growth in IT exports, and exchange rate appreciation (Korea, Taiwan Province of China); and country-specific factors, including the adverse effect of the tsunami (Thailand). There have been similar shifts in the composition of reserve accumulation in the region. Although the monthly average pace of reserve accumulation in emerging Asia thus far in 2005 remains broadly unchanged from 2003 and 2004, China now accounts for nearly two-thirds of the regional average, compared with less than one-third in the previous two years.

Looking forward, the key challenge facing the region remains to achieve appropriately balanced, twin-engined, growth consistent with an orderly reduction in external surpluses over the medium term. In China, where investment is very strong, this will require a gradual shift in the composition of demand toward private consumption, which—at 40 percent of GDP—is at a historic low. In most other countries, as discussed in more detail in Chapter II, the continued very low level of private investment is the greater concern, underscoring the need to complete the unfinished reform agenda in financial and corporate sector restructuring, including improvements in governance. A shift in the composition of growth toward domestic demand will need to be accompanied by a corresponding appreciation of regional exchange rates over the medium term (Appendix 1.2). While the inflationary impact of strong external surpluses has been contained through extensive sterilization, such a strategy will become increasingly difficult over time, and exposes regional central banks to growing capital losses on their reserves. Against this background, a gradual move to greater exchange rate flexibility remains critical. In this connection, the recent exchange rate reforms in China—and the shift to a managed float in Malaysia—are important steps in the right direction, both for the countries concerned and for the region, and the scope for greater exchange rate flexibility afforded by the reforms should be taken full advantage of in the period ahead.

Turning to individual countries, the expansion in China has continued to exceed expectations, with GDP growth now forecast at 9 percent in 2005, easing to 8¼ percent in 2006. Investment growth has moderated somewhat from the levels of early 2004, reflecting a variety of administrative and monetary tightening measures, but remains above 20 percent; moreover, the contribution from net exports has risen sharply, as described above. With large external surpluses continuing to add to considerable excess liquidity in the banking system, open market operations need to be strengthened to reduce excess liquidity, and further monetary tightening will be needed if signs of a rebound in investment growth intensify. The currency reform in July—comprising an initial 2 percent revaluation of the renminbi, a shift to setting the central rate with reference to a currency basket, and an allowable daily fluctuation rate of 0.3 percentage point against the U.S. dollar—is an important step toward greater flexibility, which, if fully utilized, should facilitate the conduct of monetary policy in the period ahead. On the fiscal side, the projected reduction in the budget deficit in 2005, along with continued gradual fiscal consolidation thereafter, will help address large off-budget fiscal liabilities and make room for future demands on public funds arising from population aging, bank restructuring, and public enterprise reform without jeopardizing debt sustainability. More generally, further reform of the banking system and public enterprises and the development of domestic capital markets remain critical to maintaining macroeconomic stability and ensuring that China's large savings are efficiently utilized to support medium-term growth. Measures to address rural-urban disparities, including through improving conditions for interregional labor mobility, are also needed.

Economic activity in India is expected to moderate from the strong pace of the past two years

to about 7 percent in 2005. Strong domestic demand arising from the industrial recovery, and higher oil prices, have led to a sharp widening of the trade balance, but buoyant service exports and remittances are expected to help limit the impact on the current account deficit. After rising sharply in mid-2004, inflation has fallen to the mid-single digits thanks in part to the incomplete pass-through of oil prices as well as monetary tightening; however, underlying inflationary pressures and rapid nonfood credit growth bear close monitoring. While progress has been made in reducing the general government deficit, aided by lower interest rates and reduced subsidies, it remains close to 8 percent of GDP (and off-budget costs of oil price subsidies have risen). Consequently, further fiscal consolidation remains a priority, including tax base broadening and full pass-through of oil price increases, as well as improvements in states' finances; the uniform state-level value-added tax (VAT) introduced in April 2005 may prove crucial in this regard. It is now critical to build a political consensus to significantly accelerate the pace of structural reforms, to ensure that India can achieve growth of 7–8 percent, absorb its growing labor force, and realize the demographic "dividend" (Box 1.4, "Is India Becoming an Engine for Global Growth?"). Much greater progress is needed in building infrastructure—including especially in the energy sector, where India is forecast to experience rapid demand growth in the next two decades; in increasing labor market flexibility and dismantling regulatory impediments in product markets; and in pension reforms.

Growth in Pakistan and Bangladesh is expected to remain strong in 2005, underpinned by robust agricultural and manufacturing growth, and supportive macroeconomic policies. An important challenge in Pakistan is to deal decisively with the overheating of the economy, with the authorities needing to stand ready to take additional monetary policy tightening measures. Fiscal policy needs to be managed tightly to reduce the burden on monetary policy to contain demand pressures. The strong growth in exports of cotton manufactures in early 2005 suggests that Pakistan's investments in the textile sector in anticipation of the expiry of quotas are paying off. In contrast, Bangladesh—the first country to benefit from assistance under the Trade Integration Mechanism—is expected to be negatively affected by the quota expiry although recent measures by the European Union and the United States to curtail garment imports from China may moderate the impact, underscoring the need for flexible exchange rate management. In both countries, priority needs to be given to energy sector reforms, and in Bangladesh, tax, trade, and investment regime reforms are also needed to achieve sustained high growth.

Following a slowdown from mid-2004, GDP growth in the NIEs and ASEAN-4 countries is generally projected to pick up in the second half of 2005 and in 2006. With policy rates still at or close to zero in real terms, and inflationary pressures edging upward, monetary policy tightening in most countries has continued, with the important exception of Korea, where low interest rates have helped to lift consumption by reducing household debt burdens. With the exception of Malaysia, where the ringgit has appreciated marginally since the introduction of the managed float, most ASEAN-4 currencies have come under downward pressure, particularly in Indonesia as noted above. Following the Bank of Indonesia's announcement of an increase in interest rates and reserve requirements in late August, financial markets have stabilized but remain fragile; the government also announced that domestic fuel prices would be raised after October, although with no set timetable or specificity on the extent of the increase. Looking forward, the key macroeconomic priorities remain continued fiscal consolidation—particularly in the Philippines, where large external financing requirements and high public debt remain significant vulnerabilities—along with structural measures to support medium-term growth and boost still-low private investment (Chapter II). Beyond the unfinished agenda of corporate and financial

Box 1.4. Is India Becoming an Engine for Global Growth?

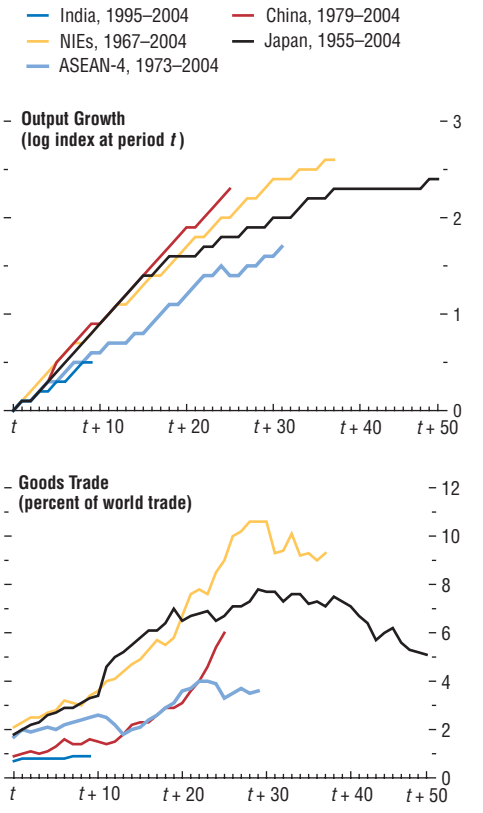
India's recent growth performance places it among the world's fastest growing economies. India experienced 7.7 percent annual growth in 2003–04, higher than growth in all other Asian economies except China, and well above its own trend growth rate since the early 1990s of about 6 percent. As a result, India's share of world output, at PPP-adjusted exchange rates, has increased from about 4.3 percent in 1990 to 5.8 percent in 2004.

One question arising from India's recent robust growth is whether it has become an engine for global growth. Given its sheer size, the pickup in growth in India has had an impact on world growth, albeit substantially smaller than that of China. Over the past two years, India has accounted for just under one-fifth of Asian growth and almost 10 percent of world growth, compared with 53 percent and 28 percent, respectively, for China. However, spillovers from Indian growth remain limited. For example, IMF staff estimates that the acceleration in Indian import growth during 2003–04 had only a marginal spillover to regional growth, adding 0.1–0.4 percentage point to growth in selected Asian countries.

India's limited role to date as a growth engine reflects the fact that it remains a relatively closed economy. While its recent growth performance is comparable to take-offs experienced by other Asian economies in the last quarter-century, it has been far less dependent on global and regional trade (see the figure). Although India has received much attention for its success as an outsourcing destination and is attracting large financial inflows,[1] trade linkages remain weak. India still only accounts for 2½ percent of the global trade in goods and services, which is small when compared with the shares of China and the newly industrialized Asian economies (10½ percent and 9.3 percent, respectively). India's participation in regional and global production chains is also in its infancy. For example, the share of intraregional trade in the total trade of nonindustrial Asia rose from 27½ percent in 1986–90 to 38 percent in 1998–2002, but India's contribution to this trade remains small, at less than 1 percent.

Various factors have hindered India's integration. Despite substantial tariff reductions in recent years, India remains a relatively protected economy, with tariffs averaging 22 percent (18 percent in trade-weighted terms)—above the average emerging Asia and global tariff rates of 9½ percent and 11½ percent, respectively—and significant nontrade barriers remain. Moreover, a

India's Takeoff: A Regional Perspective[1]



Source: IMF staff estimates.
[1]Take-off is defined as the point when a country experienced real growth of at least 10 percent in the three-year moving average of the value of exports.

Note: The main author of this box is Catriona Purfield.

[1]In 2004, India accounted for one-fourth of the portfolio flows to emerging Asia.

range of structural impediments—including restrictive labor laws and onerous red tape—have retarded the growth of manufacturing, which has been the main driver of export-oriented growth in Asia. Reflecting this, the contribution of industry to GDP and employment, at 27 percent and 34 percent respectively, remains well below that of Asia as a whole. Foreign direct investment (FDI) has been hindered by a difficult business climate as well as by caps on FDI in certain sectors (Jain-Chandra, 2005). And the growing inadequacy of India's infrastructure constitutes a major obstacle to private investment and export potential. Fay and Yepes (2003) estimate that infrastructure investment would need to rise to 7–8 percent of GDP a year, an increase of 3 percent of GDP, if India is to maintain its current trend growth. But progress in addressing this bottleneck has been constrained by persistent large fiscal deficits, which, although declining in recent years, remain in the 8 percent of GDP range.

Despite these constraints, India's recent growth spurt has been accompanied by a marked opening to the global economy, albeit from a relatively closed starting point. In 2003–04, India's imports (including services) rose by 33 percent a year, 4 times as fast as in 1990–2002, buoyed by strong investment and consumer demand. Exports grew by 34 percent a year, up from 8 percent in 1990–2002, as India's steel and petrochemical industries have benefited from the global commodity boom and India expanded into engineering goods, pharmaceuticals, and business services. Asia has been a major beneficiary of India's growing openness, although, as already noted, the impact on regional growth has been small. By end-2004, Asia's share in Indian goods imports had risen to 28 percent, up 4 percentage points since 2000. India's exports to Asia accounted for one-third of its total goods exports in 2004, up from less than one-fourth in 2000, driven by the increase in trade with China. Between 2003–04, the growth in exports to China accounted for 15 percent of India's total export growth.

With the authorities actively seeking to strengthen global linkages, India should begin playing a bigger role in the world economy. The IMF staff projects that over the period 2004/05–2009/10, Indian exports will more than double, while imports will nearly triple. The government's objectives are even more ambitious. In this context, tariffs have been reduced significantly, and the government aims to reach ASEAN levels in the next several years by reducing the simple average tariff rate by almost 11 percentage points. Regional trade agreements are being negotiated with South Asia, Mercosur, ASEAN, and China, among others. Controls on inward FDI and external commercial borrowing by domestic firms are being eased and the emergence of world-class Indian corporates is being encouraged by the lifting of controls on outward investment. India has made a start in creating fiscal space for greater public investment, and is seeking to attract greater private participation in infrastructure.

A dynamic and open Indian economy would have an important impact on the world economy. If India continues to embrace globalization and reform, Indian imports could increasingly operate as a driver of global growth as it is one of a handful of economies forecast to have a growing working-age population over the next 40 years. Some 75–110 million will enter the labor force in the next decade, which should—provided these entrants are employed—fuel an increase in savings and investment given the higher propensity for workers to save. Faster growth, rising incomes, and the accompanying urbanization and industrialization of India will, however, exert further pressure on the already tight global energy market. As the seventh-largest importer of crude oil in the world, India is one of the world's more energy-intensive economies, importing over 70 percent of its oil needs. However, with vehicle ownership forecast to quadruple by 2030, oil demand and its dependence on imported crude is likely to rise. Such estimates may be conservative, however, as car ownership could be expected to rise much faster if growth continues to accelerate from trend levels. India's emergence alongside China will thus present important economic opportunities, as well as challenges for the global economy.

sector reforms, key issues include upgrading infrastructure including in the power sector (Indonesia, the Philippines, and Thailand), reducing skill shortages (Malaysia), and further trade liberalization and rationalization of the regulatory environment (Indonesia, Korea, and Thailand).

After several years of steady strong growth in Australia and New Zealand, the pace of activity is forecast to moderate in both countries. The slowing in Australia reflects a welcome cooling of the housing market and the impact of the appreciated exchange rate. Similar trends are at work in New Zealand, although weak growth in exports is likely to play a greater role in the slowdown. Capacity utilization and unemployment rates remain at or near record levels in both economies, but inflation remains under control, owing to timely tightening of monetary policy in both countries. The external current account deficits have widened markedly in both countries, reflecting the appreciation of their currencies, with the deterioration being sharper in New Zealand owing to the strength of domestic demand; but a rebalancing of growth from external sources is expected in coming years, given the strength of global commodity demand, especially for the commodities exported by Australia. Medium-term prospects in both Australia and New Zealand are strong, owing to a consistent track record of fiscal prudence and structural reforms aimed at maintaining competitive product markets and flexible labor markets. Fiscal policy has been focused on generating operating surpluses and reducing debt, as the authorities continue to prepare for long-term spending pressures from population aging and rising health care costs. As for structural reforms, the Australian government has introduced tax and welfare reforms to improve work incentives. In addition, it has announced plans for significant reform of the industrial relations system aimed at moving toward a single national system, reducing the coverage of unfair dismissal laws, changing the determination of minimum wages, and increasing flexibility in working conditions.

Latin America: Will This Be a More Resilient Expansion?

In Latin America, growth has moderated to a more sustainable pace after a sharp rebound in 2004 (Table 1.7). Strong commodity and raw material exports and—in most large economies—broad terms-of-trade gains continue to support the growth momentum, although manufacturing exports have weakened somewhat in tandem with the slowdown in global manufacturing. After some uptick in the second half of 2004, inflation in the region has generally stabilized, but remains volatile with continued heightened commodity price variability. Looking forward, the expansion is projected to continue at a solid pace, with growth remaining above the 1990s average through 2005–06, underpinned by both external and domestic demand growth.

There are downside risks to the near-term outlook, including in particular a weakening of global nonfuel commodities markets, from a slowing of industrial country growth—particularly in the United States if the impact of Hurricane Katrina is greater than currently expected—or from a sharper rise in interest rates in industrial countries. Moreover, if spreads on emerging market debt were to widen, this would adversely affect budget and external positions in many countries and, given high levels of public debt and financial dollarization, increase vulnerabilities. Further increases in oil prices could add to these vulnerabilities in net oil importers, although they would further benefit oil-exporting countries in the region. Rising political uncertainties, as a result of both country-specific events and the crowded regional election schedule over the next year, are also a source of risk, underscoring the need for continued sound policy implementation and cautious debt management.

Nevertheless, prospects are that the current expansion will be more resilient than earlier ones (Figure 1.16). In particular, the availability of external financing is less likely to become a constraint for sustained, low-inflation growth, as growth has been driven to an important extent by strong and geographically more diversified

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]			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Western Hemisphere	**2.2**	**5.6**	**4.1**	**3.8**	**10.6**	**6.5**	**6.3**	**5.4**	**0.4**	**0.9**	**0.9**	**0.6**
Mercosur[3]	**2.7**	**6.0**	**4.4**	**3.8**	**13.4**	**5.7**	**7.0**	**5.8**	**1.4**	**1.9**	**1.4**	**0.4**
Argentina	8.8	9.0	7.5	4.2	13.4	4.4	9.5	10.4	5.8	2.0	1.3	0.1
Brazil	0.5	4.9	3.3	3.5	14.8	6.6	6.8	4.6	0.8	1.9	1.7	0.7
Chile	3.7	6.1	5.9	5.8	2.8	1.1	2.9	3.3	−1.5	1.5	0.3	−0.7
Uruguay	2.2	12.3	6.0	4.0	19.4	9.2	5.2	6.5	−0.3	−0.8	−2.8	−5.3
Andean region	**1.6**	**7.5**	**5.1**	**4.1**	**10.5**	**8.4**	**6.5**	**6.7**	**3.4**	**4.2**	**5.4**	**5.9**
Colombia	4.1	4.1	4.0	4.0	7.1	5.9	5.2	4.8	−1.5	−1.0	−1.8	−1.5
Ecuador	2.7	6.9	2.7	2.8	7.9	2.7	2.0	2.0	−1.8	—	0.2	2.4
Peru	4.0	4.8	5.5	4.5	2.3	3.7	1.8	2.6	−1.8	—	0.3	0.3
Venezuela	−7.7	17.9	7.8	4.5	31.1	21.7	16.6	18.0	13.6	12.7	15.9	14.9
Mexico, Central America, and Caribbean	**1.7**	**4.0**	**3.1**	**3.6**	**6.0**	**7.1**	**4.9**	**4.2**	**−1.7**	**−1.3**	**−1.4**	**−1.1**
Mexico	1.4	4.4	3.0	3.5	4.5	4.7	4.3	3.6	−1.4	−1.1	−1.1	−0.8
Central America[3]	3.5	3.6	3.2	3.2	5.8	7.8	7.7	5.7	−5.0	−4.9	−5.1	−4.4
The Caribbean[3]	1.6	2.1	3.6	4.8	18.6	27.2	5.9	6.6	−0.4	1.3	−0.5	−0.9

[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, as is the practice in some countries. The December/December changes in the CPI for 2003, 2004, 2005, and 2006 are, respectively, for Brazil (9.3, 7.6, 5.1, and 4.5); for Mexico (4.0, 5.2, 3.9, and 3.4); for Peru (2.5, 3.5, 1.8, and 2.5), and for Uruguay (10.2, 7.6, 6.5, and 5.5).

[2]Percent of GDP.

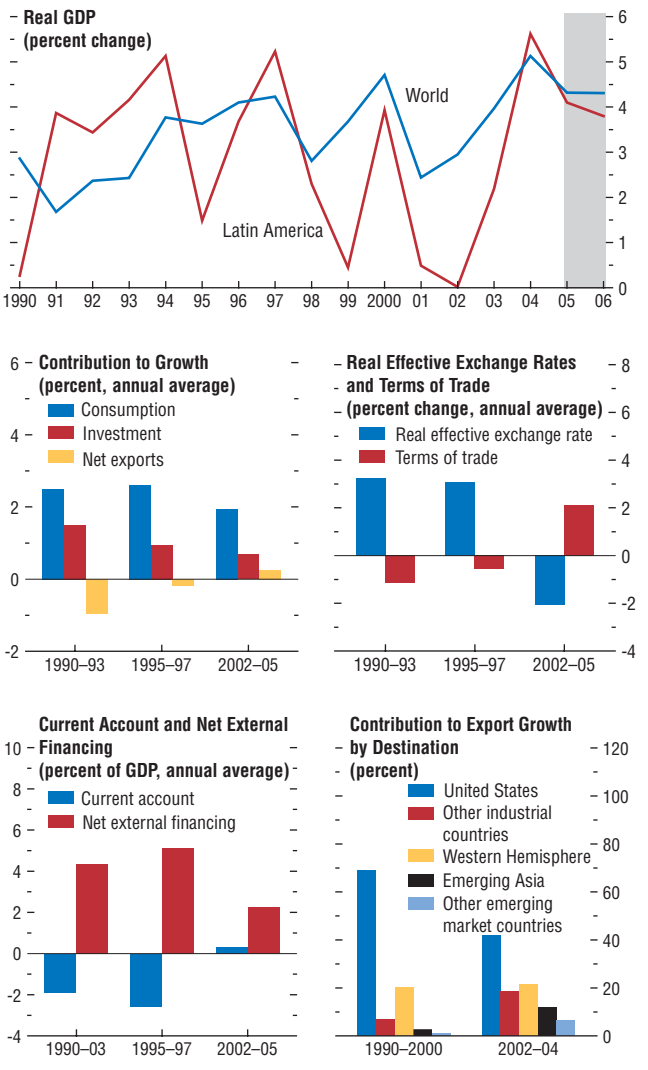
[3]The country composition of this regional group is set out in Table F in the Statistical Appendix.

exports and by terms-of-trade gains. Some countries are now running small current account surpluses—with the regional surplus expected to average more than ½ percent of GDP in 2005–06. In contrast, capital inflows provided much of the impetus in earlier recovery episodes, and growth was largely driven by domestic demand, with current account deficits widening and real exchange rates appreciating in the process. Another factor has been the reduction in the exposure to some short-term risks relative to earlier periods, as many governments have used the current benign international financial conditions to prefinance forthcoming debt service obligations, while current account and external reserves positions are much stronger. Improved macroeconomic policy frameworks have also helped the expansion's resilience. The strengthening of fiscal positions—in contrast to the procyclical policies that led to larger deficits in earlier periods—has been an important step forward, reinforced by the greater focus on achieving and sustaining low inflation—including through the adoption of inflation-targeting frameworks in Brazil, Chile, Colombia, Mexico, and Peru (see Chapter IV, "Does Inflation Targeting Work in Emerging Markets?").

The improved resilience bodes well for the future but, going forward, it will also be important to build on the foundations for higher sustained growth, not only for reasons of insurance—the strong global commodity prices and demand that have partly underpinned strong export growth may not last—but also to close the gap with the growth performance in other dynamic emerging market regions. This will require addressing the fundamental causes of low saving and investment ratios, which continue to lag those in other regions. While the efforts at reducing macroeconomic vulnerabilities will help, complementary structural policy reforms still have some way to go. Specifically, further progress is needed in fostering trade openness and foreign direct investment, in strengthening the rule of law and the enforcement of contracts, and in improving regulatory

Figure 1.16. Latin America: An Anatomy of Recent Expansions

The resilience of the expansions in Latin America has improved compared with earlier ones, helped by strong and more diversified export growth, less reliance on capital inflows, and strong current account and reserve positions.



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

frameworks governing the business environment, including by strengthening competition policy.

Turning to individual countries, economic growth in Argentina has lost some of last year's strong rebound momentum, but remains robust. With growing wage pressures and some monetary accommodation on account of unsterilized foreign exchange interventions, inflation has accelerated, with annual rates rising from 6 percent at end-2004 to above 9 percent in July. While the policy interest rates were raised, further tightening is required, not least in view of the procyclical fiscal easing targeted in the 2005 budget. To sustain solid growth over the medium term, prudent fiscal policies, structural reforms—including the phased elimination of distortionary taxes, the strengthening of the institutional framework of intergovernmental fiscal relations, and improved incentives for private sector participation in the provision of public services—and a resolution of the remaining arrears to private creditors will be required. In Uruguay, growth is projected to slow from over 12 percent in 2004 to 6 percent this year, partly reflecting a closing output gap, moderating growth in trading partners, and terms-of-trade losses. Financial indicators have improved, but significant vulnerabilities related to the high public debt and dollarization remain. Reforms to ensure sustained rapid growth and sufficiently large primary budget surpluses to put debt on a firm downward path will be the key policy challenges.

In Brazil, growth slowed from mid-2004, as domestic demand moderated in response to the tightening of the monetary policy stance, but rebounded in the second quarter of 2005, led by recovery in private consumption and investment. Growth for the year as a whole is now projected at 3.3 percent (compared with 3.7 percent in the April 2005 *World Economic Outlook*), owing primarily to a weaker-than-expected first quarter. Recent activity indicators point to some upside potential to the growth outlook, but higher oil prices and the possible fallout from the political uncertainties add to the downside risks. After

rising from 6.5 percent at end-December 2004 to over 8 percent in May, inflation declined to 6 percent in August. Inflation expectations for end-2005 are now close to the end-2005 midpoint target of 5.1 percent, and further declines in core inflation would allow for a gradual easing of the monetary stance. Fiscal performance remains favorable, with the primary surplus running above target through July, and maintaining a tight fiscal stance will be key to reducing public debt ratios further. In view of the need to accommodate essential social and infrastructure spending while maintaining large budget surpluses, reforms are needed to reduce budgetary rigidities and increase the quality and efficiency of spending. Economic activity in Chile continues to expand at a robust pace, driven by favorable export developments and a pickup in investment. Inflation has remained around the midpoint of the official target range, although core inflation has begun to rise, and the central bank has appropriately continued to tighten monetary policy. The government continues to adhere to the structural budget balance rule, and with strong growth and high copper prices, the central government surplus is projected to rise to close to 3 percent of GDP this year.

In the Andean region, economic activity in Venezuela expanded strongly in 2005, underpinned by an expansionary fiscal policy. Inflation remains high but has declined, reflecting continued price controls and some tightening of monetary policy. Favorable oil market conditions provide an opportunity for lasting improvements on the recent erratic growth performance through decisive measures to strengthen the fiscal position, liberalize the economy, and improve the investment climate. In Colombia, growth held steady in early 2005 with strong export growth, while inflation continued to decline. The fiscal situation is improving and ensuring public debt sustainability remains a key medium-term policy challenge. Structural fiscal reforms are needed to support the authorities' budget targets, including reducing the extent of distortionary taxes, simplifying the value-added tax, and strengthening the revenue-sharing mechanism between the central and regional governments. In Peru, growth remains buoyant, driven by high commodity prices and strong exports, a rebound in agricultural output, and a recovery in fixed investment. Progress in reducing the budget deficit has helped to lower public debt, but the legal and institutional frameworks for fiscal management need to be strengthened further, including at the subnational level. In Ecuador, growth in early 2005 remained solid on the back of higher oil exports—owing to volume and price increases—despite the political crisis, although downside risks to the outlook have increased. High oil prices are masking fiscal vulnerabilities, and measures to modify the fiscal policy framework and the social security system have weakened investor confidence despite declines in public debt. In Bolivia, macroeconomic developments remain favorable, although the uncertain political situation and the highly dollarized financial system present important risks.

In Mexico, growth slowed more than expected in the first half of 2005, reflecting the soft patch in U.S. industrial production and a corresponding slump in automobile-related exports and weak agricultural production. It is expected, however, to rebound in the second half of the year—supported by the recovery in the U.S. manufacturing sector, and steady domestic demand—and annual growth in 2005 is projected at 3 percent. A year of steady and substantial monetary policy tightening—short-term rates rose approximately 500 basis points from early 2004 to April 2005—helped bring core inflation down to 3.4 percent at midyear. The Bank of Mexico started to ease its policy stance in late August, but any relaxation is likely to be gradual, as the bank remains concerned that inflation and inflation expectations are still above its 3 percent target. On the fiscal side, oil revenues are likely to again exceed budget projections, and the priority should be on using these additional revenues to reduce the public debt, although there is also some scope for increasing capital expenditure. Further structural reforms

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]			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Emerging Europe	**4.6**	**6.6**	**4.3**	**4.6**	**9.5**	**6.7**	**4.9**	**4.4**	**–4.3**	**–4.9**	**–4.8**	**–4.9**
Turkey	5.8	8.9	5.0	5.0	25.2	10.3	8.4	6.9	–3.3	–5.1	–5.6	–5.3
Excluding Turkey	4.1	5.6	4.1	4.4	3.7	5.2	3.5	3.3	–4.8	–4.8	–4.4	–4.8
Baltics	**8.4**	**7.5**	**7.1**	**6.5**	**0.6**	**3.1**	**4.0**	**3.3**	**–8.5**	**–10.0**	**–9.5**	**–8.8**
Estonia	6.7	7.8	7.0	6.0	1.3	3.0	3.9	2.8	–12.1	–12.7	–10.9	–9.9
Latvia	7.5	8.5	7.8	6.8	2.9	6.3	6.3	5.1	–8.2	–12.3	–10.5	–9.4
Lithuania	9.7	6.7	6.8	6.5	–1.2	1.2	2.7	2.5	–7.0	–7.1	–8.1	–7.9
Central Europe	**3.5**	**5.0**	**3.5**	**4.0**	**2.2**	**4.2**	**2.5**	**2.7**	**–4.0**	**–3.8**	**–3.3**	**–3.8**
Czech Republic	3.2	4.4	4.1	3.9	0.1	2.8	2.0	2.5	–6.1	–5.2	–3.5	–3.2
Hungary	2.9	4.2	3.4	3.6	4.7	6.8	4.0	3.6	–8.8	–8.8	–8.5	–8.0
Poland	3.8	5.4	3.0	4.0	0.8	3.5	2.2	2.5	–2.2	–1.5	–1.0	–2.5
Slovak Republic	4.5	5.5	5.0	5.4	8.5	7.5	2.7	2.7	–0.9	–3.5	–6.3	–6.4
Slovenia	2.5	4.6	3.9	4.0	5.6	3.6	2.6	2.5	–0.4	–0.9	–1.6	–0.8
Southern and southeastern Europe	**4.5**	**6.6**	**4.7**	**4.8**	**9.2**	**8.2**	**6.4**	**5.1**	**–6.6**	**–6.8**	**–7.0**	**–6.7**
Bulgaria	4.3	5.6	5.5	5.5	2.3	6.1	4.4	3.5	–9.2	–7.5	–9.0	–8.5
Croatia	4.3	3.8	3.4	3.9	1.8	2.1	3.0	2.5	–6.0	–4.8	–4.8	–4.1
Cyprus	1.9	3.7	3.8	4.0	4.1	2.3	2.5	2.5	–3.4	–5.8	–4.0	–3.2
Malta	–1.9	1.0	1.5	1.8	1.9	2.7	2.4	1.9	–5.8	–10.4	–10.5	–8.6
Romania	5.2	8.3	5.0	5.0	15.3	11.9	8.8	6.9	–6.8	–7.5	–7.9	–7.8

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

are needed to boost medium-term growth, including in the energy and telecommunications sectors, labor market reforms to increase productivity and employment in the formal sector, and the strengthening of the judicial and regulatory systems to improve the business climate.

In Central America, growth has begun to ease, reflecting partly lower demand from the United States, but also weaker investor confidence on account of increased political uncertainty in a number of countries. The expected ratification of the Central American Free Trade Agreement (CAFTA) has already provided some impetus to investment, and with the agreement now ratified in the United States and three other countries, governments in the region should strive to use it as an opportunity to boost growth and standards of living—especially those of lower-income households—including through structural reforms aimed at lowering barriers to trade. In the Caribbean, growth is projected to strengthen in 2005, as tourism activity is expected to recover from the losses caused by last year's hurricanes. The key policy challenge in most countries is to strengthen budgets and ensure public debt sustainability.

Emerging Europe: Is Rapid Credit Growth a Cause for Concern?

Growth in emerging Europe remains robust, although the pace of expansion has eased since the middle of last year (Table 1.8). Exports have been affected by weaker growth in western Europe and the appreciation of regional currencies during 2004, while domestic demand has slowed as the surge in activity in the run-up to EU accession has abated. Indeed, with confidence remaining weak in the euro area and oil prices continuing to rise, the risks to the outlook are slanted to the downside. Nevertheless, concerns remain about possible overheating in some countries. Although inflation remains well contained—headline CPI inflation increased last year due to a number of EU accession–related tax adjustments, but is now returning to lower

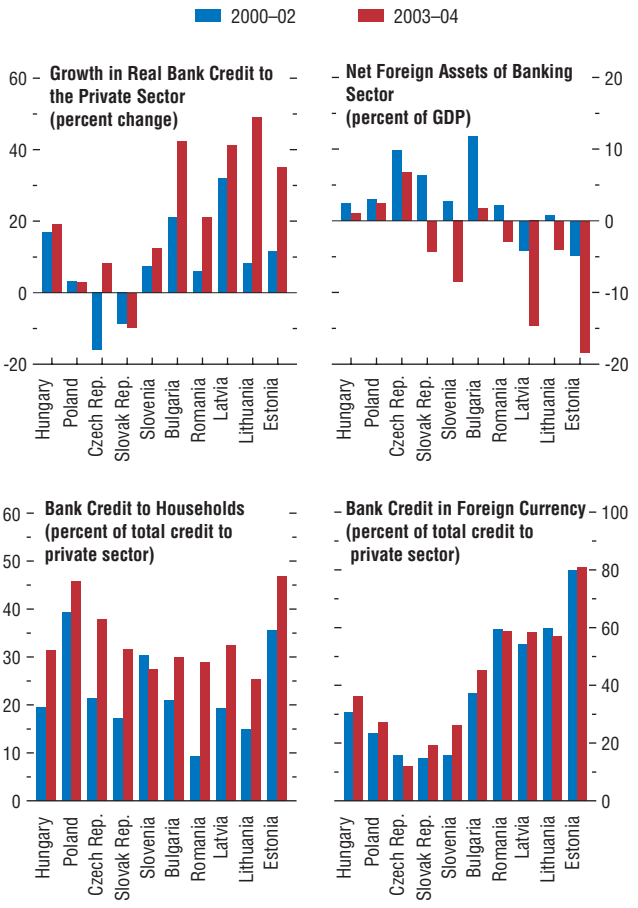
rates—credit growth is exceptionally strong, property prices have surged, and external imbalances are large.

A key question is whether strong credit growth, which is particularly apparent in the Baltic countries, Bulgaria, Hungary, and Romania, is part of the ongoing process of "financial deepening"—credit-to-GDP ratios still remain relatively low—or whether some countries are now experiencing a credit boom, a situation where credit is expanding at an unsustainable pace (Figure 1.17). The experience in emerging markets shows that credit booms can be very costly—they are typically followed by sharp economic downturns and financial crises.[16] A particular concern at present is that credit is largely being financed by bank borrowing from abroad, encouraged by low international interest rates and relatively stable exchange rates. This stands in contrast to earlier years when credit expansion was financed mostly from domestic deposit accumulation. With foreign currency lending (mostly in euros) representing a large share of outstanding credit, households and small and medium-sized enterprises—which have borrowed heavily in recent years, but are unlikely to have suitable exchange rate hedges—are particularly vulnerable to movements in exchange rates. Banks themselves are also exposed in the event of default on the loans, although the relatively strong prudential indicators do suggest that banking systems in general are well shielded from adverse shocks.

Against this background, measures are needed to reduce the risks that are associated with strong credit growth.[17] A number of steps have been taken in this direction—and credit growth

Figure 1.17. Emerging Europe: Is Strong Credit Growth a Cause for Concern?

Credit is growing strongly in many emerging European countries. Much of the credit is directed at the household sector and is in foreign currency.



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

[16]In emerging markets, real GDP typically falls about 5 percent below trend after the collapse of a credit boom. Further, three-fourths of credit booms are associated with a banking crisis and almost seven-eighths with a currency crisis (see the April 2004 *World Economic Outlook*).

[17]See Hilbers and others (2005) and Duenwald, Gueorguiev, and Schaechter (2005) for a discussion of recent credit trends in central and eastern European countries and possible policy responses.

has slowed modestly in some countries—but further efforts will be needed to upgrade monitoring and supervisory practices, ensure that tax distortions that affect housing markets are minimized, and better inform borrowers about the risks they face, and how exchange and interest rate movements could affect their debt-servicing costs. More generally, fiscal consolidation is needed to manage demand pressures, contribute to a reduction in the large current account deficits, and pave the way for adoption of the euro.

Turning to individual countries, the expansion in Poland has slowed since mid-2004, and growth this year is projected at 3 percent (down from 5.4 percent in 2004). Consumption has weakened in the face of slower wage growth and still-high unemployment, and the inventory accumulation that boosted growth prior to tax and regulatory changes accompanying EU accession has dissipated. Export growth, while still robust, has also weakened as the zloty appreciated last year and growth in western Europe slowed, although the current account deficit is small. Inflation remains well contained: the central bank responded quickly to signs of rising price pressures in mid-2004, and inflation has since declined, allowing interest rates to be reduced in recent months. Fiscal policy implementation, however, has been disappointing, with the general government deficit remaining high. The government will need to deliver an ambitious fiscal consolidation plan based on a reduction in social transfer spending and an overhaul of the tax system.

In Hungary, the economy slowed in late 2004 and early 2005 as consumption was adversely affected by the weak labor market and a decline in consumer sentiment, but has strengthened more recently. The trade deficit has narrowed, but with the investment income balance deteriorating, the overall current account deficit remains large. Despite some pickup in foreign direct investment (FDI) inflows, this deficit requires significant debt financing, which increases the economy's vulnerability to swings in investor sentiment. Reducing the fiscal deficit in a sustained way remains a key policy priority. This will require expenditure reforms in the pension, health, and education sectors. Increased labor market flexibility and wide-ranging tax reforms—based on lower rates and a broader base—are also needed to boost growth potential. In Slovenia, growth is expected to slow modestly in 2005 as export growth and domestic demand weaken. The economy appears well poised to adopt the euro, although challenges remain, particularly to consolidate the progress that has been made in reducing inflation.

In the Czech Republic, growth is expected to be about 4 percent in 2005–06. Expanding production capacity has boosted net exports, although investment is projected to slow. The stronger currency, intensifying retail competition, and productivity improvements are keeping inflationary pressures subdued, enabling the central bank to ease monetary policy this year. A key challenge is to maintain the recent progress that has been made in reducing the fiscal deficit; this will require the strict control of expenditures, including through the reform of entitlements and measures to slow the long-term growth of age-related spending. Growth remains robust in the Slovak Republic and, although the current account deficit has widened sharply, this mostly reflects imports of investment goods associated with foreign direct investment. Looking forward, macroeconomic policies need to focus on consolidating the recent gains made in reducing inflation.

Strong growth—driven by domestic demand—continues in the Baltic countries. Rapid credit growth has boosted consumption, while low real interest rates and a sharp rise in EU grants are providing a stimulus to investment. Against this background, inflationary pressures have picked up, particularly in Latvia (although partly owing to one-off factors), and current account deficits remain very large. The key policy challenges are to lower potential vulnerabilities from the large external deficits and to contain inflation. Fiscal policy will need to take the lead in achieving these objectives,

although further steps are also needed to slow credit growth, including by reducing incentives in the tax system that encourage mortgage borrowing.

Growth in Bulgaria and Romania remains strong, although recent heavy floods pose a downside risk. Domestic demand is growing strongly, supported by rising wage incomes and rapid credit growth. Large current account deficits continue to present a risk to the outlook in both countries, but financing is strong (largely comprising FDI and EU transfers), while in Romania inflation remains close to 10 percent and needs to be reduced further. Against this background, it is important that the authorities maintain a tight fiscal policy stance, take further steps to slow the pace of credit growth, and push ahead with structural reforms that improve the investment climate, encourage FDI inflows, and raise productivity. In Romania, monetary policy needs to focus increasingly on reducing inflation, and the recent shift to an inflation targeting regime should help in this regard (see Chapter IV).

Growth is expected to slow in the Balkan countries this year, largely owing to weaker domestic demand. In Croatia, inflation remains well contained and fiscal consolidation has helped reduce the current account deficit. In Bosnia and Herzegovina and Serbia and Montenegro, the large current account deficits are a significant vulnerability, while inflation has risen sharply in Serbia and Montenegro. To address these vulnerabilities, fiscal policy needs to be tightened, the rapid expansion of credit slowed, and structural reforms implemented to boost export competitiveness.

In Turkey, economic activity is slowing to a more sustainable pace, with growth of 5 percent projected this year (compared with 8.9 percent in 2004). However, after slowing significantly in the second half of 2004, domestic demand has started to strengthen, helped by lower interest rates and a pickup in credit. Inflation is on track to reach this year's target of 8 percent. Although capital inflows have remained buoyant and a large part of this year's external financing requirement has already been met, abrupt shifts in market sentiment pose a risk to the financing of the large current account deficit. Against this background, the government's continued commitment to implementing its reform program is very important. Policies should focus on reducing the external deficit and maintaining market confidence, in particular by ensuring that the primary surplus target of 6.5 percent of GNP is comfortably achieved.

Commonwealth of Independent States: Favorable Short-Term Outlook Masks Medium-Term Investment Risks

After a remarkable acceleration in 2003–04, real GDP growth in the Commonwealth of Independent States (CIS) has slowed noticeably in 2005. This has especially been the case in Russia, where policy uncertainty, the Yukos affair, and sharply higher marginal tax rates in the oil sector—to almost 90 percent at prices above $25 a barrel—have been key factors behind sluggish investment and sharply lower output growth in the oil sector, and in Ukraine, where political uncertainty has adversely affected activity and investment. However, consumption growth has generally remained buoyant, reflecting strong spillovers from favorable commodity market developments, strong wage growth, and rapid money supply and credit expansion. This has led to growing pressures on prices, especially in Russia and Ukraine, and regional inflation has picked up after a long period of sustained disinflation. Foreign currency reserves have generally continued to rise, as terms-of-trade-related increases in the current account surpluses of major energy- and metals-exporting countries have more than offset increases in capital outflows owing to heightened political and policy uncertainty.

Looking forward, regional growth is expected to remain robust at 6 percent in 2005 and 5.7 percent in 2006, with consumption remaining the main driving force, as fiscal easing is expected in a number of countries (Table 1.9). Despite this, the region's current account

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]			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Commonwealth of Independent States	**7.9**	**8.4**	**6.0**	**5.7**	**12.0**	**10.3**	**12.6**	**10.5**	**6.3**	**8.3**	**10.6**	**10.3**
Russia	7.3	7.2	5.5	5.3	13.7	10.9	12.8	10.7	8.2	10.3	13.2	13.0
Ukraine	9.6	12.1	5.5	5.4	5.2	9.0	14.2	12.1	5.8	10.5	5.0	0.2
Kazakhstan	9.3	9.4	8.8	7.7	6.4	6.9	7.4	7.1	−0.9	1.3	3.9	2.8
Belarus	7.0	11.0	7.1	4.0	28.4	18.1	12.1	12.5	−2.4	−4.6	−3.7	−3.4
Turkmenistan	17.1	17.2	9.6	6.5	5.6	5.9	13.5	5.0	2.7	1.2	3.2	2.2
CIS-7	**7.4**	**8.3**	**8.9**	**10.7**	**8.6**	**7.5**	**10.8**	**8.9**	**−6.8**	**−9.9**	**−5.6**	**2.1**
Armenia	13.9	10.1	8.0	6.0	4.7	6.9	2.2	3.9	−6.8	−4.7	−5.1	−5.4
Azerbaijan	11.5	10.2	18.7	26.6	2.2	6.7	12.7	8.3	−27.8	−30.4	−12.8	9.0
Georgia	11.1	6.2	7.5	4.5	4.8	5.7	9.0	7.0	−7.2	−7.6	−11.8	−7.2
Kyrgyz Republic	7.0	7.1	4.0	5.5	3.1	4.1	5.0	4.0	−3.0	−2.8	−4.9	−4.8
Moldova	6.6	7.3	6.0	5.0	11.7	12.5	13.3	11.9	−6.6	−4.4	−4.6	−3.2
Tajikistan	10.2	10.6	8.0	7.0	16.4	7.1	7.2	5.0	−1.3	−4.0	−4.9	−4.3
Uzbekistan	1.5	7.1	3.5	2.5	14.8	8.8	14.1	13.0	8.9	0.8	4.5	3.9
Memorandum												
Net energy exporters[3]	7.6	7.6	6.0	5.9	12.8	10.4	12.4	10.3	7.0	8.9	11.9	12.0
Net energy importers[4]	9.2	11.4	5.9	5.2	8.8	10.1	13.0	11.4	2.2	4.9	1.5	−1.2

[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, 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.

surplus is projected to rise further to about 10½ percent of GDP in 2005–06 on account of the higher oil prices. Near-term risks to growth are likely to be on the upside, given the outlook for oil and other commodities, although there are also downside risks, including a slowdown in growth in China, risks to investor confidence from market-unfriendly government interventions, and prudential risks associated with continued rapid credit growth.

Inflation is forecast to increase by over 2 percentage points to 12.6 percent in 2005, reflecting rapid consumption growth, production that is close to capacity in some sectors, and continued substantial net foreign exchange inflows in the context of monetary regimes that generally seek to limit real exchange rate appreciation with partly sterilized interventions. There are some upside risks to inflation with widespread pressures for further increases in government spending, partly owing to the opportunities provided by rising budget surpluses in oil-exporting countries, especially in Kazakhstan and Russia—at the regional level, the surplus is projected to increase by 2½ percentage points to about 4½ percent of GDP in 2005. In these circumstances, the appropriate policy mix would include a combination of tighter monetary policy and greater exchange rate appreciation to keep inflation in check, which, depending on absorptive capacity and progress with structural reforms, could provide some room to increase high-priority expenditure and implement tax reforms. At the same time, the rapid credit growth over the past few years calls for the close monitoring of prudential risks in the banking sector and further strengthening of regulatory frameworks.

In contrast to favorable short-term prospects, there are some significant downside risks to growth in the medium term. In particular, investment outlays as a share of GDP have, on average, remained at about 21 percent of GDP in the CIS countries despite a very favorable growth performance, some 5 percentage points below the average in the transition economies of emerging

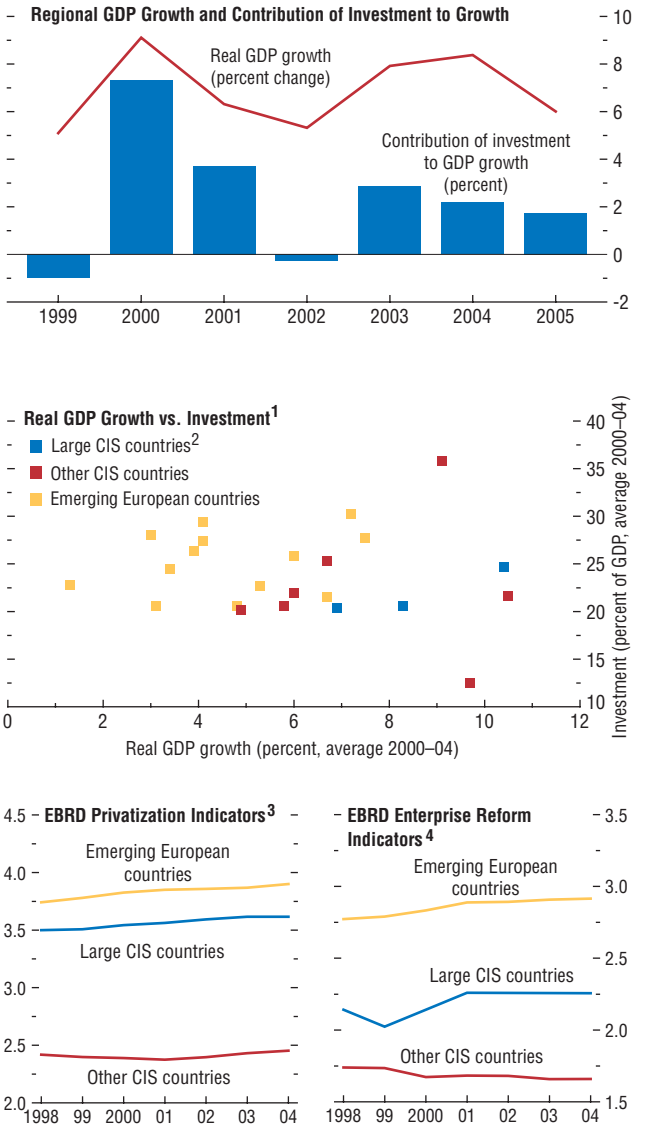
Europe (Figure 1.18).[18] Initially, when growth rebounded after the 1998 crises in the region, capacity constraints were less of a concern but, as the rising pressures on wages and prices indicate, the relatively weak investment growth increasingly appears to constrain growth—especially outside the commodity-producing sectors, which have received the bulk of investment outlays—and is an impediment to much-needed economic diversification in view of long-term commodity market risks. A more hospitable business climate is an essential precondition for more investment, but related structural reforms in the region—including in the area of enterprise reform—continue to lag those in other transition economies in emerging Europe. This underscores the need for greater resolve in advancing reforms to develop fully the institutions and structures to support property rights and competition, with rule-based government interventions guided by transparent objectives.

Turning to individual countries, economic growth in Russia slowed further to about 5½ percent in the first half of 2005, reflecting not only sluggish growth in mining and resource extraction—partly owing to the adverse effects of the Yukos affair on capacity expansion in the oil sector—but also in manufacturing, which has been hurt by capacity constraints, rising input costs, and ruble appreciation. On the demand side, buoyant private consumption growth was the main driving force, supported by strong growth in real incomes, while investment was subdued for reasons noted above. Looking forward, growth is projected to remain at about 5½ percent in 2005–06, supported primarily by continued buoyant consumption growth on the back of higher government spending. With sharply higher oil prices, the budget surplus will nevertheless increase in 2005. Inflation is projected to remain some 4–5 percent above the 8 percent target—underscoring the need for monetary policy to focus on decisive disinflation,

[18]Azerbaijan, where large foreign direct investment in the oil sector supported an investment ratio of more than 35 percent, is a notable exception.

Figure 1.18. Commonwealth of Independent States: Investment, Growth, and Structural Reforms

Investment ratios in the CIS countries remain below those in emerging European countries despite a very favorable growth performance, partly reflecting lagging structural reforms. Given large output declines early in the transition, low investment ratios are only beginning to constrain growth, as output levels recover.



Sources: EBRD; and IMF staff calculations.
[1]Excluding Uzbekistan and Turkmenistan owing to lack of investment data.
[2]Russia, Ukraine, and Kazakhstan.
[3]Average of small- and large-scale privatization index.
[4]Average of enterprise reform and competition policy index.

supported by greater upward exchange rate flexibility and fiscal discipline. The weakness of the investment climate, including that due to pervasive discretionary government interference, remains a major deterrent to private sector confidence and investment, including in the oil sector. The increase in oil revenue provides an important opportunity to accelerate the structural reform agenda, which—apart from some progress in banking sector reform, where the establishment of deposit insurance has led to some welcome consolidation in the sector—is at a standstill.

After soaring to over 12 percent in 2004, GDP growth in Ukraine has slowed noticeably, primarily on account of decelerating export demand, but also due to sluggish investment growth owing to the protracted reprivatization debate. Looking forward, growth is projected at about 5½ percent in 2005–06, supported by buoyant consumption following sharp hikes in public pensions and wages, but the uncertain investment climate and a possible fall in metal prices constitute considerable downside risks. With monetary policy defending the nominal de facto peg of the hryvnia against the dollar and fiscal policy ratcheting up public wages and pensions, inflation has been steadily increasing, reaching about 14½ percent in June. Reducing inflation to single-digit rates is a key policy priority. On the fiscal side, the budget deficit may exceed the target of 2½ percent of GDP in 2005 and will continue to deteriorate without adjustment, partly reflecting backward indexation of wages and benefits. To ensure sustainability, public sector wage schedules and entitlement programs must be adjusted in a forward-looking manner, which would also contribute to disinflation efforts. In Kazakhstan, GDP growth is projected to moderate to 8.8 percent in 2005, as the pace of new oil production capacity coming onstream decelerates somewhat. Economic diversification remains a policy priority, requiring improvements in the investment climate, as discussed above, and reforms aimed at increasing trade openness, including through the acceleration of WTO accession discussions.

The low-income CIS-7 economies continue to register robust growth, driven by strong activity in the larger countries in the region and, to varying degrees, by favorable commodity market conditions. Looking forward, growth is projected to remain solid, in part supported by foreign direct investment, improved conditions for agricultural production, and new capacity in resource extraction coming onstream, especially in the case of Azerbaijan and Uzbekistan (both oil). However, with much higher oil prices and, unlike in 2003–04, less scope for offset from increases in other commodity prices, external current account deficits of net energy importers have widened, which is a concern in view of high levels of external debt. In the circumstances, maintaining appropriately tight fiscal policies and ensuring adequate pass-through of higher energy prices to consumers and producers remain key to ensuring viable external positions.

Africa: How Can the Benefits of a Rising Working-Age Population Be Maximized?

Growth in sub-Saharan Africa is expected to slow to 4.8 percent this year, following the 5.4 percent expansion in 2004 (Table 1.10). The economies in the region continue to be underpinned by the strength of global demand, improved domestic macroeconomic policies—which have delivered the lowest inflation in 30 years—progress with structural reforms and fewer armed conflicts. Further, the recent appreciation of the dollar against the euro, if sustained, should boost non-oil exports of the CFA franc zone countries. Growth in 2004, however, was also boosted by temporary factors, not all of which are being repeated this year. In the oil-exporting countries, there were large increases in output in Angola, Chad, and Equatorial Guinea as new oil production came onstream (this largely offset the slowdown in Nigeria, which is expected to continue in 2005—see below). In oil-importing countries, agricultural production in Ethiopia rebounded strongly after a severe drought.

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]			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Africa	**4.6**	**5.3**	**4.5**	**5.9**	**10.4**	**7.8**	**8.2**	**7.0**	**–0.5**	**0.1**	**1.6**	**3.5**
Maghreb	**6.2**	**5.0**	**3.7**	**5.6**	**2.2**	**2.9**	**2.9**	**3.3**	**7.1**	**7.1**	**9.9**	**12.4**
Algeria	6.9	5.2	4.8	5.3	2.6	3.6	3.5	4.3	13.0	13.1	19.1	23.6
Morocco	5.5	4.2	1.0	5.9	1.2	1.5	2.0	2.0	3.6	2.2	–1.6	–2.8
Tunisia	5.6	5.8	5.0	5.9	2.8	3.6	2.9	2.5	–2.9	–2.0	–2.6	–2.5
Sub-Sahara	**4.1**	**5.4**	**4.8**	**5.9**	**13.0**	**9.3**	**9.8**	**8.2**	**–3.0**	**–2.1**	**–1.0**	**0.8**
Horn of Africa[3]	**1.0**	**8.8**	**7.7**	**9.9**	**10.6**	**8.4**	**7.2**	**6.5**	**–6.1**	**–6.1**	**–5.8**	**–2.5**
Ethiopia	–4.2	11.5	7.3	5.0	15.1	8.6	6.8	6.0	–2.7	–6.2	–5.7	–8.2
Sudan	4.6	6.9	8.0	13.6	7.7	8.4	7.5	7.0	–7.8	–6.2	–6.0	–0.8
Great Lakes[3]	**4.3**	**5.7**	**5.8**	**6.2**	**8.3**	**6.7**	**11.7**	**5.5**	**–2.3**	**–3.9**	**–5.2**	**–6.6**
Congo, Dem. Rep. of	5.7	6.8	6.6	7.0	12.8	3.9	23.2	8.0	–1.5	–5.5	–5.1	–7.9
Kenya	2.8	4.3	4.7	4.9	9.8	11.6	11.0	5.1	–0.2	–3.2	–5.6	–6.2
Tanzania	7.1	6.7	6.9	7.2	4.5	4.3	4.1	4.0	–2.4	–5.5	–5.1	–6.6
Uganda	4.5	5.8	5.9	6.6	5.7	5.0	8.2	4.5	–6.3	–1.7	–3.2	–5.5
Southern Africa[3]	**2.5**	**4.8**	**5.2**	**9.5**	**56.4**	**43.8**	**28.5**	**27.5**	**–3.4**	**–0.2**	**0.5**	**4.6**
Angola	3.4	11.1	14.7	27.6	98.3	43.6	22.0	10.5	–5.2	4.4	8.8	15.9
Zimbabwe	–10.4	–4.2	–7.1	–4.8	365.0	350.0	190.4	253.1	–2.8	–6.9	–5.8	–1.5
West and Central Africa[3]	**7.3**	**6.5**	**3.9**	**5.3**	**9.4**	**8.0**	**9.9**	**5.5**	**–4.1**	**–0.3**	**3.4**	**6.3**
Ghana	5.2	5.8	5.8	5.8	26.7	12.6	14.3	8.7	1.7	–2.7	–4.0	–4.5
Nigeria	10.7	6.0	3.9	4.9	14.0	15.0	15.9	7.3	–2.7	4.6	9.5	13.4
CFA franc zone[3]	**5.5**	**7.6**	**3.3**	**4.6**	**1.4**	**0.2**	**2.8**	**2.6**	**–5.8**	**–3.6**	**–1.0**	**0.3**
Cameroon	4.1	3.5	2.8	4.3	0.6	0.3	1.5	1.8	–2.1	–0.9	–0.7	–0.2
Côte d'Ivoire	–1.6	1.6	1.0	2.0	3.3	1.5	3.0	3.0	0.9	–1.4	2.1	2.6
South Africa	**2.8**	**3.7**	**4.3**	**3.9**	**5.8**	**1.4**	**3.9**	**5.3**	**–1.5**	**–3.2**	**–3.7**	**–3.5**
Memorandum												
Oil importers	3.4	4.6	4.3	5.2	9.9	7.1	7.8	7.4	–1.8	–2.8	–3.7	–3.5
Oil exporters[4]	8.4	7.5	5.1	7.8	12.0	10.0	9.3	5.9	2.9	7.3	12.8	17.3

[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, as is the practice in some countries.
[2]Percent of GDP.
[3]The country composition of this regional group is set out in Table F in the Statistical Appendix.
[4]Includes Chad and Mauritania in this table.

Oil-exporting countries in the region are benefiting from the continuing increase in oil prices, but with non-oil commodity prices not rising as strongly as in 2004, other countries are facing a much more challenging environment. This is particularly the case for cotton exporters—including Benin, Burkina Faso, Mali, and Togo—given the continued slide in world cotton prices (see Box 1.5, "Pressures Mount for African Cotton Producers"). Countries with large textile sectors (including Kenya, Lesotho, Madagascar, Mauritius, and Swaziland) are being affected by the elimination of world textile trade quotas, although the extent of the impact at this early stage is still uncertain. Elsewhere, output is expected to decline further in Zimbabwe in 2005, bringing the cumulative decline since the late 1990s to about 34 percent, while poor harvests have affected several countries in eastern and southern Africa and resulted in food production shortfalls.

Looking ahead to 2006, growth is expected to accelerate to 5.9 percent, which, if achieved, would be the strongest expansion in sub-Saharan Africa since the early 1970s. Underlying growth is again expected to be robust, although country-specific developments are largely responsible for the pickup relative to this year. In particular, the coming onstream of new oil production facilities in Angola and Mauritania is expected to

Box 1.5. Pressures Mount for African Cotton Producers

Cotton production is key to macroeconomic stability and rural cash incomes in a number of low-income countries, particularly in west Africa. Although two-thirds of global cotton is produced by China, the United States, India, and Pakistan, many smaller producers are highly dependent on cotton. In some countries, up to one-third of the population works in the cotton sector and cotton accounts for up to two-thirds of exports (see the table). A combination of the long-term trend decline in cotton prices, large cotton producer subsidies in developed countries, and an unfinished domestic reform agenda have brought into question the future of cotton as a major cash crop export in many of these countries.

Real cotton prices—as for most primary commodity prices—exhibit a long-term downward trend as well as large short-term volatility (see the figure). Recent price movements have brought real prices near to a 40-year low and pose a challenge for macroeconomic performance in cotton dependent exporters. Most vulnerable in this respect are low-income African countries, where cotton dependence is particularly high and the scope for diversification is low owing to small holder production. CFA franc zone cotton producers have, in addition, been squeezed by currency appreciation against the dollar, which has lowered local currency receipts.

Global cotton trade is distorted by various market and trade interventions in some cotton-producing countries that depress prices and reduce incomes of other cotton producers, mostly in developing countries. The subsidy equivalent of these interventions is estimated to have amounted to $4.9 billion in the 2003 season, equivalent to 18 percent of the value of world production. Against this background, four cotton-dependent African countries (Benin, Burkina Faso, Chad, and Mali) launched a Cotton Initiative in May 2003 in the context of the current round of multilateral trade negotiations (the Doha Development Agenda). They requested (1) the elimination of all forms of cotton export subsidies and other trade-distorting domestic support; (2) that compensation be paid until all subsidies are removed; and (3) that least-developed countries receive bound duty-free and quota-free market access for cotton and its by-products.

In August 2004, the World Trade Organization (WTO) Council agreed to address the trade aspects of the cotton sector "ambitiously, expeditiously, and specifically" in all three pillars of the agricultural negotiations—market access, export competition, and domestic support. Indeed, tentative agreement has been reached to eliminate all agricultural export subsidies, albeit with no specific deadline yet agreed, and to reduce other forms of trade-distorting support. The development aspects of cotton in the Doha Development Agenda are to be tackled separately, including through the exchange of information in a Subcommittee on Cotton. Both the United States and the European Union have put in place assistance packages for developing country cotton producers ranging from temporary balance of payments and budget support to technical assistance and scientific support.

Cotton producers have also been buoyed by a recent WTO ruling that concluded that support to cotton producers in the United States violated WTO rules. In 2004, Brazil charged that U.S. cotton subsidies caused harm to their inter-

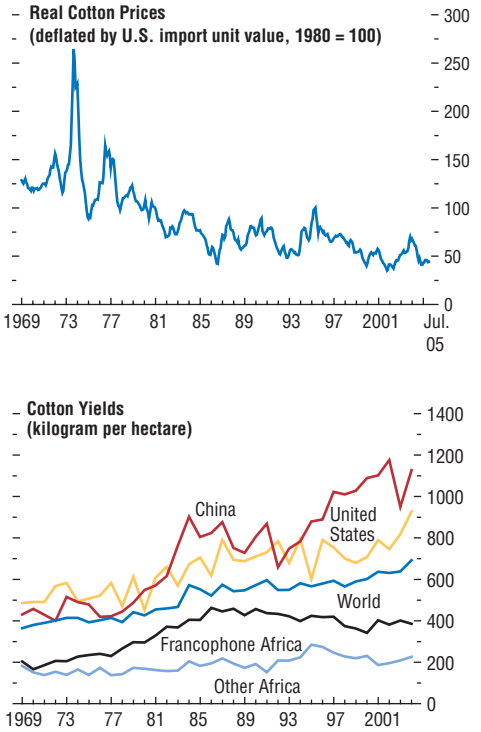
Note: The main author of this box is Chris Lane.

Indicators of Cotton Dependence in Selected Countries, 2004
(Percent)

	Benin	Burkina Faso	Mali	Togo
Exports of cotton/total exports goods and services	35	61	28	14
Cotton exports/GDP	4.4	6.0	5.2	6.5

Source: IMF staff estimates.

Developments in the Cotton Sector



Sources: IMF, *International Financial Statistics;* and U.S. Department of Agriculture.

ests. The WTO ruled in favor of Brazil, and this decision was upheld on appeal in March 2005. As a consequence, the U.S. Administration announced legislation in July 2005 that would eliminate export subsidies under the "Step-2" program as well as export credit subsidies that fell foul of WTO limits.

How much would the removal of cotton subsidies benefit African producers? Several studies have indicated that subsidy removal would raise world prices and shift production from subsidized to nonsubsidized regions. The projected increase in world prices, however, is highly divergent based on the choice of base year, methodology, assumptions on price, and demand and supply elasticities (Baffes, 2005, surveys the literature). A central estimate by the Food and Agricultural Policy Research Institute is that global agricultural subsidy removal would raise cotton prices by 12 percent over the period until 2012, equivalent to over $200 million a year for African producers. Additional gains would depend on gaining market share from industrial countries in competition with other developing country producers.

African producers have recognized, including at a May 2005 conference organized by the IMF, that the medium-term future of their cotton sectors depends on a number of factors besides the expeditious removal of trade-distorting subsidies and donor support. In particular, a key role falls on domestic policy reforms that would increase the competitiveness of cotton producers through liberalization and privatization, thus creating the incentives to cut costs, raise efficiency including through adoption of higher yielding seeds, and become more responsive to price signals.

The need for domestic policy reform is most pressing in Africa, where cotton yields have stagnated over the past decade against improvements elsewhere. In francophone west and central Africa, which accounts for two-thirds of African cotton production, the government retains an influential role in the cotton sector. Yields in Africa have been held back by the poor quality of marginal land and low levels of investment. The rapid adoption of genetically modified cotton that reduces pests and pesticide costs, and which now accounts for 35 percent of world production, has put Africa at a significant competitive disadvantage. Elbehri and Macdonald (2004) estimate that the adoption of genetically modified cotton in west and central Africa could boost production by about 12 percent and raise world export share from 10 percent to 13 percent.

With the challenges evident, African producers are putting reforms into place. For example, Burkina Faso has begun trials of genetically modified cotton, and Mali is committed to privatizing its state purchasing monopoly and has

Box 1.5 *(concluded)*

also linked domestic prices more closely to world prices to curb losses. Less progress has been made on liberalizing regional cotton trade, which is now broadly recognized as an essential complement to the broader trade agenda of the Doha Round and development partner assistance. While there remains some support for regional price stabilization funds, the size and persistence of cotton price changes make such projects unlikely to offer substantive insurance to producers. Actions to improve hedging mechanisms, presently dominated by contracts in U.S. cotton, could likely serve producers more effectively.

substantially boost growth in these countries in 2006, while oil production is also expected to increase in Nigeria.

At this juncture, the risks to these projections are tilted to the downside. While the recent commitment by the G-8 to boost aid and debt relief to the region could increase confidence, investment, and growth, an extended period of high oil prices—particularly if combined with a sharper-than-expected decline in non-oil commodity prices—would adversely affect many countries in the region (as it did in 1999–2000). Further, with global imbalances widening, a renewed decline of the dollar against the euro cannot be ruled out, which would adversely affect the CFA franc zone countries. More generally, past *World Economic Outlooks* have systematically overestimated growth in sub-Saharan Africa, largely because of the susceptibility of the region to natural disasters, climatic change that affects the agricultural sector, political instability, and other unanticipated shocks.

Looking forward, despite the favorable short-term outlook, most African countries still face enormous challenges in achieving the strong growth rates that are needed to substantially reduce poverty. Demographic trends, however, should help over the medium term. The share of the working-age population in sub-Saharan Africa is starting to rise, and it is projected to increase substantially over the next 40–50 years (Figure 1.19), despite the HIV/AIDs pandemic, which has taken a terrible toll on human life in the region.[19] This could help strengthen growth prospects if these additional workers are absorbed into the labor force. Given the higher saving propensity of workers, this could raise saving, which in turn would help finance additional investment, and boost output. Estimates in the September 2004 *World Economic Outlook* suggested that this "demographic dividend" could boost per capita growth in the region by about 0.3 percentage point a year. Of course, demographic change will also bring challenges, including that a larger population will put pressures on the environment.

To reap the full benefits of this projected rise in the share of the working-age population, further reforms will be necessary to strengthen the investment environment and foster private sector-led growth. A premium needs to be placed on building the economic and political institutions that are critical for developing a vibrant private sector–based economy, and there are examples within Africa where countries have achieved decisive improvements in their institutional structures (see Chapter III). As discussed in Chapter III, trade openness, education, transparency, and external anchors all play important roles in helping countries develop strong and effective institutions. Important initiatives are being undertaken in these areas across sub-Saharan Africa, but more needs to be done. Transparency remains too limited despite the important steps that are being undertaken through the Extractive Industries Transparency

[19]See United Nations (2004). For a discussion of the economic impact of HIV/AIDS in Africa, see Haacker (2004).

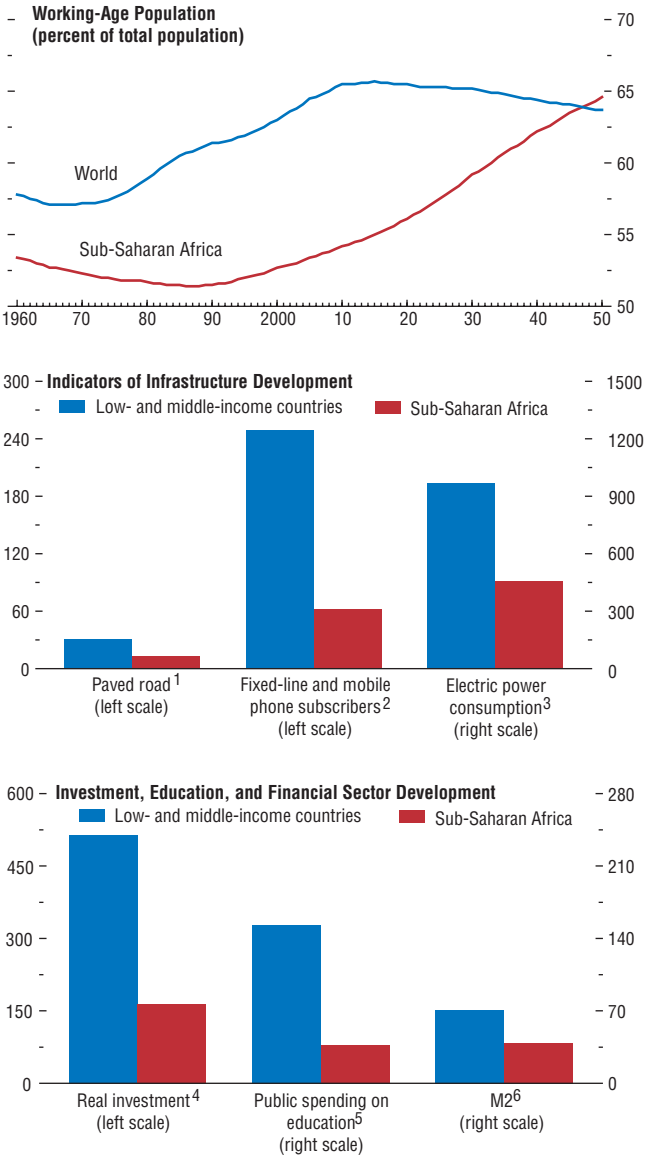
Initiative (EITI); progress under the African Peer Review Mechanism—a regional initiative launched through the New Partnership for Africa's Development to peer-review economic and political governance—has so far been slow and should be accelerated; and trade regimes need further liberalization. An emphasis also needs to be placed on developing the infrastructure to support private sector activity—on a broad range of measures, infrastructure development in Africa lags far behind other developing countries—as well as on increasing investment, including in human capital, and on making labor markets more flexible.

The global community needs to support Africa's reform efforts. A successful outcome of the Doha Round, particularly the liberalization of trade in agricultural goods, would bring substantial benefits for many African countries. The renewed commitment of the international community to provide additional resources to Africa, reflected in the G-8 agreement at Gleneagles, Scotland, in July is particularly welcome, although further improvements in governance, accountability, and transparency—as discussed above—are crucial if the full benefits are to be realized.

Turning to individual countries, the outlook for South Africa remains favorable, with growth expected to accelerate to 4.3 percent in 2005, although a deterioration in the external outlook—which would hurt the prices of commodity exports—and elevated house prices present downside risks. Inflation remains relatively well contained, although the pickup in unit labor costs, higher oil prices, the weakening of the rand this year, and rapid credit growth present upside risks. Fiscal policy implementation has remained sound, and the general government deficit is expected to remain below 2 percent of GDP this year. This prudent fiscal management has created the scope for moderate and targeted increases in social and infrastructure spending over the next few years. Despite some recent growth in formal sector employment, unemployment remains very high, and reforms are needed to boost the demand for labor.

Figure 1.19. Sub-Saharan Africa: Maximizing the Benefits of the Demographic Dividend

Sub-Saharan Africa will see a significant increase in its working-age population. To absorb these people productively into the labor force, increased investment in infrastructure, equipment, and education will be needed.



Sources: World Bank, *World Development Indicators;* United Nations; and IMF staff calculations.
1 Calculated as percent of total roads.
2 Calculated as subscribers per 1,000 people.
3 Calculated as kwh per capita.
4 Calculated as real investment in 1995 U.S. dollars per person aged 15–64.
5 Calculated as current U.S. dollar per person aged 0–14.
6 Calculated as percent of GDP.

In Nigeria, real GDP growth is expected to slow further in 2005, before rebounding in 2006. These trends are importantly driven by the oil and gas sector—existing capacity constraints mean that oil output will increase only slightly this year, but new production is expected to come onstream in 2006, boosting output. Growth in the non-oil sector remains robust, although there are increasing signs of overheating. Inflation has picked up again—partly owing to higher food prices—and monetary growth has accelerated sharply. The central bank needs to take steps to rein in monetary growth and bring inflation back down. Regarding fiscal policy, the 2005 budget incorporates a large overall surplus—underpinned by a sharp increase in revenues from the oil and gas sector—but contains a significant increase in spending. While additional spending should contribute to the government's development objectives, it needs to be carefully managed to ensure it does not put further upward pressure on inflation or crowd out private investment. Looking forward, a strengthening of public sector expenditure management is essential to ensure that oil revenues are used efficiently and that the benefits from the recent agreement by the Paris Club creditors on a concessional debt treatment for Nigeria are maximized. The government has continued to move forward with its structural reform program, including partially liberalizing pricing in the petroleum sector and improving governance and transparency. Nevertheless, subsidies on domestic petroleum products are large, the pace of the privatization program has disappointed, and the financial health of the banking system has deteriorated.

In the Maghreb region, growth is expected to slow slightly in Algeria this year. While higher oil prices should underpin stronger activity in the hydrocarbons sector, fiscal consolidation and tighter monetary policy—which has curtailed credit growth—are expected to slow growth in the non-oil economy. Inflation has been well contained, and the external position has strengthened significantly with the rise in oil prices. Regarding fiscal policy, it is important that the government remain committed to the broad parameters of the expenditure restraint set out in the 2005 budget, although additional oil revenues will permit some increase in well-targeted spending to support economic reforms. The authorities are continuing to make progress in liberalizing external trade and the energy and telecommunications sectors but, with unemployment still very high, further structural reforms—particularly in the banking and public enterprise sector—are needed to raise growth potential in the non-oil sector. In Morocco, growth is expected to slow owing to unfavorable weather conditions that have affected agricultural output and to a weak performance in the textile sector, reflecting in part the elimination of world textile trade quotas. Growth in Tunisia is projected to remain strong, with the slowdown in the textile sector being less pronounced so far. Given the degree of both Morocco and Tunisia's integration with the European Union, weak European demand is a potential risk to growth in the region.

Middle East: Managing Booming Oil Exports

With the sharply higher oil prices, the Middle East region has seen accelerating oil export revenues that—in real U.S. dollars—outstrip those of the 1970s and early 1980s (Figure 1.20). Reflecting the terms-of-trade gains, and with crude oil production in the region increasing to a 20-year high, oil-exporting countries—which account for more than 95 percent of the region's output—have enjoyed a robust growth performance, and external current account and fiscal balances have improved dramatically. Despite strong domestic demand, inflation has generally remained subdued—except, as discussed below, in the Islamic Republic of Iran—owing both to considerable flexibility and openness in product markets and, in the context of pegged exchange rates, to low global inflation. Looking forward, prospects remain favorable, given the oil market outlook, and regional GDP growth is projected at 5.4 percent in 2005

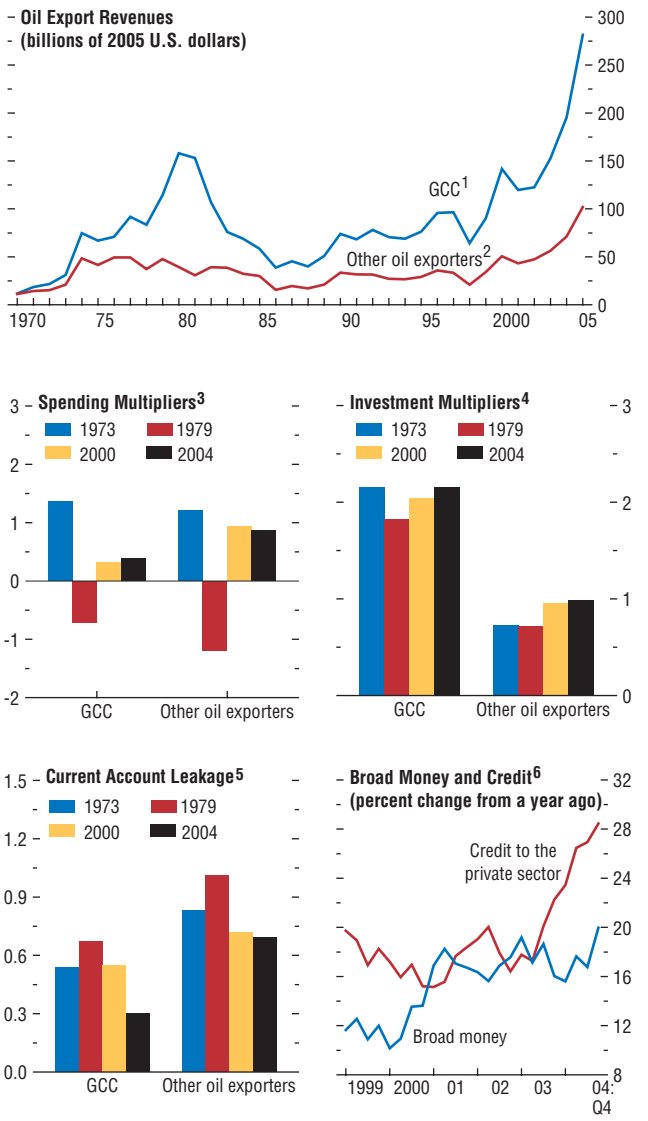
(Table 1.11). With continued prudent financial policies and oil production close to capacity, growth is expected to moderate slightly to 5 percent in 2006. The regional current account surplus is projected to rise further to about 21 percent of GDP in 2005—close to $200 billion—and to 23½ percent of GDP in 2006.

With a significant proportion of the oil revenue increase expected to be permanent, managing these revenues will be a central challenge, both domestically and—as discussed previously—for global imbalances. On the one hand, the revenue provides the opportunity to address some of the long-standing economic problems in the region, including the financing of reforms that would generate employment for the rapidly growing working-age population, the key medium-term policy challenge in most countries. On the other hand, the oil revenues are generally large compared with output, and spending can be increased only gradually, depending on macroeconomic conditions and a country's absorptive capacity. In this regard, it will be critical to avoid two mistakes of the 1970s and early 1980s. First, due priority should be given to expenditure that will have a lasting impact on growth, productivity, and standards of living. Otherwise, the supply-side response will be small, and growth will fluctuate with oil market conditions, with a tendency for boom-bust cycles and high macroeconomic volatility. Second, expenditure should only be increased by amounts that can be sustained. Otherwise, changing oil market conditions can trigger large adjustment needs that are very difficult to implement. Developments to date suggest that policymakers in the region have learned from past mistakes. Based on current policy projections, spending multipliers—the fraction of additional oil revenue spent by governments—are now lower than during the boom of the 1970s, especially in the GCC countries.

At the current juncture, the appropriate set of policies varies across countries, but will include the following elements. First, given high unemployment and generally very low inflation, there is scope for higher government expenditure

Figure 1.20. Middle East: Oil Shocks and Macroeconomic Management

With soaring oil export proceeds, prudent macroeconomic policies are key to avoiding the boom-bust cycle associated with the first and second oil shocks (1973 and 1979).



Sources: IMF, *International Financial Statistics;* and IMF staff calculations.
[1]The Cooperation Council of the Arab States of the Gulf (GCC) includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates.
[2]Consists of Egypt, I.R. of Iran, Libya, Syrian Arab Republic, and Yemen.
[3]Government spending growth over a five-year period (starting in the year indicated) as a fraction of growth in oil export revenue over the same period.
[4]Investment growth over a five-year period (starting in the year indicated) as a fraction of growth in government spending over the same period.
[5]Defined as one minus the ratio of cumulative current account balance over a five-year period (starting in the year indicated) to cumulative oil export revenue over the same period.
[6]Oil-exporting countries only.

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]			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Middle East	**6.5**	**5.5**	**5.4**	**5.0**	**7.1**	**8.4**	**10.0**	**9.7**	**8.0**	**12.4**	**21.1**	**23.5**
Oil exporters[3]	**6.9**	**5.5**	**5.6**	**5.2**	**8.8**	**9.1**	**11.1**	**10.9**	**9.6**	**15.0**	**24.9**	**27.4**
Iran, I.R. of	6.7	5.6	5.7	5.4	15.6	15.6	18.5	18.5	0.6	2.5	8.7	8.0
Saudi Arabia	7.7	5.2	6.0	4.7	0.6	0.3	1.0	1.0	13.1	20.5	32.4	37.3
Kuwait	9.7	7.2	3.2	3.2	1.0	1.8	1.8	1.8	17.5	29.2	44.8	50.2
Mashreq	**3.2**	**4.3**	**4.3**	**4.6**	**3.3**	**6.9**	**8.3**	**7.2**	**1.4**	**0.3**	**–0.7**	**–1.6**
Egypt	3.1	4.1	4.8	5.0	3.2	8.1	8.8	8.0	2.4	4.4	4.6	3.4
Syrian Arab Republic	2.6	3.4	3.5	4.0	5.0	4.6	10.0	5.0	6.0	1.9	0.2	–1.1
Jordan	4.1	7.7	5.0	2.5	1.6	3.4	3.7	8.4	11.3	–0.4	–12.3	–13.5
Lebanon	5.0	6.0	—	3.0	1.3	3.0	2.0	2.0	–12.5	–16.0	–16.9	–16.5
Memorandum												
Israel	1.7	4.4	4.2	3.9	0.7	–0.4	1.2	2.3	0.7	1.3	1.7	1.3

[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, as is the practice in some countries.
[2]Percent of GDP.
[3]Includes I.R. of Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, and Yemen.

without risks of overheating. If high public debt ratios are a concern, higher oil revenue should be used to reduce them to sustainable levels. Second, other capacity-enhancing reforms will be key to ensuring that higher expenditure will have lasting supply-side effects, including reforms that contribute to increasing trade openness and private sector participation and investment in major sectors. Third, while appropriately gradual expenditure increase will help to avoid undue pressure on real exchange rates, it will be important to allow for some of the inevitable real appreciation associated with higher oil revenue to take place. Finally, policymakers need to be mindful of financial sector implications. With oil export proceeds being partly invested in the domestic banking system, broad money and credit growth has begun to accelerate. This, together with buoyant investor confidence and an apparent increase in investor home bias, has underpinned large increases in equity and property prices, raising some concerns about increasing prudential risks in the financial sector. Supervisors need to monitor such risks carefully.

Turning to individual countries, growth in the Islamic Republic of Iran is expected at 5.7 percent in 2005, primarily reflecting robust domestic demand and a rebound in agricultural production after a weather-related slump in 2004. With strong domestic demand and expansionary monetary policy, inflation has remained above 15 percent. Since the scope of monetary control is limited by inadequate instruments, fiscal policy tightening is required to reduce inflation, supported by greater exchange rate flexibility. With elections completed, policymakers should take advantage of the current favorable economic conditions and push ahead with structural reforms, especially those aimed at increasing labor market flexibility and improving the business climate for private investment.

In Saudi Arabia, real GDP growth is expected to accelerate to 6 percent in 2005 before moderating to 4.7 percent in 2006. Driven by higher oil revenue, budget surpluses have soared, allowing for a substantial reduction in public debt, which is projected to decrease to below 50 percent of GDP by end-2005. Private non-oil sector growth is expected to benefit from ongoing reforms lifting restrictions to private sector participation in postal and railways services, electricity generation, water desalination, and non-oil mining. Divestment of government assets in these sectors would further enhance the scope for private sector development in the economy.

In Iraq, the economic reconstruction continues, although the volatile security situation and the slow progress in expanding oil production remain obstacles. After surging to over 30 percent in 2004, consumer price inflation has begun to moderate, but with unstable supply conditions, inflation volatility remains high. Looking forward, the new government faces daunting medium-term challenges, including advancing the reconstruction of the country's infrastructure, reducing macroeconomic instability, and developing the institutions that can support a market-based economy.

In Egypt, the expansion gained momentum in the second half of 2004, and growth is expected to remain robust at about 5 percent throughout 2005–06. Buoyant export growth, partly owing to the pound's depreciation during 2001–04, remains the key driving force. Additional support comes from a moderate rebound in domestic demand, owing to the favorable confidence effects of the government's new resolve in moving ahead with structural reforms. Inflation has begun to decrease from the high levels reached in 2004. Looking forward, a new policy framework with a clearly defined nominal anchor is needed to guide the conduct of monetary policy in the context of greater exchange rate flexibility. Net public debt has stabilized at about 65 percent of GDP, but with government borrowing remaining at about 7 percent of GDP, decisive multiyear fiscal adjustment is required to put public debt on a declining path and make room for more private investment.

Elsewhere in the Mashreq, growth in Jordan is expected to moderate to 5 percent in 2005, from 7.7 percent last year, reflecting the adverse impact on domestic demand of higher oil prices. In view of the latter, and given a substantial reduction in external budgetary grants, the current account deficit is projected to widen to 12.3 percent of GDP in 2005. To maintain medium-term macroeconomic stability, fiscal policy needs to be tightened decisively, including through a reduction in budgetary subsidies on petroleum products. In Lebanon, the recent political turmoil had a large adverse impact on economic activity, with output contracting in the first half of the year. Activity should recover with restored political stability, and growth is projected to resume next year. Expenditure restraint has kept the fiscal situation in check, but with very high levels of public debt and financial vulnerabilities, substantial fiscal consolidation is required for lasting improvements.

After rebounding in 2004, growth in Israel remained strong in the first half of this year. Growth in 2005 is now projected at 4.2 percent, underpinned by solid high-technology exports and private consumption. Core inflation and inflation expectations have remained within the Bank of Israel's target range of 1–3 percent, and monetary policy has appropriately been held steady. Given the vulnerabilities associated with the high level of public sector debt—at over 100 percent of GDP—strict adherence to the medium-term budget deficit target of 3 percent of GDP remains essential, and the credibility of the current fiscal policy framework should be enhanced with a medium-term spending plan.

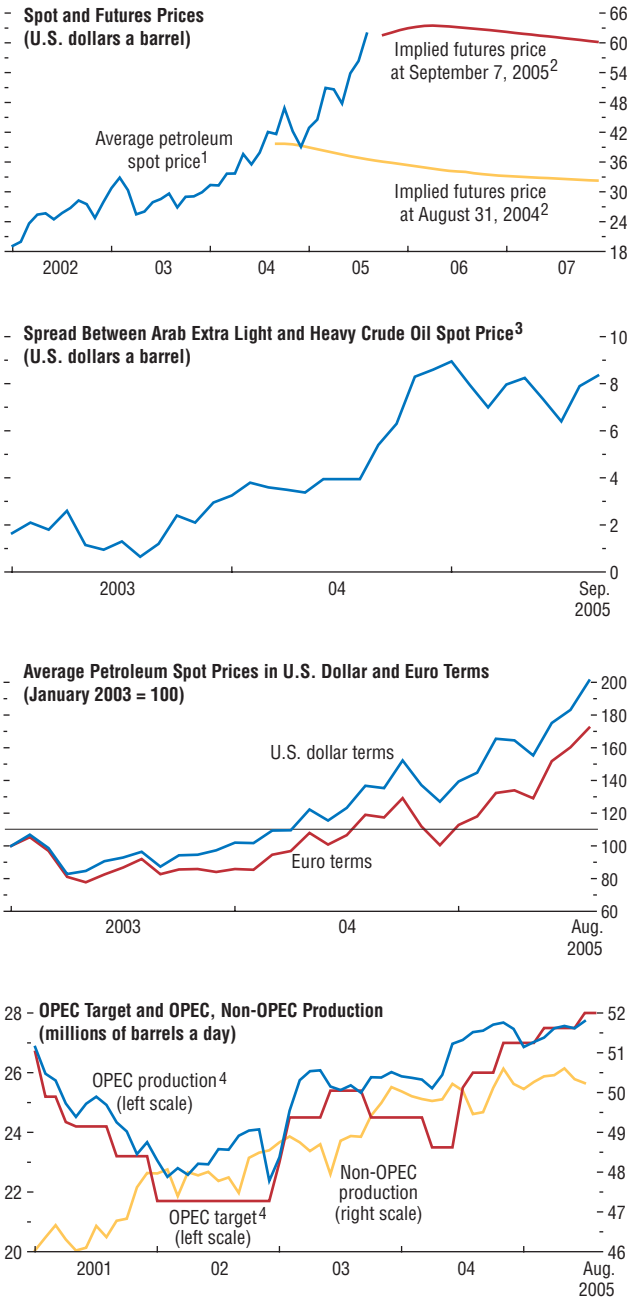
Appendix 1.1. Recent Developments in Commodity Markets

The authors of this appendix are To-Nhu Dao, Paul Nicholson, Sam Ouliaris, and Hossein Samiei.

The overall index of primary commodity prices increased by 29 percent in U.S. dollar terms (35 percent in SDR terms) during January–August 2005 (Figure 1.21).[20] Energy prices, which rose by 41 percent, remained the main driver of the index, reflecting strong growth in crude oil consumption and expectations of tight crude oil and product markets going forward. As a result, both spot and futures prices of oil and petroleum products have become extremely sensitive to short-term developments—as clearly demon-

[20]Unless otherwise stated, percentage changes and summary statistics refer to the January 2005–August 2005 period.

Figure 1.21. Oil Prices, Futures, and Production



Sources: International Energy Agency; Bloomberg Financial Markets, LP; IMF, *International Financial Statistics;* 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]Saudi Arabian crude oil deliverable in Asia. Arab Extra Light (Berri) has an API gravity of 37 and a sulphur content of 1.15. Arab Heavy (Safaniya) has an API gravity of 27 and a sulphur content of 2.8.

[4]Excluding Iraq.

strated by the initial impact of Hurricane Katrina on crude oil and petroleum product prices.

In contrast to the energy component, the non-fuel commodity price index rose by only 5 percent in U.S. dollar terms (9 percent in SDR terms) over the same period, led by metal and food prices. Metals prices rose by 9 percent largely because of robust demand arising from the current global economic expansion. Food prices rose by 4 percent owing to strong growth in China's demand for soybeans. Reduced harvests in South America and lower North American grain output forecasts placed upward pressure on prices of agricultural products.

Crude Oil

Crude oil prices continued their rise during 2005 even though the growth in crude oil consumption has been broadly in line with expectations. While shortfalls in non-OPEC supply have contributed to the rise, it appears that crude oil prices are being increasingly driven by expectations of future tightness in the market. These expectations are based on forecasts of continued robust global economic growth, low spare capacity among OPEC producers, and fears that the recent slowdown in non-OPEC production may be somewhat permanent. With limited upstream (i.e., crude oil production) and downstream (i.e., refinery) spare capacity, short-term disruptions to product or crude oil production, which prior to 2003 had temporary effects on oil prices, have become powerful catalysts for higher prices. Interestingly, even long-dated futures prices are now more responsive to daily market news, prompting some analysts to argue that speculative activity is having an excessive influence on crude oil futures prices.

The sensitivity of prices to short-term developments was strikingly demonstrated by the damage recently caused by Hurricane Katrina to the oil and gas infrastructure in the Gulf of Mexico, which is responsible for 20 percent of daily U.S. crude oil domestic production and nearly 50 percent of its total refinery capacity. Crude oil, gasoline, and natural gas prices spiked as the hur-

ricane hit the continental shores of the United States on August 31, but eased somewhat following decisions by the U.S. Administration and the International Energy Agency (IEA) to release oil from their strategic reserves (the latter to bolster global crude oil supplies by 2 mbd[21] for 30 days), and an offer by Saudi Arabia to increase its crude oil production by 500 thousand barrels a day. While the impact of Hurricane Katrina on crude prices is likely to be temporary—indeed the actions taken by the IEA and others may even trigger some weakening in crude oil prices in the period ahead—product prices are likely to remain high and volatile for sometime yet because of delays in restoring refinery production.

The steady rise in crude oil prices over the past year has occurred despite OPEC's systematic efforts to ease fears about potential supply shortages. OPEC's accommodative stance, by maintaining actual production and official quotas at record levels for most of 2005, has allowed OECD commercial crude oil stocks to rise to near six-year highs (Figure 1.22). This stance reflects a growing concern that the seasonal surge in crude oil consumption during the Northern Hemisphere winter will require a large draw on commercial inventories. Oil futures have moved into a near-term contango position since December 2004 on these concerns, with the delivery price increasing steadily through to the first quarter of 2006. Interestingly, futures prices remained in contango even after Hurricane Katrina hit the Gulf of Mexico, suggesting that traders remain more concerned about seasonal tightness than about the initial effects of Hurricane Katrina on crude oil production.

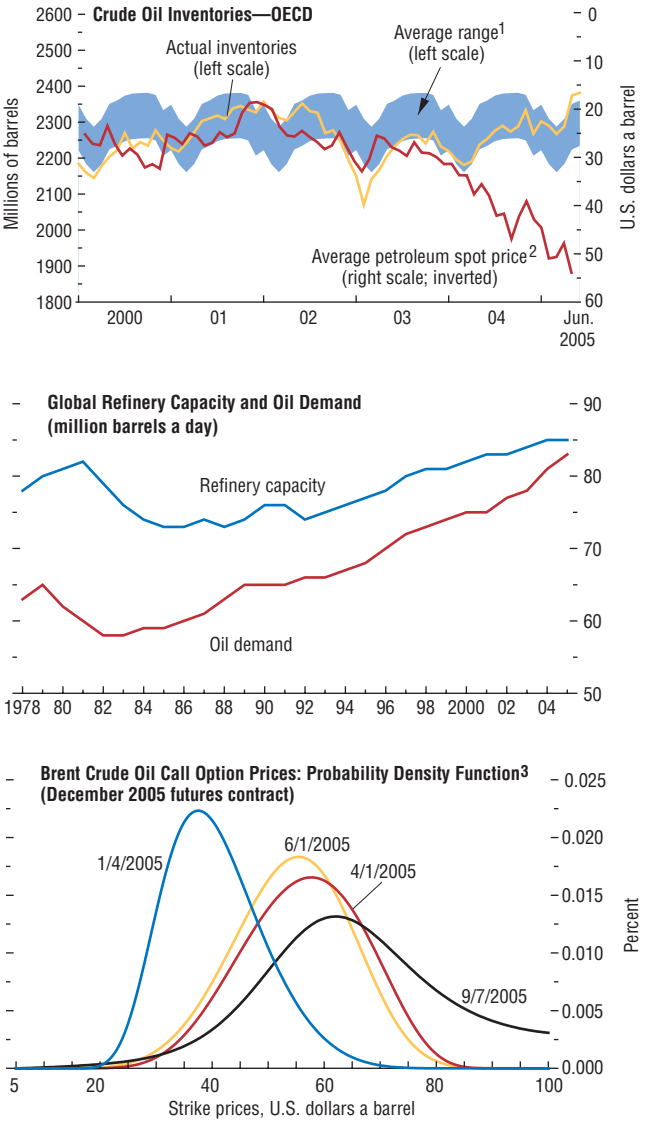
Price Developments

The average petroleum spot price[22] (APSP) rose by 44 percent during January–August 2005.

[21]Mbd refers to millions of barrels a day, while kbd denotes thousands of barrels a day.

[22]The IMF average petroleum spot price (APSP) is an equally weighted average of the WTI, Brent, and Dubai crude oil prices. Unless otherwise noted, all subsequent references to the oil price are to the APSP.

Figure 1.22. Commercial Oil Inventories, World Refinery Capacity, and Option Prices



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

[1]Average of each calendar month during 1992–2004, plus a 40 percent confidence interval based on past deviations.

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

[3]Call options are European-style options for an option to buy (call) International Petroleum Exchange Brent Contract for December 2005 delivery.

After exceeding $50 a barrel for most trading days in March–April 2005, the APSP eased during May on seasonal weakness in oil consumption. However, the APSP began a steady rise soon after, and eventually breached the $65 mark at beginning of September—with the nominal West Texas Intermediate (WTI) spot price closing at $69.81 (see Figure 1.21). As of August 31, the APSP was 72 percent above the average for 2004 and three times the 20-year average of $21.73. Moreover, price differentials between light and heavy grades of crude oil remain high because of shortage of light crude oil, limited refinery capacity to distill heavier grades of crude oil, and the fact that OPEC's marginal production is mostly of the heavy type. Hurricane Katrina increased these differentials further by reducing the production of light crude oil in the Gulf of Mexico, and forcing the shutdown of U.S. refineries. Lastly, crude oil price volatility over the first eight months of 2005 (as measured by the variance of daily crude oil prices) was 2.8 times that of the same period in 2004 (Figure 1.22).

High refinery utilization rates in 2005 have also made petroleum product prices very sensitive to unexpected refinery outages—as demonstrated by the 28 percent rise in U.S. wholesale (front month) gasoline futures in the immediate aftermath of Hurricane Katrina. Despite announcements by the U.S. Administration and the IEA to release oil from their strategic reserves, higher crude oil supplies are unlikely to result in greater supply of petroleum products in the near term, owing to refinery closures. Indeed, wholesale gasoline futures prices eased significantly on September 2, largely on news of an increase in gasoline shipments to the United States from Europe and the reopening of a major pipeline between the Gulf coast and the East Coast.

Consumption

Though consumption growth has eased relative to 2004 levels and is broadly in line with expectations, it remains high, suggesting that the higher crude oil prices have so far not had a significant impact on consumption. Owing to some apparent weakness in demand in the United States and China during the first quarter of 2005, the increase in global consumption in the first half of 2005, at 1.6 percent year-on-year (or 1.3 mbd), was lower than the increase of 4.0 percent (3.2 mbd) during the same period in 2004. However, this increase remains high compared with OPEC-10's (excluding Iraq) spare capacity, which stood at 1.4 mbd (annual basis) at end-July 2005.

The IEA increased its forecast for 2005 consumption growth from 1.4 mbd (at the end of 2004) to 1.8 mbd (in March) before lowering it to 1.6 mbd in July, citing apparent weakness in the United States' and China's demand for oil (Table 1.12). While the IEA's projection has so far been corroborated by actual consumption data, it is somewhat lower than that made by other analysts (for example, the U.S. Department of Energy). Looking ahead, China's crude oil consumption, despite some weakening, remains potentially strong, while consumption in non-OECD countries—especially the Middle East and emerging markets other than China—is growing relatively rapidly. In the case of the Middle East, the higher consumption growth reflects in part the windfall gains of higher oil prices in 2003–04 and a limited increase in domestic prices.

Table 1.12. Global Oil Demand by Region
(Millions of barrels a day)

	Demand 2005	Annual Change	
		(mbd)	(percent)
North America	25.65	0.29	1.1
Europe	16.34	0.05	0.3
OECD Pacific	8.67	0.14	1.6
China	6.75	0.32	5.0
Other Asia	8.79	0.27	3.2
Former Soviet Union	3.77	0.03	0.8
Middle East	5.88	0.29	5.2
Africa	2.89	0.09	3.2
Latin America	4.97	0.11	2.3
World	83.72	1.60	1.9

Source: International Energy Agency, *Oil Market Report*, August 2005.

Production

OPEC's efforts to accommodate rising consumption of crude oil have coincided with lower-

than-expected average growth in non-OPEC output, which (excluding processing gains and natural gas liquids) declined to 0.2 mbd (year-on-year) in the first half of 2005. This slowdown has raised concerns about the projected strength in non-OPEC crude oil production growth for the second half of 2005. Russian production, in particular, has been weaker than expected in the first half of 2005, and production for 2005 is projected to decline in Mexico, the North Sea, and Canada. Given low investment in infrastructure and aging oil fields, many analysts expect the growth in non-OPEC production for 2005 to weaken further. For example, the IEA recently revised non-OPEC production growth down from 1.1 mbd in January to 0.7 mbd in August 2005. Some analysts caution that this trend has a longer-run implication, providing corroborative evidence that non-OPEC oil fields are peaking and that current production, in the absence of new reserve discovery and substantial investments, will soon move into permanent decline.

Given slower production growth in non-OPEC countries, the need for OPEC production—the so-called "call on OPEC"—is rising. In response, OPEC has increased its members' quotas by 4.5 mbd since mid-2004, well above the growth in consumption over the same period, with the most recent increase of 0.5 mbd effective July 2005.

While overall OPEC production remains above official quotas, some OPEC members have found it difficult to meet their quota allotments, thereby increasing supply uncertainty. According to the IEA, Venezuelan crude oil output fell unexpectedly in the first half of 2005 by 2.4 percent (year-on-year), while Indonesian production fell 2.6 percent (year-on-year) because of declining wells that have not been replaced. Moreover, Iraqi output continues to decline because of an aging infrastructure and frequent attacks by insurgents—Iraqi crude oil production in the first half of 2005 was 11 percent lower than a year earlier.

Despite these uncertainties, OPEC has committed to meeting the year's crude oil demand in full, allowing commercial inventories to rise in the second quarter in anticipation of increased consumption later in the year. This policy—which suggests that the organization anticipates facing binding constraints if it were to satisfy residual demand fully in the fourth quarter—is the most telling sign of OPEC's efforts to stabilize the market. As a result, by June 2005 total OECD commercial inventories increased 5.7 percent on a year-on-year basis, and are currently equivalent to 53 days of forward consumption. Moreover, prior to the release of crude oil to offset production losses from Hurricane Katrina, the U.S. strategic petroleum reserve (SPR) reached its stated capacity of about 700 million barrels. Comfortable commercial inventory levels, in the absence of unforeseen problems with production, should soften the impact of the upcoming Northern Hemisphere winter on prices.

Short-Term Prospects and Risks

Owing to strong apparent demand and limited supply, particularly of light sweet crude, many analysts have raised their oil price projections for 2005–06. *World Economic Outlook* projections for the APSP, which are based on futures markets, have been revised to $54.23 for 2005 and $61.75 for 2006, compared with $46.50 for 2005 and $43.75 for 2006 in the April 2005 *World Economic Outlook*. These higher price forecasts reflect a growing consensus that recent levels of consumption are likely to be more persistent and will continue to tax available spare capacity, thereby amplifying the price effects of any exogenous supply shocks. Though the impact of Hurricane Katrina on crude prices may not be long lasting, it has clearly increased short-term risks. Moreover, terrorism and insurgent attacks in the Middle East remain a real concern. Based on option prices, the probability that the price of West Texas Intermediate will rise above $80 by December is now 20 percent, compared with zero percent in early 2005.

While upside risks to prices remain, a major unknown is when crude oil consumption will

respond meaningfully (and by how much) to higher prices. During the oil price hikes of the 1970s and 1980s, oil consumption responded with a significant lag, and only after the higher prices created a tangible impact on importers' current accounts and consumers' share of expenditure on oil products. With lower oil intensity, even higher prices may be necessary before there is a significant impact on the world economy and a subsequent unwinding of crude oil prices.

Longer-Term Prospects, Futures Prices, and the Role of Speculation

In contrast to previous episodes of large crude oil price increases, long-dated futures prices have increased significantly during the past two years. Specifically, the correlation between six-year-out futures and spot prices has been about 0.9 since 2003, compared with almost zero during 2000–02, when spot prices also drifted upward. More generally, econometric evidence suggests that since 2003 variations in spot prices now explain a larger portion of movements in long-dated futures prices.

The volatility of long-dated futures prices has also significantly increased in recent years. Before 2003, long-dated futures showed almost no volatility: the variance of (the rate of change in) prices during 2000–02 was only 0.05, compared with 0.15 during January 2003–June 2005. Futures markets for crude oil have also become much deeper: the volume of 6-year futures contracts is 330 percent greater than the 1997–2005 average. In contrast, near-term contracts are only 150 percent higher.

The large increase in total contracts and volatility in prices have led some analysts to suggest that the ability of speculators to influence prices in these markets has increased. Some analysts go even further and suggest the presence of a speculative bubble in oil prices—especially in futures prices. They interpret the oil price increase in the broader context of an increase in asset prices, including long-term bonds and real estate.

While the day-to-day movements in long-dated futures prices are hard to explain, the persistent increase of the past two years can be largely attributed to actual and perceived changes in fundamentals, in particular: (1) the perception that demand has permanently shifted upward owing to strong growth in emerging countries (especially China and India); (2) a growing awareness that supply from non-OPEC sources might peak in the next 5–10 years, and decline permanently thereafter; and, in view of current rates of oil consumption growth, (3) limited upstream investment in countries where oil reserves are plentiful, with obvious implications for future productive capacity relative to growing demand. While smaller oil companies and some oil exporters have boosted investment, oil majors and national oil companies have generally been slow to respond to higher oil prices according to the IEA. Investment by major international oil companies appears to have been constrained by (1) downsizing in these companies in the 1990s; (2) an apparent desire to distribute higher profits to shareholders; and (3) impediments to foreign investment in oil-exporting countries, some of which are largely closed to foreign investment (such as Saudi Arabia, Mexico, and Kuwait), while some others are introducing regulations discouraging foreign investment (such as Russia and Venezuela). These impediments often reflect the divergence between the interests of international oil companies and host governments. Investment by national oil companies, furthermore, appears inadequate given the current momentum in demand. These companies generally remain cautious in increasing upstream investment significantly, given their experience with the capacity overhang of the 1980s and competing budgetary demands for oil revenues—particularly after many years of low oil prices.

These structural factors could, to some degree, also explain the increased upward bias in long-term futures prices. Long-term futures prices have responded asymmetrically to spot prices in the past two years, rising more or less proportionally when spot prices rise (from peak to trough), but falling back by about one-third

Table 1.13. Causality Tests: Spot Price, Long-Term Futures Prices, and Net Long Position[1]

	Short-Run Component[2]		Long-Run Component[3]	
	2/11/1997–12/26/2000	10/21/2003–6/28/2005	2/11/1997–12/26/2000	10/21/2003–6/28/2005
	Dependent Variable: Spot Price			
Explanatory variables				
Long-term futures price	×	×	×	•
Net long position	×	×	×	×
	Dependent Variable: Long-Term Futures Price			
Explanatory variables				
Spot	×	•	•	•
Net long position	×	×	×	•
	Dependent Variable: Net Long Position			
Explanatory variables				
Spot	•	•	•	•
Long-term futures price	×	×	×	×

Source: IMF staff calculations.
[1]A dot (or ×) indicates the presence (or absence) of a causal link from the explanatory variable to the dependent variable. The statistical analysis is based on approximate ideal band pass filters of the time series variables (see Corbae and Ouliaris, 2005). Causality is tested using weekly data and Granger causality tests involving two lags.
[2]The "short-run component" isolates the short-run impulses in the time series.
[3]The "long-run component" isolates the long-run trend in the time series.

when they decline. This ratcheting effect suggests that the short-term price declines in the oil market are not expected to last, and that future demand-supply conditions will remain fundamentally tight.

Nonetheless, the extent to which futures markets increasingly respond to day-to-day events, such as temporary supply disruptions, is puzzling. Recent large upward swings in futures prices have often occurred at times when no new information about fundamentals has become available. For example, the large increases in prices in June–July 2005 appear to reflect diminishing pressure from short-sellers, as opposed to any fundamental movements in demand or supply.

The short-term behavior of prices together with higher volatility and increased trading activity in the futures markets suggest that speculative activity might be playing a greater role in driving spot and futures prices. To formally assess this issue, Granger causality tests based on a tri-variate vector autoregression (VAR) involving spot prices, long-term futures prices, and noncommercial net long positions—the latter being a proxy for speculative activity, in the absence of better measures—were conducted. The tests were also carried out on the short- and long-run components of the data separately to determine whether speculative activity only matters over subcomponents of the data.

The statistical results, which are based on weekly data spanning 1997–2005, suggest that speculative activity does *not* precede movements in spot prices for either the short- or long-run components of the spot price (Table 1.13). There is evidence, however, of a modest impact on the long-run component of long-dated futures prices. Irrespective of the component of the data considered, the causality tests imply that speculative activity *follows* movements in spot prices, thereby raising doubt about speculative activity being a key driver of spot prices. In particular, the results suggest that noncommercial net long positions increase after spot prices increase, suggesting that speculators generally assume that a rising trend in spot prices will continue. Lastly, spot prices appear to influence both the short- and long-run movements of long-dated futures prices. This is especially true for the recent period, with the most likely explanation being lower and limited spare capacity among OPEC members in recent years,

which has made the market far more responsive to geopolitical events.

Given these results, it can be argued that market fundamentals (rather than speculative activity) remain the main driver of both spot and futures prices—although speculative activity has some modest impact on futures prices. In addition, events that move spot prices on a day-to-day basis (news of supply disruptions, for example) are affecting long-dated futures prices to a greater extent than in the 1990s. This may suggest that uncertainties about prospects for long-term supply and demand has increased volatility in the futures market and caused some loss of direction.

Are Higher Oil Prices Affecting Global Activity?

Crude oil prices remain a key input in the determination of global economic prospects. A rise in crude oil prices affects the global economy through a variety of channels.[23]

- An initial fall in global aggregate demand owing to a transfer of income from oil consumers to oil producers, which tend to have a lower propensity to consume than oil consumers on average.
- A supply-side effect reflecting higher production costs and lower profit margins. However, with falling oil intensity over the past three decades, especially in industrial countries, this effect has become weaker.
- A rise in inflation resulting from higher production costs, depending on the response of monetary policy and the extent to which consumers and producers can offset the declines in incomes and profits, respectively.
- A potential impact on activity through lower consumer and investor confidence and reduced willingness to commit to longer-term capital projects.
- A lasting impact on energy demand and supply over time, depending on the duration and extent of the price increases.

In contrast with the experience of the 1970s, however, the significant increase in oil prices since 2003 appears so far to have had a limited impact on the global economy. Indeed, projected global growth for 2005 remains healthy at 4.3 percent—a marginal decline of 0.8 percent compared with the 5.1 percent growth estimated for 2004. MULTIMOD simulations based on historical estimates of the parameters, for example, would suggest a fall in activity over 2 percent of GDP owing to the rise in prices. This estimate is based on the simple rule implied by the IMF (2000) study, which associates a persistent US$5 exogenous increase in oil prices to 0.3 percent reduction in world activity.[24] Elasticities obtained from other studies (for example, Jones, Leiby, and Paik, 2004) would suggest an even larger impact on the global economy—closer to 4 percent.

Two questions naturally arise: (1) why has the current increase in oil prices had such a benign effect on the global economy compared with the oil price shocks of the 1970s? and (2) what is the likely impact of higher prices in the period ahead as they become increasingly driven by expectations?

The limited impact of higher crude oil prices reflects, first and foremost, the fact that, in contrast to the 1970s, crude oil prices have risen largely because of a significant (and somewhat unexpected) increase in consumption, rather than an exogenous supply shock. As a result, most of the increase in prices (especially prior to 2005) has acted as an "automatic stabilizer," operating to slow robust global growth rather than raise costs for the same level of global output. Second, there has been a substantial decline in oil intensity since the early 1980s. Global oil intensity is now about 38 percent lower compared with the late 1970s, implying that any increase in crude oil prices will necessarily have a lower first-round negative effect on global growth. Third, higher oil prices have yet

[23]IMF (2000) contains a comprehensive analysis of the impact of higher crude oil prices on the global economy.

[24]It goes without saying that this, and other similar simple rules, obviously do not apply in all circumstances. The impact of a US$5 increase in prices, for example, also depends on initial conditions, relating to, for example, the level of oil prices and the output gap.

to manifest themselves in core inflation, mitigating the need for higher interest rates (and lower output) to ward off second-round core inflation effects. Improved monetary policy credibility in industrial countries and a subdued global inflation environment (in part reflecting low labor costs in China and other major Asian exporters) appear to have anchored inflationary expectations.

Taking into account these offsetting factors, the impact of an oil price shock is less than earlier rules of thumb imply. For example, revised MULTIMOD simulations assuming the oil prices are increased by a demand shock and inflationary expectations remain well anchored suggest that a persistent 10 percent increase in oil prices is associated with a 0.1–0.15 percent reduction in global GDP. These simulations would imply that the cumulative effect of the oil price rise since 2003 on global activity may have been in the 1 to 1½ percent range.

A number of other factors may also have further mitigated the impact. First, given the continuing growth in crude oil consumption—and, in some countries, declining household savings—it may be that oil consumers are treating part of the price increase as temporary in nature despite higher long-dated futures prices. Second, in a number of countries, the pass-through of higher oil prices to domestic prices has been limited, financed by explicit or implicit budgetary subsidies. Both factors may have further reduced the impact of higher oil prices on inflation and activity.

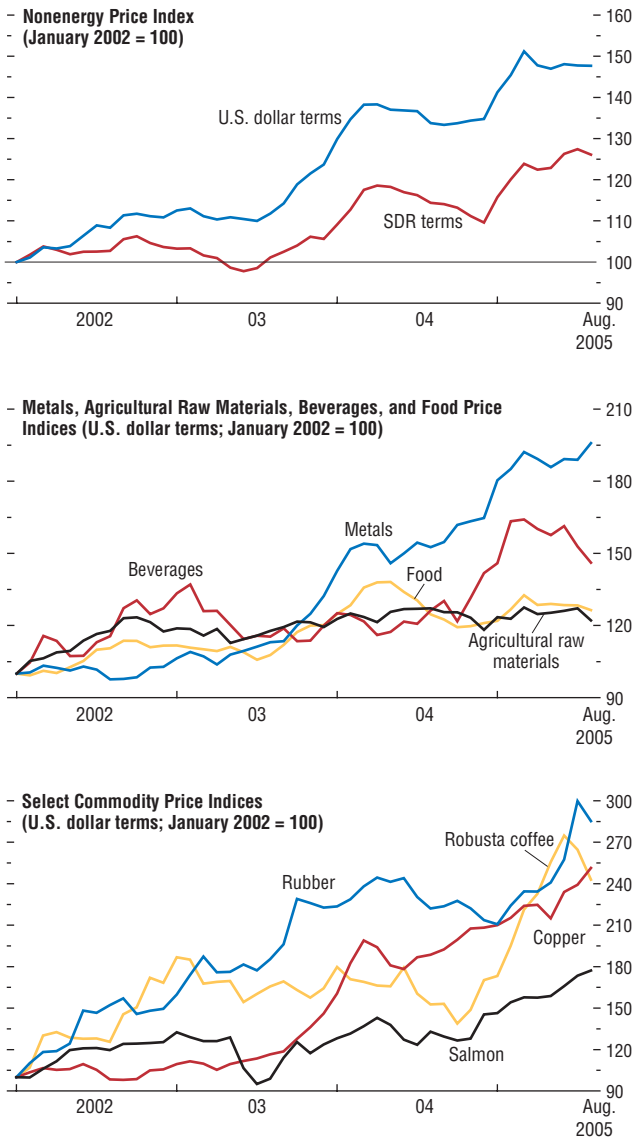
Looking forward, however, the impact of higher oil prices may not continue to be so benign. If the increase in oil prices is permanent—as futures markets suggest—budgetary subsidies and consumer behavior will ultimately need to adjust. More generally, with limited excess capacity among OPEC producers, the market remains vulnerable to shocks. As such, further increases in oil prices cannot be ruled out (as options markets suggest). These increases—especially if driven by concerns about the availability of supply- rather than demand-side shocks, as seems to be increasingly the case in 2005—are likely to have more marked effects on inflationary expectations, requiring a more active monetary policy response. There may also be adverse effects on consumer confidence, which has been relatively resilient to date. Indeed, IMF staff estimates suggest that higher interest rates combined with adverse impacts on consumer/investor confidence (in line with past experience) could double the impact of the revised rule of thumb given above.

Nonenergy Commodity Prices

Average nonenergy prices rose by 5 percent in U.S. dollar terms (and 9 percent in SDR terms) during January–August 2005, with metals and food prices being the main drivers of the nonenergy index (Table 1.14; Figure 1.23). While most metals markets reacted to further reductions in inventory positions and specific labor issues of mining companies, strong Chinese demand for soybeans pushed the food index higher. Looking forward, the upward momentum in nonenergy commodity prices is expected to ease for the remainder of 2005 as supply responds strongly to 2004 prices. On average, the nonenergy commodity price index for 2005 is projected to register an overall gain of 9 percent.

Turning to specific commodity markets, metals prices have increased by 9 percent since January and are expected to plateau, reflecting an easing in the overall tightness of the metals sector. Robust demand for construction and manufacturing products in both the United States and China increased metals prices during 2004, and continue to do so in 2005. Robust steel demand has resulted in a significant increase in iron ore—steel producers signed new contracts to purchase iron ore at prices 71.5 percent higher than last year. Copper prices rose by 20 percent to an all-time high, as inventory levels of copper fell to historical lows and recent strikes by mining workers threatened world supplies. Uranium prices increased by 44 percent in 2005—following a

Figure 1.23. Nonenergy Commodities



Source: IMF staff calculations.

Table 1.14. Nonenergy Commodity Prices

(Percent change from January to August 2005)

	U.S. Dollar Terms	Contribution[1]	SDR Terms
Food	3.7	42.9	8.0
Beverages	0.2	6.6	4.4
Agricultural raw materials	–1.1	20.7	3.1
Metals	8.6	29.8	13.1
Overall Nonenergy	4.6	100.0	9.0

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.

60 percent increase in 2004—because the extra demand arising from newly constructed (and planned) nuclear reactors exceeds existing global mine capacity. In contrast, aluminum prices increased only slightly, reflecting the impact of a significant growth in exports from China. Looking forward, mine activity is expected to increase for almost all metals, most likely allowing inventories to recover in 2006, and prices to ease.

Overall beverage prices have remained unchanged since January as the strength of Robusta coffee prices has been offset by price reductions for other products. Severe drought conditions in Vietnam (the largest producer of Robusta coffee) have pushed Robusta prices up by 40 percent since January. In contrast, sizable tea harvests in Asia have allowed prices to ease by 10 percent. Looking forward, a better-than-expected harvest in Brazil should ease coffee prices, though Robusta prices could stay relatively high owing to crop damage caused by the drought in Vietnam.

Food prices, which went up by 4 percent during January–August 2005, are expected to ease later in the year as relatively large global harvests of many food items are expected this year. While unfavorable weather conditions in several growing regions (e.g., North and South America) have raised concerns about the summer and fall harvests of coarse grains and soybeans, China is expected to absorb much of the record harvest of soybeans for 2005. Chinese

demand, coupled with the poor weather conditions in key growing areas, has pushed soybean prices up 18 percent since January. Salmon prices rose by 21 percent during a period of robust demand and limited supply. In contrast, banana prices declined by 43 percent over the same period as supplies outpaced consumption in European markets, where consumers switched to local fruits owing to hotter than normal weather conditions.

Agricultural raw material prices fell by 1 percent for the first eight months of 2005 as the supply of raw materials outpaced global demand. Timber prices have experienced a pronounced turnaround during 2005. Softwood prices have declined by about 14 percent since January, after increasing by about 15 percent in 2004. Increased harvests have helped to ease timber prices. The strong weight of timber in the index has obscured strength in cotton and rubber prices. Cotton prices have risen 5 percent owing to strong Chinese demand. Rubber prices have strengthened 35 percent since January because higher oil prices raised synthetic rubber prices and temporary supply disruptions of natural rubber restricted substitution. Looking forward, increased demand for raw materials is expected because of strong global economic growth. This should help to keep agricultural raw materials prices from contracting further in 2005, especially for timber.

Hurricane Katrina, which devastated ports and cities in the U.S. southern region (a large hub for grain exports and warehouses for other commodities), appears to have had only a temporary impact on specific nonfuel commodity markets. The temporary closure of ports and transportation blockage in the Mississippi River slowed down U.S. exports of soybeans, wheat, and corn. Hurricane Katrina also damaged cotton crops from Mississippi to Georgia. The current status of stockpiles of a significant amount of coffee and base metals, including nearly half of the world's inventories of zinc, remains unknown. Lumber prices have risen on expectations of significant construction activities to rebuild affected areas.

Semiconductor Markets

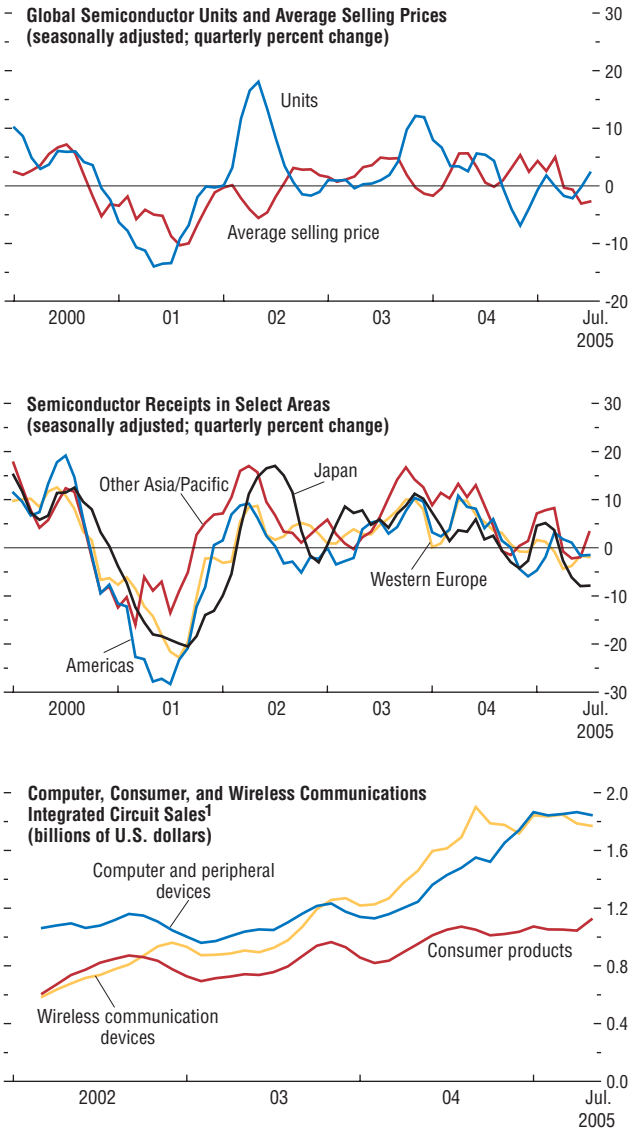
Following a record increase of 28 percent in 2004, sales revenue grew at a substantially lower rate during January–July 2005 compared with the same period in 2004. Most of the decline reflects weak average semiconductor prices (Figure 1.24). By July, the average (seasonally adjusted) selling price for semiconductors had fallen by 9 percent, though specific sectors posted larger price falls. For example, dynamic random access memory (DRAM) prices have fallen 37 percent on average since January. Looking forward, semiconductor prices are expected to rebound in the second half of the year owing to seasonal back-to-school purchases and holiday-season demand, with the rebound muted somewhat by the release of inventories. Sales revenue growth for 2005 is now projected at 6 percent compared with a zero percent growth forecast at end-2004.

Purchases of semiconductor production equipment appear to be contracting. The global book-to-bill ratio (an indicator of future relative to current investment) is hovering around 0.9, compared with the 2004 average of about 1.0. Lower capital investment in 2005 reflects in part an overhang in capacity arising from the large investment projects in 2004, which resulted in a significant fall in capacity utilization from 0.95 in 2004:Q2 to 0.88 in 2005:Q2. This spare capacity has resulted from the strong growth in production facilities of 9.5 percent over the past year, outstripping by a wide margin the growth in production of about 2 percent. Utilization rates in leading-edge production facilities, however, remain high, suggesting that overall prices of leading-edge products will not soften further.

Consumer demand for new electronics has been affected by a combination of high energy prices, rising interest rates, and falling confidence. However, falling prices for maturing consumer products should support sales going forward. While the most recent hike in energy prices has dampened business optimism somewhat, business purchases should eventually pro-

vide a strong market for the latest computing technology.

Figure 1.24. Semiconductor Market



Sources: World Semiconductor Trade Statistics; and IMF staff calculations.
[1]Sectors are defined by the final use of integrated circuits (ICs) in product categories. Definition excludes dual/multipurpose chips. Three-month moving averages.

Appendix 1.2. How Will Global Imbalances Adjust?

The authors of this appendix are Doug Laxton and Gian Maria Milesi-Ferretti, with support from Susanna Mursula. The simulations using the Global Economy Model have greatly benefited from earlier work by Dirk Muir and Paolo Pesenti.

Background

Global imbalances have been widening in the past few years. Since 1996, the U.S. current account balance has deteriorated substantially, mirrored by improvements in the current account balance of emerging Asia, oil-producing developing countries (especially in recent years), and, to a lesser extent, small industrial countries such as Switzerland, Norway, and Sweden (Figure 1.25). The euro area's current account has remained close to balance, with divergent developments between surplus countries (Germany, the Benelux countries, and Finland) and deficit countries (such as Greece, Portugal, and Spain).

The deterioration of the U.S. current account was matched by a substantial appreciation of the U.S. dollar, which rose by some 35 percent in real effective terms between mid-1995 and early 2002, matched by real effective depreciations in the euro area and emerging Asia (Figure 1.26). Since early 2002, the U.S. dollar has depreciated by some 12 percent, matched primarily by appreciations of the euro and of the currencies of other main industrial countries; currencies in emerging market trading partners have remained broadly unchanged. Correspondingly, the depreciation of the U.S. dollar to date has offset less than one-half of the earlier appreciation, and has been significantly more muted than was the case during the adjustment episode of the mid-1980s.

As global current account imbalances have grown, the dispersion in net foreign asset posi-

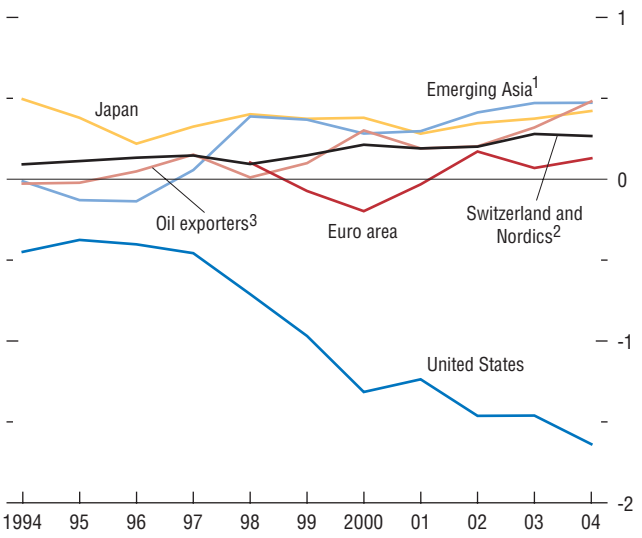
tions (the difference between a country's claims on the rest of the world, and the rest of the world's claims on it) has correspondingly increased (Figure 1.27).[25] The U.S. net foreign asset position steadily deteriorated between 1996 and 2002, while Japan, some small industrial countries, emerging Asia, and oil exporters have built up significant creditor positions. Since 2002, despite widening current account deficits, United States' net liabilities have actually declined as a share of GDP. This is mainly due to valuation effects: the depreciation of the dollar and strong stock market performance outside the United States have resulted in substantial capital gains by the United States on its net external position (which includes assets mostly denominated in foreign currencies and liabilities denominated in U.S. dollars).[26]

Current World Economic Outlook projections, based on the assumption of constant real exchange rates, suggest little improvement in global imbalances. The U.S. current account deficit is projected to remain at about 6 percent of GDP into the medium term, with some improvement in the U.S. fiscal position offset by low private savings and rising interest payments, matched by continued large surpluses in Japan, emerging Asia, and oil-exporting countries. Hence the United States' net external position would continue to deteriorate, reaching a record 50 percent of GDP by 2010, matched by rising net creditor positions in the rest of the world.

Long-Run Sustainability Implications

Examining the stylized facts presented in the previous section, two key questions arise. What caused the widening in external imbalances? And what are the implications for long-run sustainability? We discuss these issues in turn.

Figure 1.25. Current Account Balances
(Percent of world GDP)

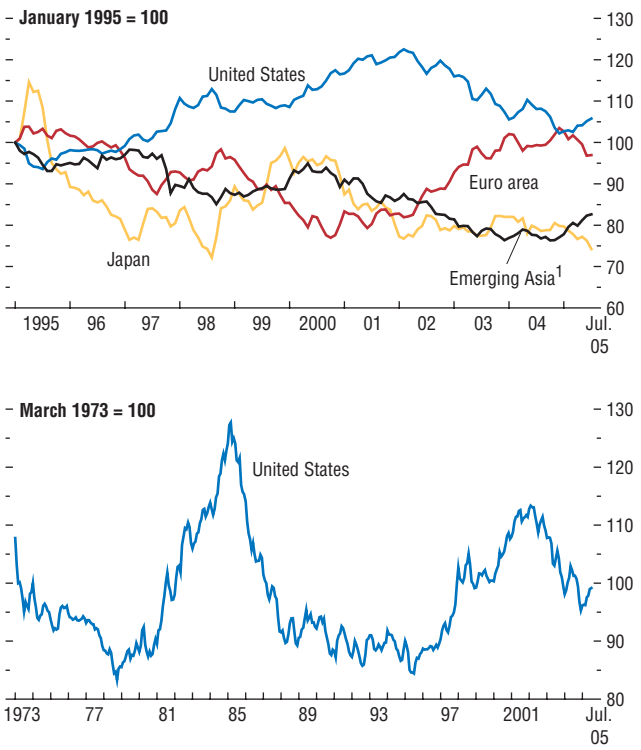


Source: IMF staff calculations.
[1]China, Hong Kong SAR, Korea, Malaysia, Singapore, Taiwan Province of China, and Thailand.
[2]Norway, Sweden, and Switzerland.
[3]Algeria, Bahrain, Egypt, I.R. of Iran, Jordan, Kuwait, Libya, Russia, Saudi Arabia, Syrian Arab Republic, United Arab Emirates, and Yemen.

[25]The net foreign asset data are from the comprehensive database developed by Lane and Milesi-Ferretti (2005), with data for 2004 based on preliminary calculations by the authors.

[26]These capital gains are not incorporated in the current account.

Figure 1.26. Real Effective Exchange Rates



Sources: U.S. Federal Reserve Board; and IMF staff calculations.
[1]China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, and Thailand.

Beginning with the causes of imbalances, there is considerable consensus that the dollar appreciation and buildup of U.S. current account deficits during the second half of the 1990s were associated with high productivity growth and a shift in preference toward U.S. assets, possibly as a consequence of overoptimistic expectations about future asset returns, the Asian crisis, and sluggish economic performance in Europe and Japan.[27] However, even following the sizable correction in stock market valuations after 2000 and the slowdown in economic activity in the United States, the U.S. current account deficit did not adjust. A number of factors have been at play.

- Fiscal and monetary policies in the United States became sharply expansionary—both absolutely and relative to other countries—thus sustaining domestic demand. In addition, booming house prices, fueled by low interest rates, have contributed to a reduction in household saving.
- Investment in a number of key countries, such as Germany and Japan, has remained depressed, and—with the exception of China—investment in emerging Asian countries continues to be weak, relative to historical standards.
- National saving rates in China and oil-exporting countries have risen sharply.

Views on the relative importance of these factors vary. Some authors have emphasized the role of U.S. fiscal imbalances and foreign-exchange intervention by Asian central banks (Roubini and Setser, 2005), while others have downplayed the role of fiscal policy and highlighted the importance of a "global saving glut" (particularly in emerging markets) reducing world interest rates (Bernanke, 2005).

Looking forward, as already described, the global imbalances are clearly unsustainable in

[27]On the impact of U.S. productivity shocks and related expectations, see Erceg, Guerrieri, and Gust (2002) and Hunt (2002). Hunt and Rebucci (2003) explore the combined implications of a U.S. productivity shock and a shift in preference toward U.S. assets.

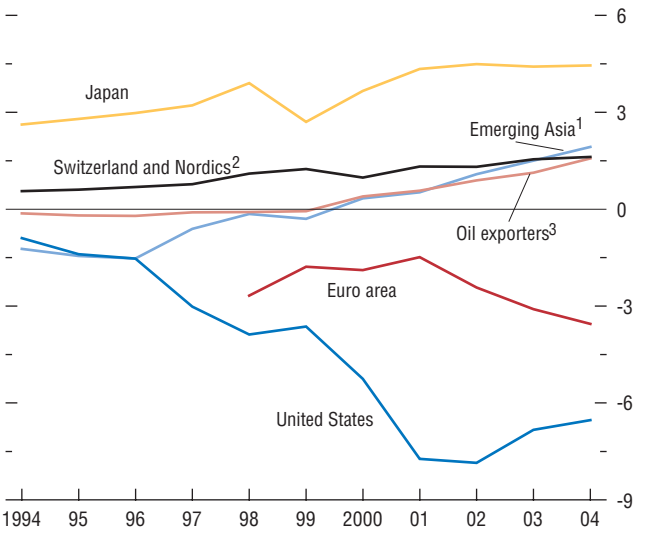
the long term: if the U.S. external current account balance excluding investment income remained at its current level of over 5 percent of GDP, there would be an unbounded accumulation of external liabilities.[28] To date, however, the United States has experienced little difficulty in financing imbalances, reflecting partly increased financial globalization—which has boosted the allocation of wealth to foreign financial instruments—and partly substantial purchases of U.S. bonds by monetary authorities, particularly in Asia.

Views again differ, however, as to how long this situation can persist. On the one hand, the "new Bretton Woods hypothesis"—advanced by Dooley, Folkerts-Landau, and Garber (2003, 2004)—posits that the constellation of external imbalances partly reflects the deliberate actions (e.g., de facto pegs) of "periphery" countries—particularly China—seeking export-led growth as a development strategy, which they believe can continue for a significant period. Another "benign" view of imbalances stresses the role of globalization, with the weakening in the correlation between national saving and domestic investment reflecting the better functioning and increasing integration of global capital markets. Finally, the rise in U.S. indebtedness has been described as reflecting optimal private sector behavior, and hence not a source of concern, in line with the Lawson doctrine. More specifically, U.S. imbalances are viewed as the natural consequence of a large increase in the stock of U.S. wealth and weak investment opportunities in other countries, rather than the consequence of large U.S. fiscal deficits and private sector overborrowing (Backus and Lambert, 2005; Cooper, 2005).

On the other hand, a number of authors (see, for example, Obstfeld and Rogoff, 2004, 2005; Roubini and Setser, 2005; and Blanchard,

[28]To stabilize its external liabilities as a percentage of GDP, a debtor country must run a surplus on its external current account excluding net investment income (assuming, as is generally the case, that the interest rate it pays on its external liabilities exceeds its long-run growth rate).

Figure 1.27. Net Foreign Assets
(Percent of world GDP)



Source: Lane and Milesi-Ferretti (2005).
[1]China, Hong Kong SAR, Korea, Malaysia, Singapore, Taiwan Province of China, and Thailand.
[2]Norway, Sweden, and Switzerland.
[3]Algeria, Bahrain, Egypt, I.R. of Iran, Jordan, Kuwait, Libya, Russia, Saudi Arabia, Syrian Arab Republic, United Arab Emirates, and Yemen.

Giavazzi, and Sa, 2005) emphasize that the current pattern of global imbalances will have to be unwound through a substantial real depreciation of the dollar. While financial globalization makes it easier to finance external imbalances, these authors note that, given the small size of the U.S. traded goods sector relative to the size of the U.S. economy, the trade deficit expressed as a share of traded goods production is very large. As a consequence, the relative price of nontraded goods in the United States has to fall substantially to ensure that the consumption of traded goods by U.S. residents declines, making room for an adjustment in the trade balance.[29] While the models are of course less specific on the timing of this adjustment, they underscore that the longer current account deficits are sustained, the bigger the stock of U.S. external liabilities, and the larger the ultimate adjustment in real exchange rates that will be required.

Model-Based Adjustment Scenarios

In this section we present a baseline scenario for global current account rebalancing and then consider potential risks and possible policy initiatives that would help mitigate these risks. The scenarios are based on a four-region version of the Global Economy Model (GEM), comprising the United States, the euro area and Japan, emerging Asian economies, and the rest of the world. In the model, described in more detail in Faruqee and others (2005) and the April 2005 *World Economic Outlook*, each region produces both tradable and nontradable goods, with bilateral trade flows taking place between the blocs. Both goods markets and labor markets are characterized by the presence of imperfect competition and nominal rigidities, and consumers are non-Ricardian—that is, they treat a portion of government debt as net wealth—so that changes in macroeconomic policies can have significant short- and long-term effects.

Turning to policies, monetary policy in the United States, the Japan–euro area bloc, and the rest of the world is characterized by an interest rate feedback rule that gradually moves inflation toward a constant desired rate.[30] In contrast, in emerging Asia the exchange rate is assumed to be pegged to the U.S. dollar (although the implications of a shift to a more flexible exchange rate regime, accompanied by a monetary policy rule similar to the other regions, are also considered). Fiscal policy plays a more passive role, stabilizing the debt-to-GDP ratio in the medium term.

The desired level of net foreign assets (or foreign liabilities) in each region over the medium term plays a key role in determining the equilibrium level of current account balances—and therefore exchange rates. In the long run, the United States is assumed to be the only debtor region, with the remaining regions holding positive net foreign assets.[31]

Before turning to the scenarios, it is important to underscore three additional points.

- The model provides *simulations*, not *forecasts*, with key parameter assumptions in GEM broadly in line with those in similar large-scale macroeconomic models. One important assumption for these scenarios is the value chosen for the elasticity of substitution between traded goods produced in different countries, which leads to higher price elastici-

[29]Estimates presented by Obstfeld and Rogoff (2004, 2005) suggest that the real effective depreciation of the dollar needed to eliminate the U.S. current account deficit is about 30 percent, with a corresponding large appreciation in Asia and the euro area (although they do not allow for supply-side effects, which would tend to reduce the extent of the depreciation). Using a different model, which emphasizes shocks to asset markets, Blanchard, Giavazzi, and Sa (2005) also come to the conclusion that a substantial—if gradual—dollar depreciation is likely to occur over the medium term, which would bring the U.S. trade balance to sustainable levels.

[30]Japan is assumed to have exited from deflation and the zero interest rate constraint on monetary policy is thus assumed to be no longer binding.

[31]Ghironi, Iscan, and Rebucci (2005) describe how differences in agents' discount factors across countries lead to nonzero net foreign asset positions in the long run.

ties of demand for both exports and imports than is normally found in standard export and import equations. Consequently, estimates of the exchange rate adjustments that need to accompany global rebalancing in the scenarios may be regarded as conservative.

- No model incorporates every aspect of the real world, and GEM is no exception. In particular, the financial market sector is quite limited—there are no portfolio effects (notably valuation effects on gross external positions and differences in rates of return between external assets and liabilities), no room for sterilized intervention, and limited scope for the financial sector to amplify the effect of real shocks. Finally, the model does not explicitly incorporate oil prices and consequently cannot be used to address the potential role of oil exporters in the adjustment process.[32]
- The model does not match historical data perfectly. Therefore, caution should be exercised in interpreting the short-run movements in certain variables during the first periods of the simulations, which may simply reflect the adjustment of these variables to the path suggested by the model.

Adjustment Without Policies

Because, as described above, the global imbalances are unsustainable over the long run, the issue is not *whether* but *how* they adjust. This section looks at how the global economy might adjust in the absence of policy changes, barring modest fiscal adjustments, to ensure that public debt stabilizes in the long run. We consider two scenarios: a relatively benign baseline, in which non-U.S. residents are willing to continue increasing their holdings of U.S. assets for a considerable period without demanding a large risk premium; and a more disorderly adjustment, in which there is a sudden loss in demand for U.S. assets combined with a surge in protectionist pressures across the globe.

Benign Baseline Scenario

In the benign scenario, as noted above, it is assumed for the sake of illustration that policies remain broadly unchanged relative to their 2004 levels[33] (in practice, since GEM does not allow for sterilized intervention, the exchange rate in emerging Asia adjusts more rapidly in this scenario than might otherwise be the case). In the United States, the budget deficit remains at its 2004 level of 4 percent of GDP, and in other regions there is a modest tightening of fiscal policies to ensure that public debt is broadly sustainable over the longer term.[34] Consequently, current account adjustment is primarily driven by changes in private sector behavior, which must in turn be consistent with the desired level of net foreign assets (or liabilities) in each region. In this scenario the initial constellation of current account imbalances is generated by low private (and public) saving in the United States, together with strong foreign demand for U.S. assets.[35] As the various shocks that drive the current constellation of imbalances unwind, the world economy gradually adjusts toward its long-run equilibrium. The scenario results are displayed in Figures 1.28–1.30, together with bands that provide a measure of uncertainty surrounding the model results. Adjustment across the various regions takes place broadly as follows.

- In the *United States*, the gradual reduction in private consumption necessary to raise savings

[32]Chapter II discusses in more detail the implications of saving and investment behavior in oil-exporting countries for global imbalances.

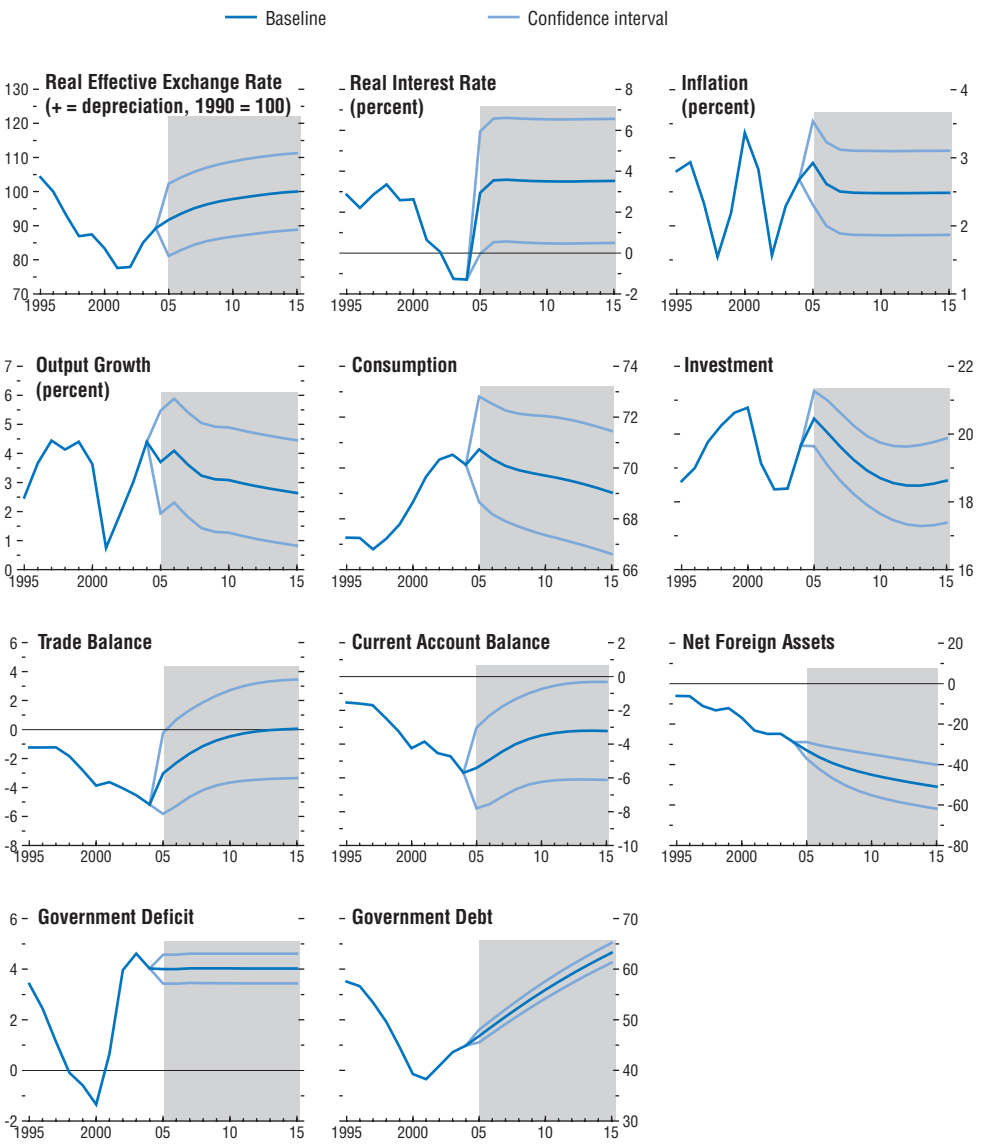
[33]As described in the main text, some measures have in fact been taken since that time.

[34]A constant deficit of 4 percent of GDP in the United States does imply some fiscal consolidation, because the increase in the stock of debt from its current level raises the interest burden, so that the underlying primary balance must strengthen.

[35]The baseline scenario also allows for persistent differentials in productivity growth (higher growth in emerging Asia and lower growth in the Japan–euro area bloc) and an increase in appetite for imports from emerging Asia. However, these factors have a more modest impact on the dynamics of current accounts than do the assumptions about saving behavior.

Figure 1.28. United States: Baseline Scenario

(Percent of GDP unless otherwise noted)



Source: IMF staff estimates.

is accompanied by higher real interest rates—which also reduce private investment through 2010—and a further real effective depreciation of the U.S. dollar of about 15 percent over the long term.[36] This results in some slowdown in GDP growth, and a steady reduction in the current account deficit to about 3½ percent of GDP by 2010 (Figure 1.28), and to 3 percent of GDP over the long run, with U.S. net foreign liabilities eventually stabilizing at about 70 percent of GDP.[37]

- The main counterpart of U.S. adjustment is in *emerging Asia*, where the current account surplus gradually declines to about 2 percent of GDP, consistent with maintaining a substantial net creditor position over the longer term, with a sharp rise in private consumption more than offsetting some decline in investment over the longer term (Figure 1.29).[38] This is accompanied by a gradual real exchange rate appreciation of about 15 percent, which—if exchange rates do not adjust—is achieved through a persistent positive inflation differential vis-à-vis trading partners. Productivity growth declines over the medium term as the level of productivity catches up to the levels in more advanced economies.
- The impact on *Japan and the euro area* is relatively limited, with the current account surplus projected to decline by about 0.5 percent of GDP over the next 10 years, accompanied by a 5 percent real effective appreciation (Figure 1.30). Productivity growth is assumed to remain below trend over the medium term and to eventually recover gradually, generating a similar trend in private investment.
- In the *rest of the world*, the adjustment process in the current account is similar to the one in emerging Asia, given the strong trade linkages with the United States (mainly Canada and Mexico), but real exchange rate changes are muted because there is a smaller underlying change in its preferences for holding U.S. assets.

In summary, this adjustment scenario is characterized by a sizable—if relatively gradual—private sector–led adjustment, accompanied by somewhat lower U.S. and global growth, and noticeable but orderly exchange rate adjustments in a number of regions. All in all, the scenario looks fairly benign, but it depends critically on the willingness of foreigners to accommodate a further substantial buildup in U.S. foreign liabilities, in the face of further foreign exchange losses—as noted above, not included in the model—without demanding a large risk premium.[39]

A More Abrupt Adjustment

The second scenario looks at the impact of a much more abrupt and disorderly adjustment, assuming a combination of a temporary rise in protectionist pressures,[40] accompanied by a sudden decline in demand for U.S. assets—including an abandonment of pegs in emerging

[36]A lower elasticity of substitution between traded goods produced in different countries would imply a larger dollar depreciation. On the other hand, the valuation effects of exchange rate changes (not fully captured in the model) would mitigate somewhat the size of the needed adjustment, by inflicting capital losses on holders of dollar assets and thus improving the U.S. net external position.

[37]The model is calibrated to match the U.S. current account during the historical period but it underpredicts the U.S. trade deficit, because it assumes that the U.S. income balance is negative, in proportion to the outstanding stock of U.S. net external liabilities. Consequently, the change in the trade balance between its actual level in 2004 and the predicted one in 2005 is magnified.

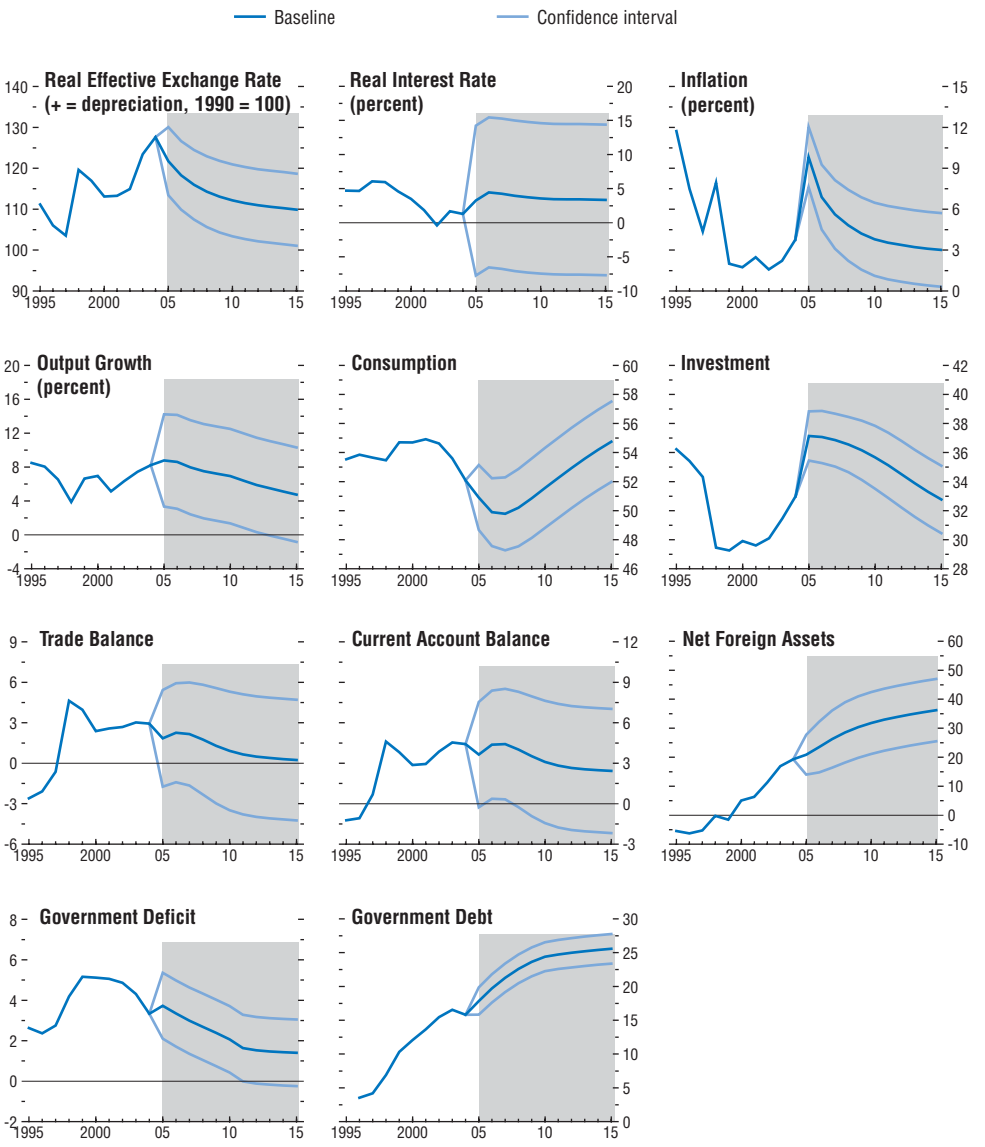
[38]As mentioned earlier, the model does not match historical data perfectly—in particular, it predicts higher-than-realized investment and inflation in emerging Asia. The first periods of the simulations thus reflect an increase of these variables to the path suggested by the model.

[39]The baseline assumes that real interest rates in the United States are about 50 basis points higher than in the rest of the world. A larger risk premium on U.S. dollar liabilities would increase the trade surplus required to stabilize the net external position, and would therefore act as a brake on the accumulation of external liabilities by the United States (as exemplified in the next scenario).

[40]In GEM, this is modeled as a substantial—if temporary—increase in margins in product markets in all regions, which is particularly large for the traded goods sector.

Figure 1.29. Emerging Asia: Baseline Scenario

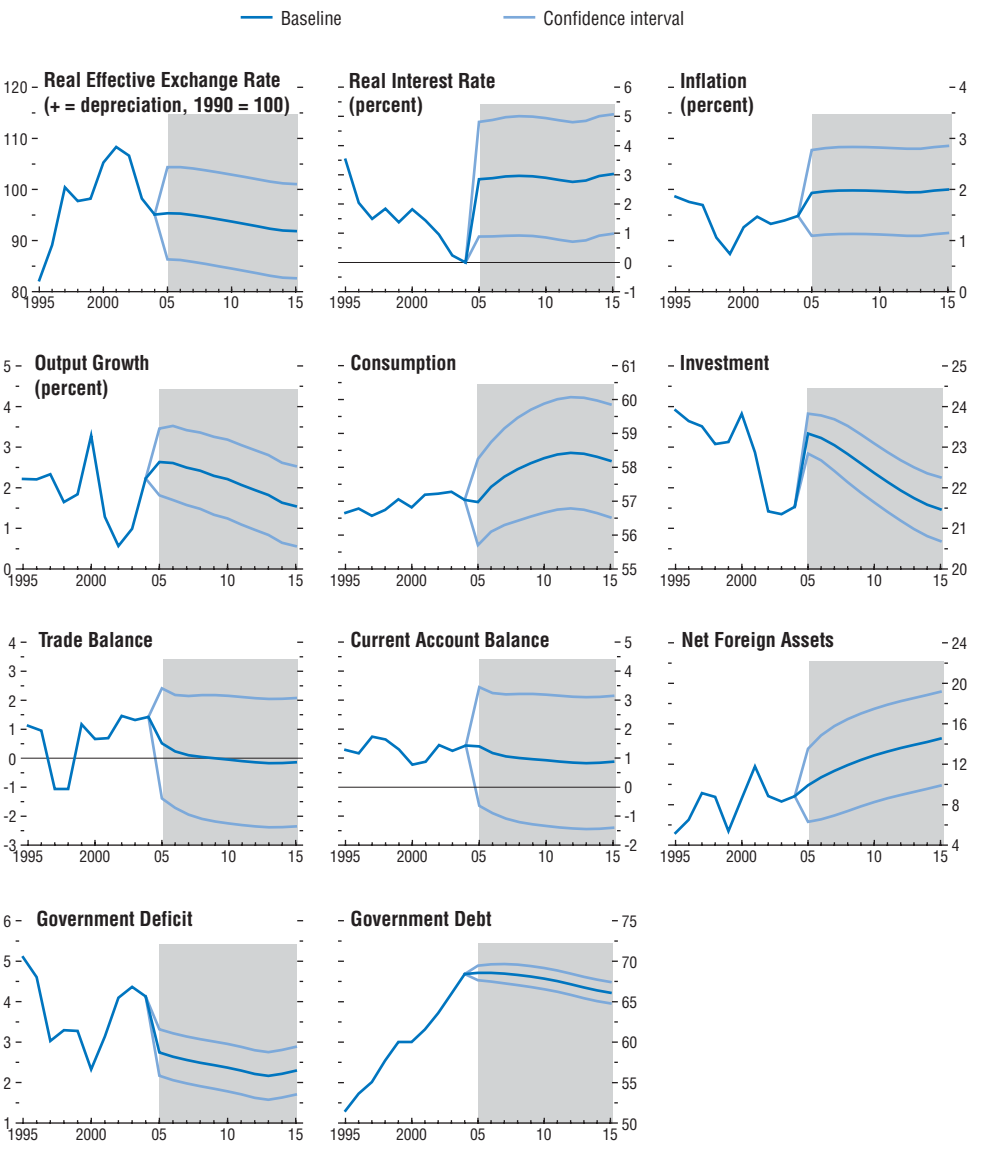
(Percent of GDP unless otherwise noted)



Source: IMF staff estimates.

Figure 1.30. Japan and Euro Area: Baseline Scenario

(Percent of GDP unless otherwise noted)



Source: IMF staff estimates.

Asia. The decline in demand for U.S. assets is assumed to be stronger in emerging Asia than in other regions, and to be reflected in a general decline in the desire to hold foreign assets.

Scenario results are presented in Figure 1.31, with the blue line reporting the "benign" baseline and the red line the abrupt adjustment outcomes. The consequence of these shocks is a sharp contraction in U.S. economic activity, relative to the baseline. The shift in portfolio preferences away from U.S. assets forces a large real depreciation of the dollar and a sharp correction in the U.S. trade balance. Together with the increase in protectionism, this leads to rising inflationary pressures, requiring a significant short-term monetary tightening, which amplifies the contractionary effect on GDP growth.

The economies of emerging Asia experience a sharp real appreciation, a deterioration in the trade and current account balances, and a slowdown in economic activity. The appreciation, together with a monetary policy tightening (as the focus of monetary policy shifts from the exchange rate peg to an inflation target), helps contain inflationary pressures relative to the baseline. In the euro area and Japan, growth slows sharply, the current account deteriorates, and the real exchange rate appreciates on impact, helping to contain the jump in prices arising from protectionism.[41] Finally, in the remaining countries, the pattern of adjustment is qualitatively similar to the one in the euro area and Japan.

In summary, this scenario highlights the danger that sudden shifts in market sentiment, along with rising protectionist pressures, could entail for global growth. Given the very large short-term exchange rate adjustments that take place in this scenario, there is also significantly greater risk of financial market disruption—not explicitly considered in GEM—with further negative implications for global stability and growth.

How Can Policies Help?

How can policies help reduce the risks of a disorderly adjustment taking place, and limit the impact on global growth? To address this key policy question, we present three illustrative scenarios, which highlight the implications of increased exchange rate flexibility in emerging Asia, faster fiscal consolidation in the United States, and growth-enhancing structural reforms in the euro area and Japan (see Box 1.6, "Policies to Reduce Global Imbalances").

Greater Exchange Rate Flexibility in Emerging Asia

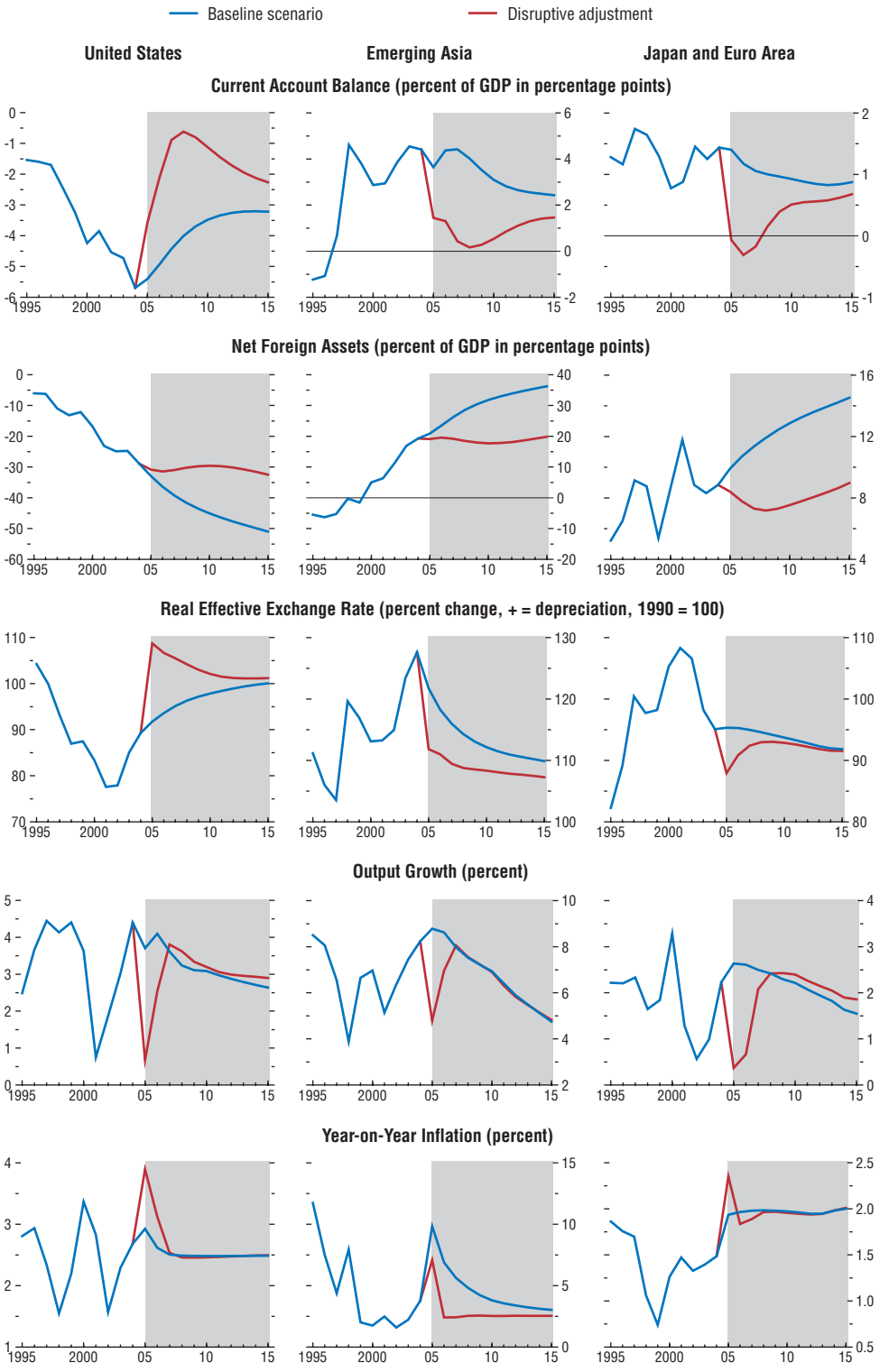
As has already been described in the benign baseline scenario, exchange rates in emerging Asia will need to appreciate over the medium term. Consequently, the key questions are how this is achieved—whether through a nominal appreciation or through higher inflation—and when it takes place. To emphasize the implications of an increase in exchange rate flexibility in emerging Asia, not driven by disruptive events as in the previous scenario, we consider a scenario where the move toward increased exchange rate flexibility in the region is accompanied by a decline in the rate of accumulation of foreign exchange reserves, leading to a reduced stock of net foreign assets relative to the baseline. The decline in holdings of foreign assets by emerging Asia is spread across all other regions, but is stronger vis-à-vis the United States.

The results are presented in Figure 1.32 (red line), together with those of the baseline (blue line). The shift in exchange rate and reserves policy in emerging Asia is accompanied by a more rapid—but still gradual—real effective appreciation relative to the baseline, which helps stymie inflationary pressures.[42] The downward adjustment in the current account is mirrored by

[41]If the portfolio shock entailed higher demand by emerging Asia for euro area or Japanese assets, rather than a generalized decline in demand for foreign assets, there would be a larger initial appreciation of the euro and the yen and a smaller appreciation in emerging Asia.

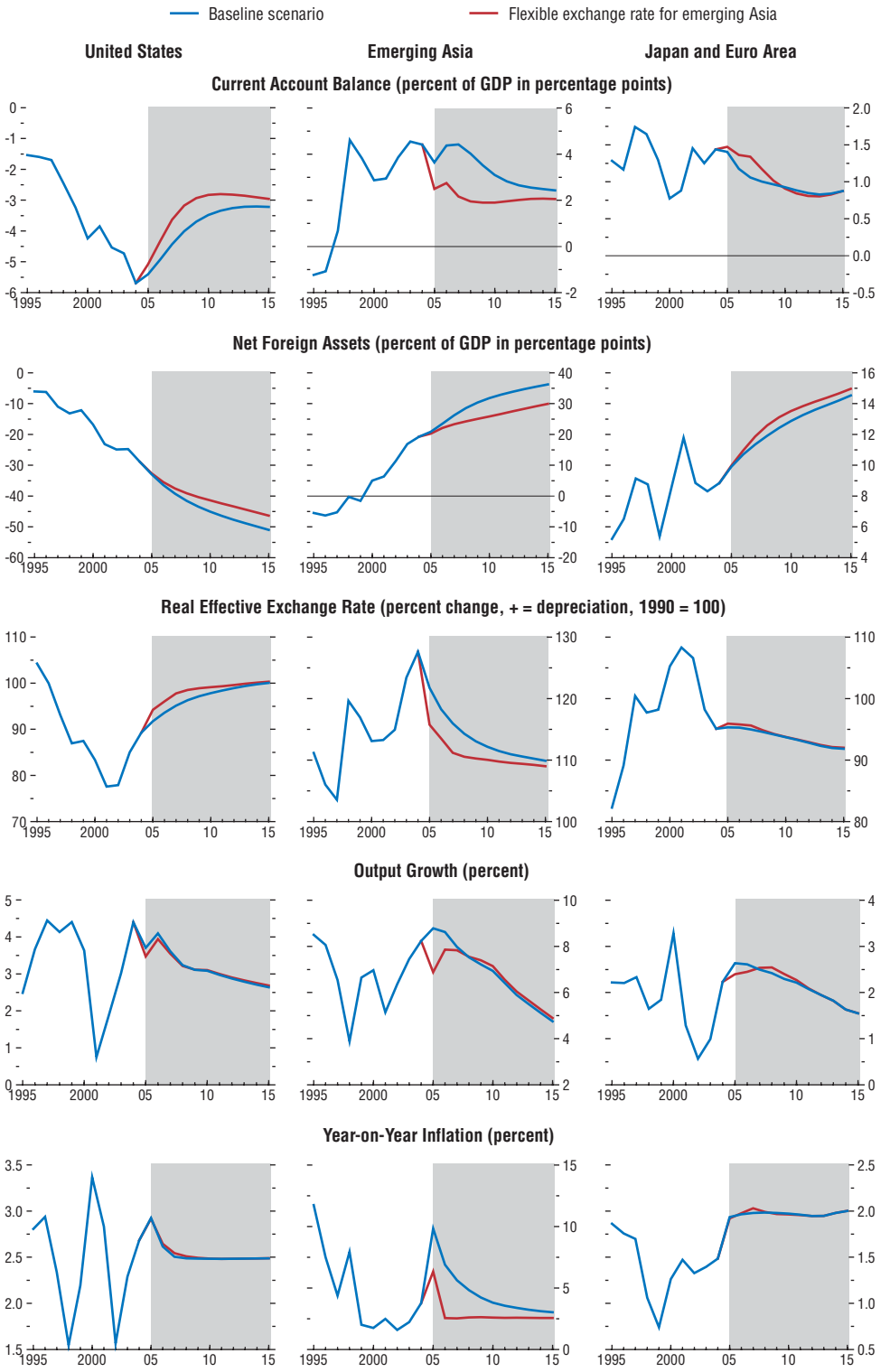
[42]Over the medium term, the real effective appreciation in this scenario is actually lower than in the baseline, because the net foreign asset position is smaller and hence the equilibrium trade deficit is smaller.

Figure 1.31. Disruptive Adjustment



Source: IMF staff estimates.

Figure 1.32. Greater Exchange Rate Flexibility in Emerging Asia



Source: IMF staff estimates.

Box 1.6. Policies to Reduce Global Imbalances

This box sets out, in broad terms, policies in each country/region that would contribute to an orderly adjustment in global imbalances.

In the *United States*, the priority is to increase national savings, with the main policy instrument available to achieve this being fiscal consolidation. The projections underlying the fiscal adjustment scenario assume that the federal budget excluding Social Security is balanced by 2013, and that reform of entitlement programs ensures their long-term fiscal sustainability. Achieving this objective would require the following.

- Full implementation of the adjustment plans in current U.S. Administration projections (as contained in the 2006 Mid-Session Review), including tight limits on discretionary spending. This would be facilitated by the introduction of a legislated fiscal rule requiring the costs of proposals to increase the deficit to be offset elsewhere in the budget.
- Revenue-enhancing measures, preferably through base broadening. These could include eliminating tax exemptions (for example, the deductibility of state and local taxes, interest on state and local bonds, mortgage relief, and employer contributions for medical insurance premiums); raising energy taxes; or the introduction of a federal VAT or sales tax.

In *emerging Asia*, the priorities are to allow greater exchange rate flexibility, consistent with the required medium-term appreciation of regional currencies, along with measures to strengthen domestic demand.

- In China, the authorities should take full advantage of the additional exchange rate flexibility afforded by the recent exchange rate reform. This, in turn, would facilitate greater upward exchange rate flexibility in other countries in the region, as appropriate.
- On the demand side, priorities differ across countries. In China, where investment is already high, reforms to strengthen the social safety net would allow households to reduce precautionary savings; improved household access to credit—subject to strict prudential requirements—would also contribute. Elsewhere, the issue is primarily relatively low investment. While that may partly reflect the lingering impact of the crisis, which should gradually ebb over time, policies need to focus on supporting that process by addressing weaknesses in the investment climate, including by completing outstanding financial sector reforms, reducing entry requirements, promoting a level playing field, and clarifying the framework for labor relations.

In *euro area countries*, the key contribution to help ensure an orderly reduction in global imbalances is through measures to boost growth and domestic demand. In this connection, progress in structural reform has been achieved in a number of areas—for example, pension reform in France and Italy and the "Hartz-IV" reforms in Germany. However, significant scope remains for packages of measures designed not only to raise employment and productivity, but also to strengthen competition in product markets, and thereby reduce markups and increase real wages, such as the following.[1]

- *Increasing product market competition.* At the euro area level, the priority is to implement the Services Directive, which could substantially increase cross-border provision of services. In individual countries, priorities include increasing competition in the network, telecommunications, and transport industries (France, Italy); deregulation in the retail sector (France, Italy); and reducing barriers to entry in services, particularly professional services (Germany).
- *Increasing labor market competition and flexibility.* Priorities vary widely across countries, but for the largest countries they include reforming minimum wages (France) and allowing greater flexibility in wage bargaining (Germany and Italy); lowering tax wedges (Germany and

Note: The main author of this box is Gian Maria Milesi-Ferretti.

[1]See, for example, Estevão (2005).

Box 1.6 *(concluded)*

Italy); and reforming employment protection (all countries) and social safety nets (France and Germany).

In *Japan*, priorities for reforms to raise competition and growth include the following.

- *Further improving flexibility and participation in labor markets.* Key measures would include clarifying the conditions for dismissing workers, and implementing more family-friendly policies to encourage women to enter (or reenter) the labor force.
- Enhancing competition in product markets. Regulation could be relaxed further in sheltered sectors (e.g., retail sector, network industries). The Fair Trade Commission could further stiffen penalties for anticompetitive behavior. There is also scope for allowing more private sector involvement in health and education at a national level (in line with "Special Zones" initiatives).
- *Reforming the agricultural sector.* This sector can particularly benefit from reform, in light of its current high protection and low efficiency. Reducing import barriers and moving toward direct payments to farmers would bolster productivity and enhance growth prospects.
- Continuing to strengthen the financial and corporate sector, including by pressing ahead with implementation of the authorities' Program for Further Financial Reform and the privatization of Japan Post.

In the *oil-producing countries*, the challenge is to achieve an orderly increase in domestic demand in response to higher oil revenues, while avoiding wasteful expenditures—a key problem in the 1970s. Within this, the appropriate policies vary significantly across countries, depending on cyclical conditions—which in some cases limit the room for immediate budgetary expansion—as well as the medium-term fiscal outlook.[2] However, there are three common elements:

- *Boosting expenditures in areas where social returns are high*, including—depending on the country—education and health; infrastructure; schemes to boost private sector employment; and strengthened social protection schemes;
- *Taking advantage of a stronger external position to address structural constraints to growth*, for instance, by improving the investment climate and, in some countries, reducing restrictiveness of trade regimes; and
- *Allowing gradual real exchange rate appreciation as appropriate*, consistent with higher domestic absorption over the medium term.

[2]See "Oil Market Developments and Issues" (IMF, 2005b) and Box 1.6 in the April 2005 *World Economic Outlook*, "How Should Middle Eastern and Central Asian Oil Exporters Use Their Oil Revenues?" for a more detailed discussion.

an improvement in both the United States and the euro area–Japan region. As a reflection of these developments, over the medium term net foreign assets in emerging Asia and net liabilities in the United States will be smaller than in the baseline. While there is a temporary slowdown in GDP growth in emerging Asia, related to the weaker contribution to growth coming from net exports, consumption is higher relative to the baseline.[43] As noted above, the model simulations probably underestimate the impact of a more flexible exchange rate policy since—because GEM does not allow for sterilization—a portion of the effect is effectively included in the baseline.

This scenario can also provide insights on the possible consequences of the opposite policy choice by emerging Asia—namely, sustained

[43]The slowdown in growth is accentuated by the tightening of monetary policy in response to high inflation in the baseline. Allowing for sterilization in the baseline would imply a more modest difference in the monetary policy stance, and hence in growth, between the two scenarios.

sterilization. While GEM does not allow for this policy choice, the effect of delayed adjustment through sterilization can be approximated by assuming that emerging Asia raises its desired level of net foreign assets (the opposite of what is postulated in Figure 1.32). Symmetrically to the scenario presented above, this policy choice would induce an initial exchange rate *depreciation* relative to the baseline, which may help growth in the region over the short run, but at the cost of higher inflation, lower consumption, and larger external imbalances.

In sum, with the move toward a more flexible exchange rate, the nominal and real exchange rates appreciate, facilitating external adjustment, stimulating domestic consumption, and containing inflationary pressures relative to the baseline. From a domestic perspective, increased exchange rate flexibility would thus help emerging Asia cope with rapid external adjustment needs without jeopardizing macroeconomic stability.

Rapid Fiscal Consolidation in the United States

We consider next a scenario featuring a substantial reduction in the U.S. budget deficit over the medium term (some of which is already under way). This is assumed to take place through a cut in government consumption of ¾ percent of GDP and a gradual but ultimately sizable increase in taxation, leading to a broadly balanced budget by 2010.[44] The fiscal consolidation, which is assumed to become fully credible after two years, results in a sizable reduction in the debt-to-GDP ratio over the medium term.[45] It is also assumed that the U.S. fiscal consolidation is accompanied by an increase in exchange rate flexibility in emerging Asia, along the lines described above.

Results are presented in Figure 1.33 as deviations from the scenario of Figure 1.32 featuring flexible exchange rates in emerging Asia. The tightening of U.S. fiscal policy leads to a notable improvement in the current account—by about 2 percent over 10 years—and a reduction in U.S. net foreign liabilities by over 10 percent over the same horizon, accompanied by a modest depreciation of the U.S. dollar.[46] This comes at the cost of an initial slowdown in U.S. growth, although over time the reduction in U.S. government debt leads to a reduction in long-term interest rates, boosting private investment and eventually raising long-run output above that in the baseline scenario.[47]

In the rest of the world, the impact on growth is broadly similar—though somewhat smaller in magnitude—to that in the United States, with a short-run decline in growth and a subsequent recovery bringing output above its baseline level in the long run, helped by lower real interest rates. All regions also experience a deterioration in the current account—most pronounced in emerging Asia—and a slight appreciation of their currencies.

Overall, these simulations indicate that fiscal consolidation in the United States would have a noticeable effect on the current account balance, and—over time—on U.S. net external liabilities, thereby reducing external risks. The adjustment entails short-term output costs, in

[44]Over the long term, the deficit rises again on account of demographic pressures, and is eventually stabilized at 3 percent.

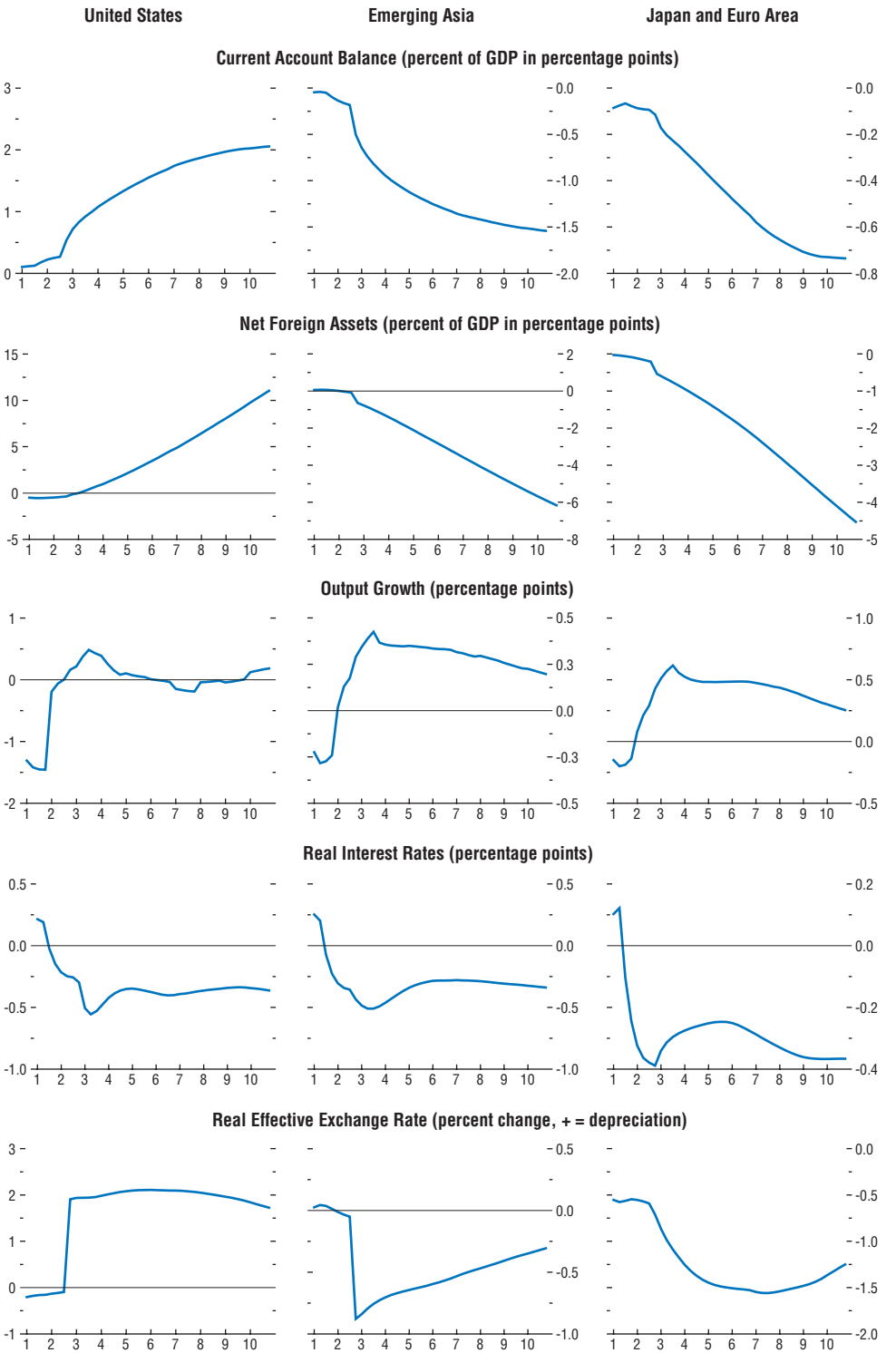
[45]A fiscal consolidation that was fully credible from the outset would induce a more moderate output contraction by ensuring a more rapid decline in interest rates. For technical details and examples of credible and noncredible deficit reductions, see Bayoumi and Laxton (1994).

[46]See Kumhof, Laxton, and Muir (2005) for a more comprehensive assessment of medium- and long-term effects of fiscal consolidation on output and external imbalances in the United States using a four-country version of the IMF's Global Fiscal Model (GFM). Botman and others (2005) discuss structure and properties of a two-country version of the model.

[47]It should be acknowledged that the projected impact of fiscal policy on the current account is at the high end of existing estimates in the literature. For example, Erceg, Guerrieri, and Gust (2005) find a smaller response of the current account to fiscal policy, primarily because they assume that the fiscal adjustment is temporary, with no long-run change in public debt, and because half of the consumers are assumed to have an infinite planning horizon. In this event, of course, the adverse impact of fiscal consolidation on growth will also be lower.

Figure 1.33. Incremental Effects of Fiscal Consolidation in the United States

(Deviation from baseline; x-axis in calendar years)



Source: IMF staff estimates.

both the United States and—to a lesser degree—the rest of the world. However, over time the positive effects of sustained lower real interest rates would imply an increase in global output of about 0.2 percentage points.[48]

Structural Reform in the Euro Area and Japan

Finally, we look at the implications of stronger growth in the euro area and Japan through structural policies aimed at improving competition, raising capital accumulation, and reducing distortions in labor and product markets. To study such a scenario we follow Bayoumi, Laxton, and Pesenti (2004) and assume that price markups in both the tradable and nontradable sectors in Europe and Japan decline gradually to U.S. levels over a 10-year period.[49] Labor market reform is introduced gradually, and takes the form of an increase in labor market competition. Consumers and investors initially treat labor and product market reforms as temporary—credibility builds over time, and the reforms become fully credible after three years.[50] The prospect of a comprehensive structural reform package in these countries is also assumed to gradually reduce precautionary saving, thus entailing some reduction in the long-run creditor position of the region (and a corresponding increase in foreign assets in the other regions).

The results presented in Figure 1.34 show the additional effects of these reforms relative to a baseline where U.S. fiscal policy is tighter and emerging Asia moves to a flexible exchange rate. The boost to competitiveness results in a significant investment-driven increase in GDP growth in Europe and Japan, which starts materializing after two years. This in turn results in a deterioration in the external current account; and—after an initial appreciation—a long-term depreciation of the real effective exchange rate.[51] Higher growth in Europe and Japan leads to a general improvement in current account balances and some appreciation of real effective exchange rates elsewhere; there are also modest positive spillover effects to growth on the rest of the world, with global growth rising by about ¼ percentage point over the medium term.[52] To the extent that brighter productivity prospects are reflected in asset prices, spillover effects may be magnified by financial market linkages that are not included in the model.

In sum, structural reforms in the euro area and Japan would help spur global growth, while also contributing to reducing external imbalances—albeit to a lesser extent than the U.S. fiscal consolidation presented earlier. It should be noted that the adjustment path will depend critically on the effects of these reforms on confidence—and thereby precautionary savings. If structural reforms led to greater uncertainty in the short run, the positive impact on growth—and the rise in the current account deficit—would likely be delayed. In contrast, if the reform package was fully credible, the prospect of higher and more certain growth in these countries could encourage consumer spending, boosting the impact of higher productivity growth on the global rebalancing of external positions.

Benefits of Joint Action

The current constellation of global imbalances arises from a combination of shocks and economic trends across several countries and

[48]A more modest response of investment to lower interest rates would imply a smaller impact on growth than the model suggests.

[49]Several studies have highlighted the benefits of product market reforms aimed at spurring competition—including through facilitating market entry or market access—for output and productivity growth. See, for example, Nicoletti and Scarpetta (2003) and Salgado (2002).

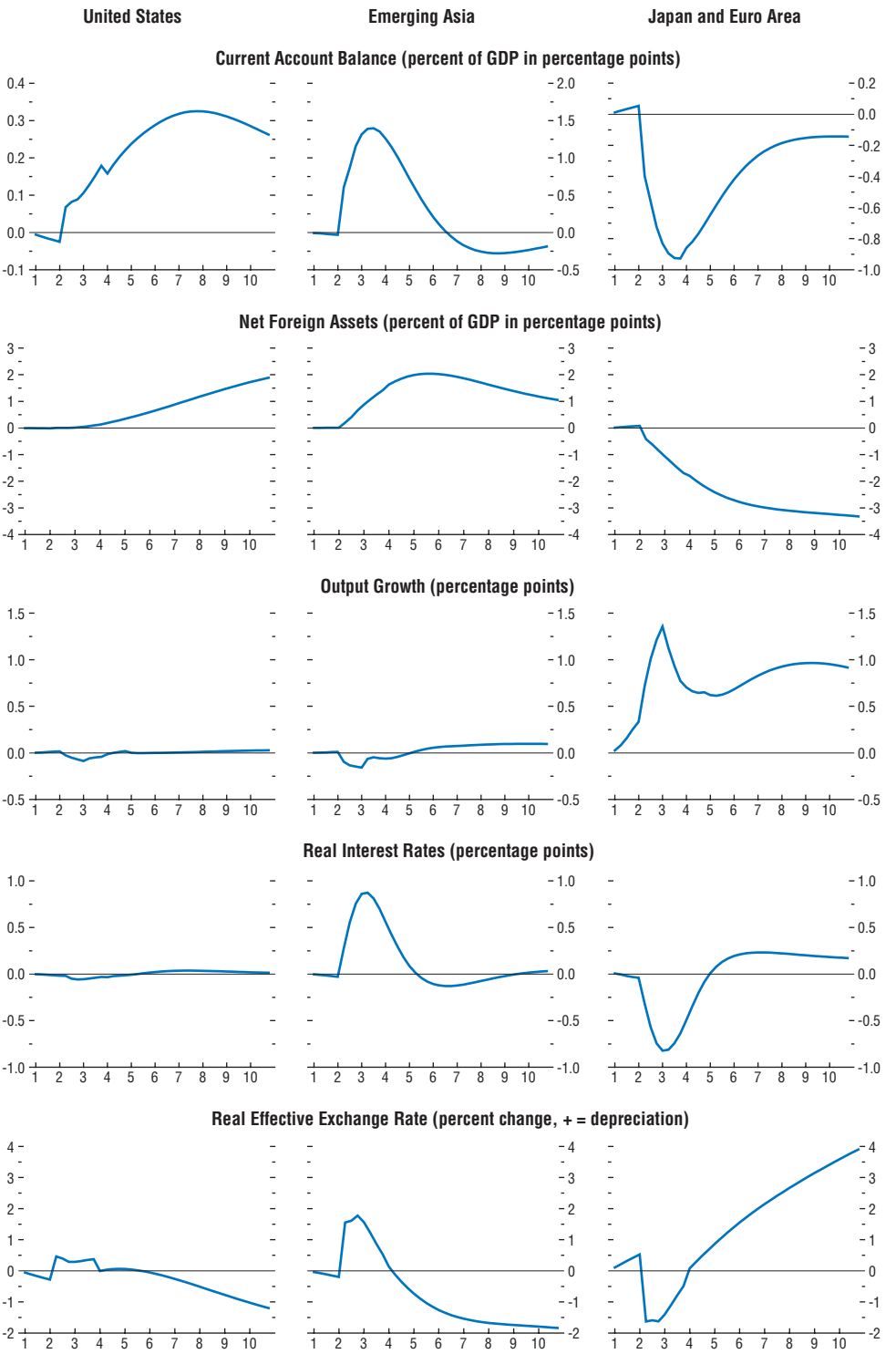
[50]Given that the initial markups in the euro area and Japan are calibrated on their level in 1995, the effects of competition-enhancing policies adopted since then may already be in the pipeline.

[51]The increase in productivity is particularly strong in the nontraded goods sector, generating a reverse Balassa-Samuelson effect.

[52]Batini, N'Diaye, and Rebucci (2005) examine the implications of an increase in productivity growth in Japan in a five-region version of GEM and find similar results.

Figure 1.34. Incremental Effects of Competition-Friendly Policies in Europe and Japan

(Deviation from baseline, x-axis in calendar years)



Source: IMF staff estimates.

regions. Current account adjustment foremost requires changes in private sector behavior, which will in time inevitably take place: the role of policy measures is to facilitate these changes and minimize the attendant risks. The variety of factors driving current patterns of international borrowing and lending—including a number that are not explicitly captured by the model[53]—also implies that policy actions by a country taken individually may have a relatively modest impact, but in combination with actions by other countries can add up to significant adjustment.

The scenarios just described illustrate these points. They show that while a relatively benign private sector–driven unwinding of external imbalances is possible, the rising stock of U.S. external liabilities would involve significant risk, exemplified by the low-probability but high-cost abrupt adjustment scenario. The three adjustment scenarios illustrate the benefits and costs of three public policy actions that would facilitate this adjustment while simultaneously being in each country's own national interest. Other such actions—including measures to boost private investment in some parts of Asia, or measures to facilitate the absorption of oil revenues in oil-producing countries—are discussed in more detail in Chapter II. While each such measure would bring about desirable changes, benefits would be magnified and risks minimized by joint action on the part of all major actors in the global economy, this being a clear instance in which coordinated policies would be a public good.

More specifically, combined policy action along the lines described in the various scenarios would have the following desirable consequences.

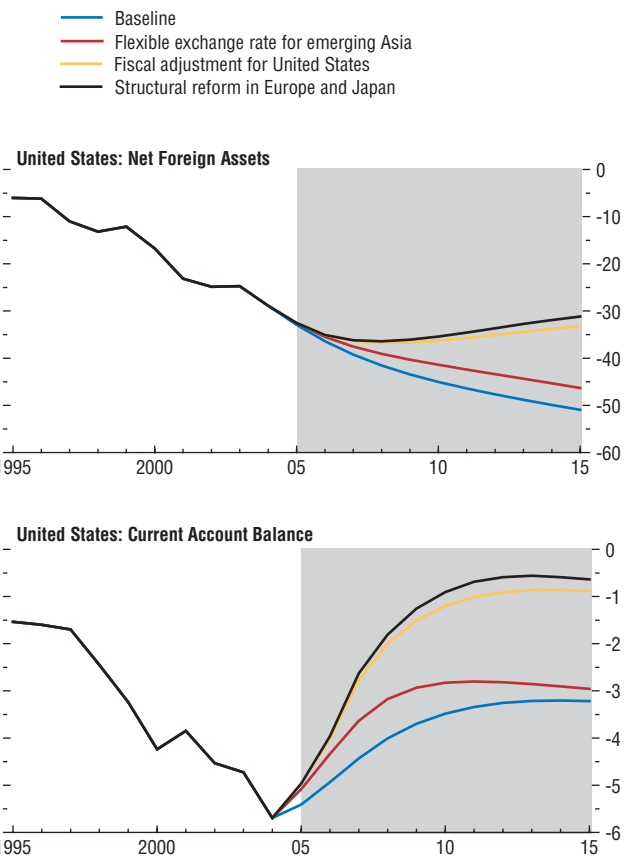
- Global imbalances in general, and the ultimate buildup in U.S. net foreign liabilities in particular, would be significantly reduced (Figure 1.35). Correspondingly, the risk of an

[53]As already mentioned, the model does not explicitly allow for sterilized intervention, nor does it include low investment in emerging Asia (excluding China), oil price developments, or booming asset prices (discussed in Chapter II).

Figure 1.35. Scenarios for Global Adjustments

(Percent of GDP)

Combined policy action—with the effects of individual measures on the baseline shown cumulatively in the figure—could significantly reduce global imbalances.



Source: IMF staff estimates.

abrupt adjustment in imbalances would be considerably limited.

- Global growth would be better balanced than in the baseline scenario, and significantly higher over the medium term, reflecting both lower global interest rates and stronger productivity growth in the euro area and in Japan.
- Last, but not least, each individual region would be better off. Emerging Asia's consumption would increase, as residents benefit from more favorable terms of trade; consumption and growth in the euro area and Japan would be stimulated by higher productivity; the United States would face lower risks of a decline in appetite for U.S. assets, and the recovery in private and public saving would contribute to lower interest rates relative to the baseline; and the rest of the world would also benefit from more appreciated real exchange rates and lower world interest rates.

While the combined adjustment scenario is clearly superior to the baseline from an overall perspective, two final points should be noted.

- First, there is a possibility that global growth could be weaker than expected, especially if structural adjustment in the euro area and Japan were to have a negative effect on confidence. This is perhaps of somewhat lesser concern in the current environment of relatively strong global growth, and—as the analysis above suggests—such risks would be reduced the more credible the underlying policy measures in all regions are seen to be.
- Second, the unwinding of imbalances will, even in a relatively favorable scenario, require significant exchange rate adjustment—in this connection, as already noted, the simulations may be conservative.[54] Policymakers and private sector decision makers will need to ensure that national economies and financial and nonfinancial corporations are resilient in the face of potential changes.

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