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Assumptions and Conventions

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates will remain constant at their average levels during March 1–18, 1997 except for the bilateral rates among the European exchange rate mechanism (ERM) currencies, which are assumed to remain constant in nominal terms; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary policies in industrial countries, see Box 2); that the average price of oil will be $19.69 a barrel in 1997 and $18.36 a barrel in 1998, and remain unchanged in real terms over the medium term; and that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 6.0 percent in 1997 and 6.1 percent in 1998. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The estimates and projections are based on statistical information available at the end of March 1997.

The following conventions have been used throughout the *World Economic Outlook*:

. . . to indicate that data are not available or not applicable;

— to indicate that the figure is zero or negligible;

– between years or months (e.g., 1994–95 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (e.g., 1994/95) to indicate a fiscal or financial year.

"Billion" means a thousand million; "trillion" means a thousand billion.

"Basis points" refer to hundredths of 1 percentage point (e.g., 25 basis points are equivalent to ¼ of 1 percentage point).

Minor discrepancies between sums of constituent figures and totals shown are due to rounding.

* * *

As used in this report, the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

Preface

The projections and analysis contained in the *World Economic Outlook* are an integral element of the IMF's ongoing surveillance of economic developments and policies in its member countries and of the global economic system. The IMF has published the *World Economic Outlook* annually from 1980 through 1983 and biannually since 1984.

The survey of prospects and policies is the product of a comprehensive interdepartmental review of world economic developments, which draws primarily on information the IMF staff gathers through its consultations with member countries. These consultations are carried out in particular by the IMF's area departments together with the Policy Development and Review Department and the Fiscal Affairs Department.

The country projections are prepared by the IMF's area departments on the basis of internationally consistent assumptions about world activity, exchange rates, and conditions in international financial and commodity markets. For approximately 50 of the largest economies—accounting for 90 percent of world output—the projections are updated for each *World Economic Outlook* exercise. For smaller countries, the projections are based on those prepared at the time of the IMF's regular Article IV consultations with member countries or in connection with the use of IMF resources; for these countries, the projections used in the *World Economic Outlook* are incrementally adjusted to reflect changes in assumptions and global economic conditions.

The analysis in the *World Economic Outlook* draws extensively on the ongoing work of the IMF's area and specialized departments, and is coordinated in the Research Department under the general direction of Michael Mussa, Economic Counsellor and Director of Research. The *World Economic Outlook* project is directed by Flemming Larsen, Deputy Director of the Research Department, together with Graham Hacche, Chief of the World Economic Studies Division.

Primary contributors to the current issue are Francesco Caramazza, Robert F. Wescott, Staffan Gorne, Mark De Broeck, Paula De Masi, Jahangir Aziz, Kornélia Krajnyák, Ramana Ramaswamy, Phillip Swagel, and Cathy Wright. Other contributors include Paul Armknecht, Tamim Bayoumi, David Ordoobadi, Blair Rourke, Anthony G. Turner, and Andrew Tweedie. The authors of the annex are indicated on its first page. The Fiscal Analysis Division of the Fiscal Affairs Department computed the structural budget and fiscal impulse measures. Sungcha Hong Cha, Toh Kuan, and Michelle Marquardt provided research assistance. Shamim Kassam, Allen Cobler, Nicholas Dopuch, Isabella Dymarskaia, Gretchen Gallik, Mandy Hemmati, and Yasoma Liyanarachchi processed the data and managed the computer systems. Susan Duff, Caroline Bagworth, and Margaret Dapaah were responsible for word processing. Juanita Roushdy of the External Relations Department edited the manuscript and coordinated production of the publication.

The analysis has benefited from comments and suggestions by staff from other IMF departments, as well as by Executive Directors following their discussion of the *World Economic Outlook* on March 31 and April 2, 1997. However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities.

I

Global Economic Prospects and Policies

World economic growth quickened during 1996 following widespread deceleration of activity in 1995 (Chart 1). Economic and financial conditions are generally propitious for the global expansion to continue in 1997 and the medium term at rates at least matching those seen in the past three years (Chart 2). There are few signs of the tensions and imbalances that usually foreshadow significant downturns in the business cycle: global inflation remains subdued, and commitments to reasonable price stability are perhaps stronger than at any other time in the postwar era; fiscal imbalances are being reduced with increasing determination in many countries, which should help contain real long-term interest rates and foster higher investment; and exchange rates among the major currencies appear to be generally consistent with broader policy objectives.

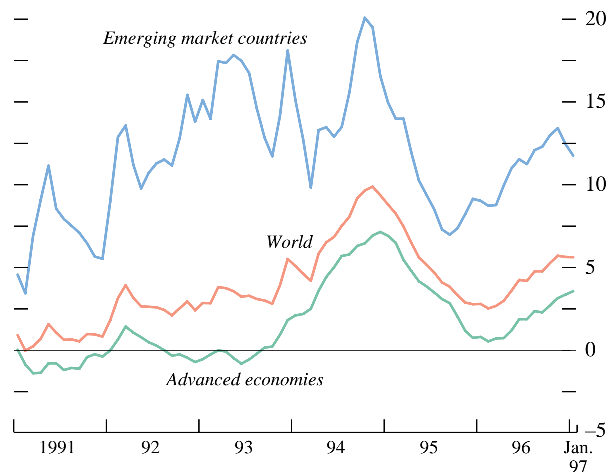
In many countries, structural reforms are enhancing the role of market forces and thereby strengthening the basis for sustained, robust growth. The process of trade integration continues to deepen and is being supported by growing liberalization of external payments. Also, changes in the role of the state through privatization and deregulation are raising efficiency and spurring private sector activity in a growing number of successfully managed economies in all regions.

The favorable global economic conditions are underscored by the continued robust growth performance with low inflation in the United States and the United Kingdom, the pickup in growth in Japan in 1996, and improved prospects for a strengthening of the recoveries in continental Europe and Canada. In many of the dynamic emerging market countries, there was a desirable moderation of growth and inflation in 1996, which should allow their expansions to be sustained in the period ahead. Growth has picked up in those developing countries in the Western Hemisphere that were particularly affected by the financial crisis in Mexico in 1995. Activity has also strengthened in the Middle East and Africa, while the transition countries, as a group, are expected to register positive growth in 1997 for the first time since the collapse of central planning.

Nevertheless, despite these grounds for optimism, it is important to recognize that contrasts in economic performance across countries have become starker in recent years. There are also a number of risks to the central scenario. First, in much of the European Union

Chart 1. World Industrial Production[1]
(Percent change from a year earlier)

Following a marked slowdown in 1995, the pace of world industrial activity quickened during 1996.



[1]Data are for output in manufacturing in 30 advanced and emerging market economies representing 75 percent of world output; three-month centered moving average.

(EU), unemployment has risen further to new postwar peaks, and neither prospective growth nor the progress made with labor market reforms gives reason to expect any significant decline in joblessness in the near future. High unemployment and weak growth could make it difficult for EU members to fully meet the fiscal deficit targets associated with the plan for monetary union, affect expectations about the likelihood of the project going ahead on time, and lead to turbulence in financial markets.

Second, stock markets. The strength of equity prices in the United States and many other countries in the period up to early March was a reflection of investors' positive assessment of the business outlook. But recent declines in equity prices have underscored the risk of a more significant correction, especially if earnings expectations were to be downgraded or a reemergence of inflationary pressures were to require a marked rise in interest rates. The potential for a market correction large enough to contribute to a cyclical downturn depends partly on the extent to which the rise in stock prices has been an element in a broader buildup of demand pressures. In contrast to the run-up in asset prices in the late 1980s, especially in Japan but also in the United States and several other countries, a generalized overvaluation of asset prices, leveraged by increased indebtedness, does not appear to be present in most countries with strong stock markets. Nevertheless, a significant decline in stock prices could undermine confidence in some countries.

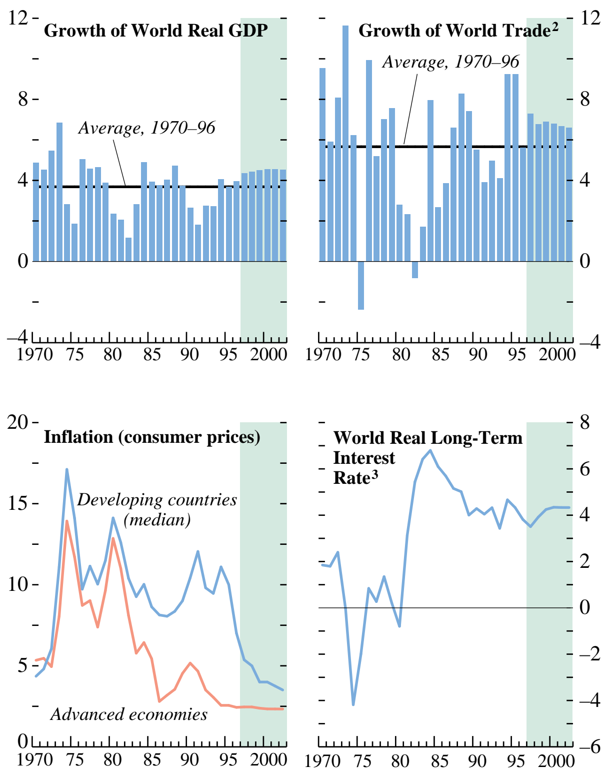
Third, capital flows to emerging market countries. The surge in such flows in recent years reflects both the growing shift to a more open global financial system and the successful economic policies of many recipient countries. But caution is warranted since both the global availability of these flows and their cost are vulnerable to higher global interest rates and to adverse developments affecting systemically important capital-importing countries. While the aggregate global flows do not seem excessive, the reliance on capital inflows by some countries, and the associated narrowing of their interest rate spreads, may not be sustainable.

Finally, fragile banking systems are of concern in a broad spectrum of countries. These problems often stem from excessive credit expansion in the past under conditions of inadequate prudential supervision. In some emerging market countries, banking sector difficulties linked to significant exposure to foreign exchange risk have become more apparent following the reversal of capital flows from abroad. Among transition countries, bank loans have often allowed enterprises to delay restructuring, and as a result many firms have become increasingly unable to service their debt. Large portfolios of nonperforming loans, the erosion of banks' capital bases, and outright banking crises can affect countries' economic performance by obstructing banks' ability and willingness to lend, by

Chart 2. World Indicators[1]

(In percent a year)

The global expansion is expected to continue with the growth of world output and trade above trend, while inflation should remain contained in the advanced economies and slow further in the developing countries.



[1]Shaded areas indicate IMF staff projections.

[2]Volume of goods and services.

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

constraining the operation of monetary policy, and because of the budgetary costs of rescuing and restructuring ailing financial institutions.

* * *

It is becoming increasingly clear that the benefits of a favorable global economic environment do not accrue automatically to any country. In fact, remarkable differences persist in the degrees of success that countries have had in taking advantage of the opportunities for strengthening their economic performance.

- Among the advanced economies, developments have been mixed and cyclical positions differ widely. Prospects for recovery have improved in continental western Europe following disappointing performances in 1995 and much of 1996. But unemployment is expected to remain at or near record levels in France, Germany, Italy, and several other countries. In Japan, growth was stronger than expected in 1996, and there is upside potential for activity in 1997 although there remains uncertainty in financial markets, in particular, as to whether the momentum of Japan's recovery will be maintained in the period ahead. The uncertain prospects and lack of confidence characteristic of these economies in recent years contrast with the favorable performance of the United States and the United Kingdom as well as a number of smaller countries including Australia, Denmark, Ireland, New Zealand, and the Netherlands. These contrasts reflect both cyclical and structural factors, including policies.

- An increasing number of developing countries in all regions are reaping the benefits of the steadfast pursuit of sound financial policies and outward-oriented, market-based structural reforms. This is reflected in large inflows of foreign direct investment, rapid expansion of both exports and imports, and solid growth prospects. But some countries have experienced setbacks and others are vulnerable to changes in investor sentiment. While economic conditions have clearly been improving in a growing number of low-income countries, many of the poorest countries have continued to fall behind, facing the risk of marginalization from the mainstream of global economic progress.

- Among the transition countries, the contrasts in performance have also widened between some of the early, relatively successful reformers and countries that have started adjustment and reform later and with less determination and consistency. Between these two extremes, which, to be sure, also reflect widely different starting conditions, there are wide ranges of policy effort and economic success.

Motivated in part by these contrasts, the Interim Committee in its September 1996 "Declaration on Partnership for Sustainable Global Growth" set out a range of broad policy principles to promote the full participation of all economies in the global economy. These principles stress the need to implement sound macroeconomic policies that consolidate success in bringing inflation down, strengthen fiscal discipline, enhance budgetary transparency, and improve the quality of fiscal adjustment; to foster financial and exchange rate stability and avoid currency misalignments; to maintain the impetus toward trade liberalization and current account convertibility; to tackle labor and product market reforms more boldly; and to ensure the soundness of banking systems and promote good governance in all its aspects. The complementary and mutually reinforcing roles of macroeconomic and structural policies were given particular emphasis.[1]

The uneven performance across countries and uneven distribution of rewards within them are frequently linked to the phenomenon of *globalization*—the rapid integration of economies worldwide through trade, financial flows, technology spillovers, information networks, and cross-cultural currents. There is no doubt that globalization is contributing enormously to global prosperity. At the same time, however, public debate often focuses on perceived negative aspects of globalization, including the effects on employment and real wages, especially of the low skilled, in the advanced economies. Globalization, like any form of technological or structural change, may adversely affect the living standards of some in the short run. However, it does not seem to be the principal force behind the unfavorable developments in employment and income distribution observed in some advanced economies.

Another widespread perception is that globalization may, at some cost, limit the autonomy of policymakers at the national level. It is argued in this report that while it does appear that globalization increases the costs of economic distortions and imbalances, policy related or otherwise, it clearly enhances the rewards of sound policies. In this way, globalization may be contributing to the apparent polarization between successful countries and those that are falling behind in relative, and sometimes even absolute, per capita income positions. Globalization is not, however, a zero-sum game with some economies winning at the expense of living standards and employment elsewhere. If policies are adapted to meet the requirements of integrated and competitive world markets, then all countries should be better able to develop their comparative advantages, enhance their long-run growth potential, and share in an increasingly prosperous world economy.

[1]See *World Economic Outlook,* October 1996, p. xii.

Globalization is not a new phenomenon. Highly integrated markets contributed to the rapid growth of trade and output during the period of the gold standard prior to World War I. But two world wars, the Great Depression, the adoption of central planning in a substantial part of the world economy, and the pursuit of protectionist and interventionist policies in many countries seriously disrupted international economic and financial interactions. The liberalization of trade and financial flows over the past fifty years has gradually resulted in a level of integration similar in some respects to that known at the beginning of the century—with plenty of scope for further integration as the next century approaches. This issue of the *World Economic Outlook* particularly focuses on the opportunities arising from globalization and on how countries may best meet the challenges of a rapidly changing and highly integrated world economy.

Box 1. Revised Country Classification

Beginning with the current issue of the *World Economic Outlook,* a number of newly industrialized economies in Asia (Hong Kong, Korea, Singapore, and Taiwan Province of China), as well as Israel, are considered together with the group of countries traditionally known as industrial countries. The reclassification reflects the advanced stage of economic development these economies have now reached. In fact, they all now share a number of important industrial country characteristics, including per capita income levels well within the range indicated by the group of industrial countries, well-developed financial markets and high degrees of financial intermediation, and diversified economic structures with relatively large and rapidly growing service sectors. Rather than retaining the old industrial country label, the expanded group is labeled the "advanced economies" in recognition of the declining share of employment in manufacturing common to all of these economies.

Advanced Economies

Recent indicators point to a moderate firming of output growth in the advanced economies in 1997–98 following a slowdown in a number of countries, particularly in Europe, in 1996 (Table 1). Long-term interest rates have come down significantly in many countries with inflation remaining generally subdued, and the danger of overheating has subsided in the newly industrialized economies of Asia following policy tightenings (Box 1). External imbalances are projected to remain relatively well contained, although a few large surplus and deficit positions may not be sustainable. And exchange rates of the major currencies appear to be reasonably consistent with fundamentals, taking into account cyclical conditions.

Despite the many positive developments, longstanding differences in the advanced economies' ability to achieve and maintain high levels of employment have become even starker in recent years. In much of continental Europe, rates of unemployment have recently risen to postwar record levels, and widespread resort to work sharing and early retirement is not only adding to the underutilization of labor resources but in many cases is raising business costs and budgetary expenditures. The growing imbalance between the inactive population and those employed may require further increases in already very heavy tax burdens. It also undermines future economic growth and living standards and threatens the viability of public pension systems. This situation is particularly striking compared with the impressive ability of the United States to create jobs for a rapidly expanding labor force and the progress achieved by the United Kingdom and a number of smaller countries in reversing earlier increases in trend unemployment. Addressing the malfunctioning of labor markets has clearly become the most pressing economic policy issue of the late 1990s for many advanced economies.

Both macroeconomic and structural policies need to be strengthened to improve growth and labor market performance. For fiscal policy, as discussed below, the priority remains the need to further reduce budgetary imbalances, which are still excessive in many cases. This is a key requirement for restoring higher sustainable rates of economic growth in the medium term. As discussed in the May 1996 *World Economic Outlook,* the short-term effects on output and employment of fiscal consolidation depend partly on the composition of fiscal adjustment measures. Also, in countries with unsustainable fiscal imbalances credible steps to improve the fiscal outlook can have positive effects on confidence and activity relatively quickly. Normally, some short-run costs tend to be associated with implementing budgetary retrenchments, but progress toward fiscal consolidation and the achievement of reasonable price stability provide added scope for monetary policy to support activity in countries with significant margins of slack. This has been generally recognized by monetary authorities, which have appropriately eased official interest rates to support demand when price stability would not seem to be threatened. Even so, official interest rates could have been adjusted more rapidly in some European countries in recent years in response to widespread signs of cyclical weakness, without compromising the credibility of monetary policy. This would have helped to put the recovery on a stronger footing.

The greatest need for policy action to strengthen Europe's economic performance is in the structural area (which is also true of Japan, as discussed below).

Table 1. Overview of the *World Economic Outlook* Projections

(Annual percent change unless otherwise noted)

			Current Projections		Differences from October 1996 Projections	
	1995	1996	1997	1998	1996	1997
World output	**3.7**	**4.0**	**4.4**	**4.4**	**—**	**0.2**
Advanced economies	2.5	2.5	2.9	2.9	—	0.1
Major industrial countries	2.0	2.2	2.6	2.6	—	0.1
United States	2.0	2.4	3.0	2.2	—	0.6
Japan	1.4	3.6	2.2	2.9	—	–0.5
Germany	1.9	1.4	2.3	3.0	0.1	–0.1
France	2.2	1.3	2.4	3.0	0.1	—
Italy	3.0	0.7	1.0	2.4	–0.4	–1.2
United Kingdom	2.5	2.1	3.3	2.8	–0.1	0.4
Canada	2.3	1.5	3.5	3.4	0.1	0.3
Other advanced economies	4.2	3.7	3.8	4.1	—	–0.1
Memorandum						
Industrial countries	2.1	2.3	2.7	2.7	—	0.2
European Union	2.5	1.6	2.4	2.9	—	–0.1
Newly industrialized Asian economies	7.4	6.3	5.7	6.1	–0.3	–0.9
Developing countries	6.0	6.5	6.6	6.5	0.2	0.5
Africa	2.9	5.0	4.7	4.8	—	–0.4
Asia	8.9	8.2	8.3	7.7	0.2	0.7
Middle East and Europe	3.8	4.5	3.9	3.9	0.7	0.6
Western Hemisphere	1.3	3.5	4.4	5.1	0.5	0.5
Countries in transition	–0.8	0.1	3.0	4.8	–0.7	–1.0
Central and eastern Europe	1.6	1.6	3.0	4.7	–0.5	–1.2
Excluding Belarus and Ukraine	5.0	3.4	3.3	4.7	–0.8	–1.4
Russia, Transcaucasus, and central Asia	–4.0	–1.9	3.0	4.9	–0.9	–0.8
World trade volume (goods and services)	**9.2**	**5.6**	**7.3**	**6.8**	**–1.1**	**0.2**
Imports						
Advanced economies	8.7	5.3	5.9	6.1	–0.5	–0.1
Developing countries	11.6	8.3	10.7	8.4	–2.9	0.6
Countries in transition	15.9	7.7	9.8	6.8	–4.2	1.8
Exports						
Advanced economies	8.4	5.0	6.9	6.7	–0.2	0.2
Developing countries	11.2	7.0	11.0	8.0	–3.3	0.5
Countries in transition	13.5	4.7	6.9	7.0	–5.8	1.1
Commodity prices						
Oil[1]						
(In SDRs)	1.9	24.3	1.4	–6.4	6.4	9.0
(In U.S. dollars)	8.0	18.9	–3.6	–6.7	5.8	4.0
Nonfuel[2]						
(In SDRs)	2.1	3.1	5.2	0.1	–1.7	7.7
(In U.S. dollars)	8.2	–1.3	—	–0.3	–1.9	2.5
Consumer prices						
Advanced economies	2.6	2.4	2.5	2.5	—	–0.1
Developing countries	21.3	13.1	9.7	8.5	–0.2	–1.1
Countries in transition	119.2	40.4	30.7	11.6	1.4	14.1
Six-month LIBOR (in percent)[3]						
On U.S. dollar deposits	6.1	5.6	6.0	6.1	—	—
On Japanese yen deposits	1.3	0.7	1.0	2.8	–0.3	–1.4
On deutsche mark deposits	4.6	3.3	3.3	3.8	—	–0.5

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during March 1–18, 1997, except for the bilateral rates among ERM currencies, which are assumed to remain constant in nominal terms.

[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 $20.42 in 1996; the assumed price is $19.69 in 1997 and $18.36 in 1998.

[2]Average, based on world commodity export weights.

[3]London interbank offered rate.

There has been some progress in reforming the complex web of regulations, benefits, and taxes that discourage job creation and job search, but efforts to date have been piecemeal and inadequate in many cases. Opposition to more comprehensive reforms stems from fears that changes in Europe's social welfare system would reduce job security, widen wage differentials, and threaten living standards. Mounting evidence that labor market regulations and high benefit levels are major contributing factors to high and persistent unemployment, excessive tax burdens, chronic fiscal imbalances, and lack of economic dynamism is too often ignored.

It is therefore essential to strengthen the public's understanding of the economic forces that are at work. At the same time, there is a continued need to persevere with comprehensive reforms to reduce overly generous levels of unemployment compensation, tighten eligibility criteria, reduce taxes on employment, and facilitate not only job search and training but also restructurings and layoffs—and thereby hirings. Such reforms would allow market forces a greater role in helping to clear the labor market at much lower levels of unemployment. Tax and transfer systems also will need to be reformed so that they may better meet equity objectives and safeguard a reasonable level of social protection without the negative implications for incentives and employment that are clearly associated with present arrangements. Reducing unemployment would in itself alleviate a major source of income inequality and social exclusion.

To what extent can the difficulties in labor markets in the advanced economies—whether in the form of unemployment or widening wage differentials—be attributed to pressures from globalization? As discussed in this *World Economic Outlook,* there is little indication that increased trade with low-cost countries has contributed significantly to the declining share of employment in manufacturing, which is the principal tradable goods sector. Nor does it seem to explain much of the relative decline of low-skilled wages. The claim that these phenomena stem from globalization and could be alleviated through trade protection and other inward-looking policies does not appear to be supported by the evidence. The relative decline of employment in manufacturing has occurred in spite of relative stability in the distribution of expenditures between manufactures and services at constant prices; it seems attributable mainly to the relatively rapid growth of labor productivity in manufacturing, as a result of technical progress and the normal process of capital deepening. Although the share of manufacturing employment has been declining in these countries—a development referred to as deindustrialization—the trend of industrial output remains positive in most of them.

As economies mature, it seems likely that the share of employment in industry will continue to fall while the importance of services increases further. However, whereas many service industries attract highly qualified labor into well-paid jobs, some service jobs are in activities with low value added and paying correspondingly low relative wages. This is one of the ways in which technological change appears also to have affected wage differentials. The precise mix of service jobs created, however, is likely to depend on the quality of the labor available. Better education and training, therefore, should be of high priority in dealing with both the unemployment problem and the tendency for wage differentials to widen as technical progress demands new skills. In many countries, governments are appropriately pursuing policies whereby those who benefit the most from these developments contribute to the assistance of those less well positioned. However, in designing such policies it is important to avoid creating poverty traps while promoting incentives to enhance skills and to seek out better employment opportunities.

The need for fiscal consolidation is another key policy priority in many advanced economies. There has been welcome progress in many cases and structural fiscal imbalances have been brought down, on average, from 3½ percent of GDP in 1990 to about 2 percent of GDP in 1996. Nevertheless, fiscal imbalances are still excessive in a large number of countries, with the prospective aging of populations and the attendant pressures on health and pension outlays adding to the urgency of fiscal reforms. The need to restore and safeguard sound public finances has led a number of countries to consider introducting codes of fiscal transparency as exemplified by New Zealand's Fiscal Responsibility Act and the Charter of Budget Honesty that is expected to be enacted in Australia. Similar concerns have stimulated interest in rules for the conduct of fiscal policy, as reflected in the Stability and Growth Pact that has now been agreed among members of the European Union, and the discussions of balanced budget constitutional amendments in the United States and Switzerland.

The introduction of fiscal rules is one approach to achieving greater fiscal discipline and to avoiding the "deficit bias" that has emerged from discretionary policy or from the unintended consequences of social insurance programs adopted under more favorable economic circumstances. Sustained and committed efforts to contain fiscal imbalances through discretionary actions could equally achieve the same objective. Opponents of fiscal rules argue that they could unduly constrain the conduct of fiscal policy during cyclical downturns. But this does not need to be the case. In fact, the increased discipline involved in the adherence to such rules may well permit a greater stabilizing role for fiscal policy than has been possible in most countries for a long time. It is of course essential that fiscal rules be well designed and provide reasonable room to accommodate cyclical fluctuations. A requirement to

balance revenues and expenditures every year would necessitate immediate adjustments of the level of outlays or taxes in response to cyclical variations in revenue and expenditure, which would be neither feasible nor desirable. Moreover, to be effective, any fiscal rule would need to be supported by increased transparency of off-budget transactions, unfunded pension liabilities, and other future commitments.

The year 1997 is especially important for Europe—the test year for deciding, by the spring of 1998, which members of the EU meet the criteria for initial participation in the planned Economic and Monetary Union (EMU). This project has already achieved much, notably in terms of promoting a sustained decline in inflation and an impressive start on fiscal consolidation. Public sector deficits, which averaged 6.5 percent of GDP in 1993, had been reduced to 4.4 percent of GDP by last year, when 6 of the 15 members were in compliance with the 3 percent reference value for budget deficits that forms part of the eligibility criteria for participation in EMU. Indeed, had it not been for the relatively large output gaps, it is estimated that all but four of the members would have met that reference value last year (Chart 3). Despite continuing output gaps, virtually all members are aiming to satisfy the deficit criterion in 1997, and a fortiori in 1998 and beyond. The policy achievements that have been accomplished set the stage for stronger economic performance in the future. But the run-up to EMU is nonetheless exacting a toll, both because of the short-term consequences of fiscal consolidation and also by contributing to uncertainties and hesitancies in business and consumer confidence that have fed back into demand and activity. It is critical to get through this period promptly by bringing the project to term within the agreed time frame. To this end, governments need to continue to follow through on their policy commitments and objectives, in both the fiscal and structural areas. A strong foundation is being laid, and it is time to begin to reap the fruits.

The EMU project reflects the political will to forge ever-closer links among the member countries of the EU. From an economic perspective, the attractiveness of monetary union includes the prospect of greater economic and financial stability among the participants, associated with a strong commitment to price stability, to be implemented by one independent central bank, and increased efforts to achieve and safeguard fiscal balance. This should help contain real interest rates, especially in countries where risk premiums have been high. In addition, the monetary union is likely to foster deeper capital market integration in Europe and help increase efficiency in financial markets. The introduction of a single currency will also eliminate the potential for tensions to develop among the members' currencies, which in the past have often accentuated the effects of asymmetric economic and financial disturbances.

Of course, disturbances may still affect countries unevenly, and a need to promote a smooth adjustment to such shocks will remain. Since monetary policy will be determined by areawide considerations, fiscal policy will have to play some role, subject to the constraints agreed in the framework of the Stability and Growth Pact. In some instances, financial assistance from the EU budget may be warranted, as indicated in the Maastricht Treaty, to help a country address severe difficulties caused by exceptional occurrences beyond its control. Most critical for the success of the EMU project, and for the dynamism of the European economies, is the need to improve the functioning of European labor markets. From this perspective, most members of the EU must strive to make much more progress irrespective of their plans to participate.

Changes in the exchange rates among the major currencies during the past 18 months have been generally consistent with underlying fundamentals and relative cyclical positions and constitute a substantial correction of the misalignments of spring 1995. These exchange rate changes are a reflection of, and are helping to reinforce, the policy stances that are needed from a cyclical perspective—in the United States and the United Kingdom to restrain inflationary pressures, and in Japan, Germany, and France to support fragile recoveries. However, they should not be viewed as fully substituting for adjustments of monetary policies that may be needed for domestic reasons. Over the medium term, some of the recent appreciation of the dollar and depreciation of the yen may not be compatible with further reduction of external imbalances, and these currency movements may be reversed as cyclical positions become less uneven.

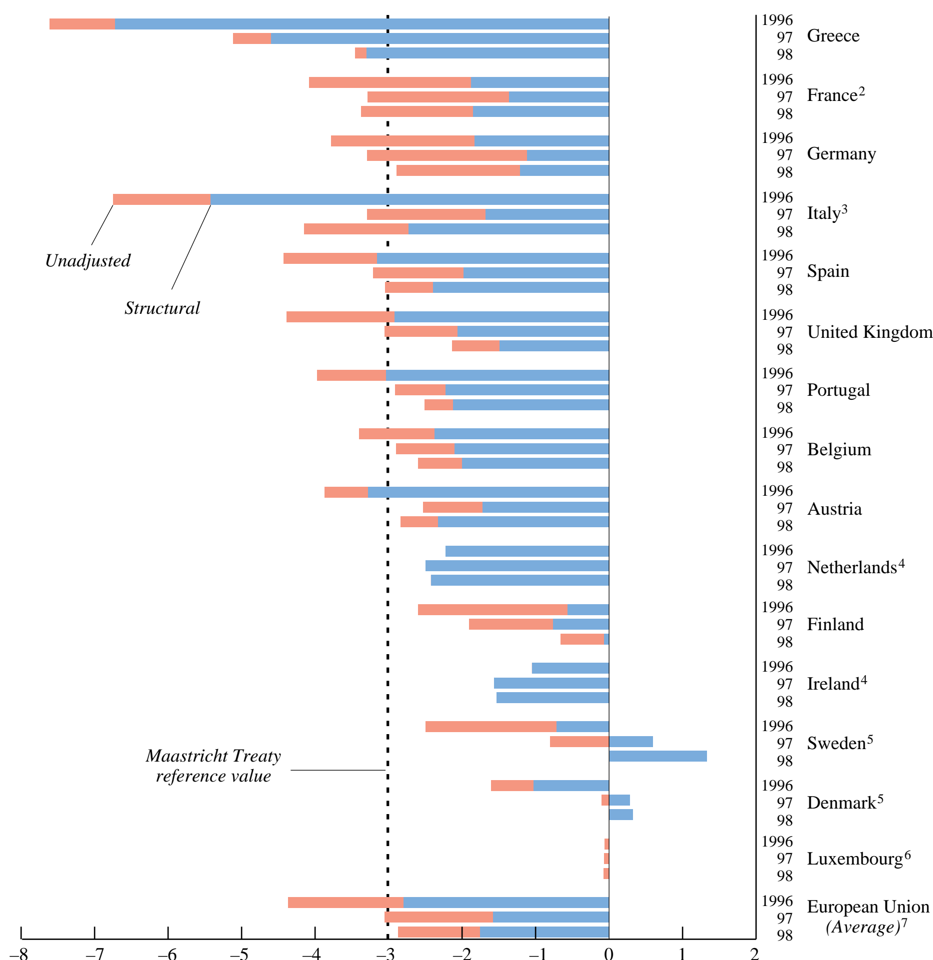
* * *

With regard to prospects and policies in individual countries, the *United States* has been remarkably successful in maintaining a high level of employment while reducing its fiscal deficit and safeguarding low inflation. The economy expanded by 2½ percent in 1996, and price pressures remained subdued despite high resource utilization, including a tight labor market. In 1997, real GDP is expected to increase by 3 percent, somewhat faster than envisaged in the October 1996 *World Economic Outlook*. To reduce the risk of rising inflation the Federal Reserve raised short-term rates slightly in late March. Given the strong underlying growth momentum, a moderate further firming of monetary conditions may soon be needed and is assumed in the forecast (the policy assumptions underlying the projections are set out in Box 2). Continued efforts are also needed to balance the budget over the medium term and to avert a rise in the deficit in the longer run due to the rapid growth in spending on pensions and medical care for the elderly. Enhancing national saving performance through a stronger fiscal position would help sustain future

Chart 3. European Union: General Government Budget Positions[1]

(In percent of GDP)

Expected progress toward reducing underlying budgetary imbalances is masked to some extent by large cyclical components in fiscal deficits.



[1]The detailed assumptions underlying the fiscal projections are set out in Box 2. The ordering of countries is based on the projected unadjusted budget positions in 1997, except that where the differences between projections are not significant the ordering is alphabetical.

[2]The projection for 1998 is based on the assumption that, in the absence of official measures, most categories of primary expenditures will increase in line with potential output. Therefore, it does not take into account the planned decrease in general government financing needs of 0.65 percent of GDP for 1998 (i.e., the same target as for 1997) that the French authorities have officially announced. Full implementation of the government's policy intentions would yield a deficit below 2.9 percent of GDP.

[3]The projection for 1998 is made on a "current services" *(tendenziale)* basis. It therefore does not take into account any possible effects of the announced review of pension and welfare spending.

[4]The unadjusted budget positions for Ireland and the Netherlands are not shown separately because they are about equal to the structural balance, given that output is estimated to be close to potential in both countries.

[5]The unadjusted budget position for Sweden is projected to show a surplus of 0.3 percent of GDP in 1998. Denmark's unadjusted budget position is projected to be in balance in 1998.

[6]Structural budget positions are unavailable and unadjusted budget positions are expected to be in approximate balance in 1996–98.

[7]Excludes Luxembourg.

growth. It would also be the best way, from both a domestic and global perspective, to address the chronic external deficit.

In *Canada,* after a disappointing performance in 1995 and early 1996, economic activity picked up in the second half of last year; unemployment has begun to decline, and the economy is poised for solid growth in 1997 and 1998. The general government fiscal deficit, which reached 7½ percent of GDP in 1992, has been reduced progressively and is expected to disappear next year. This has helped restore financial market confidence, which together with subdued inflation has allowed official interest rates to be reduced well below U.S. money market rates without undermining the credibility of the authorities' commitment to price stability or weakening the exchange rate.

The recovery in *Japan* became more broadly based in 1996 and the economic climate improved under the influence of supportive fiscal and monetary policies and a correction of the excessive appreciation of the yen through the spring of 1995. GDP growth picked up in the fourth quarter reflecting strong domestic demand as well as the effects of yen depreciation on net exports. Easy monetary conditions and improving labor market conditions are expected to underpin continued recovery at a moderate underlying pace in 1997. Although there is potential for growth to turn out stronger than expected, uncertainties remain about the impact of fiscal consolidation measures and the effects of strains in the financial system. Thus monetary policy will need to remain easy until an autonomous recovery is firmly established. Fiscal consolidation should proceed at a sustained pace without undermining prospects for continued recovery.

The sluggish performance of the Japanese economy in recent years reflects not only weak demand related partly to financial sector difficulties but also the lack of progress in many areas of structural reform. This is apparent in the divergences that have built up over time between the performances of the tradable and nontradable goods sectors. The latter have remained overregulated, subject to a low degree of competition, relatively inefficient, and characterized by very high cost and price levels. As in other mature economies, however, the tradable goods sector accounts for a declining share of total employment so that jobs and living standards increasingly have to be supported by more dynamic service sectors. It will therefore be important to translate quickly into substantive reforms the growing consensus on the need for further deregulation.

In both *Germany* and *France,* growth slowed to about 1½ percent in 1996 and is expected to be in the range of 2–2½ percent in 1997. In Germany, strong exports should eventually spill over into domestic demand, which will also benefit from lower interest rates. M3, the principal monetary aggregate monitored by the Bundesbank, has expanded relatively strongly. However, confidence indicators are still quite mixed, unemployment has risen to postwar records, and the pace of fiscal consolidation is set to strengthen in 1997. In the structural area, Germany is confronted both with the need to enhance the flexibility of its labor and product markets and with the special challenges posed by the dependence of the eastern Länder on transfers and subsidies. In France, the business climate has improved somewhat, but consumer confidence is still weak, and the projected pickup in business investment seems fragile. Moreover, it remains necessary to implement more comprehensive labor market, tax, and public sector reforms in order to foster job creation and entrepreneurship.

Short-term interest rates have been reduced considerably in both Germany and France to help offset recessionary forces. In combination with the absence of inflationary pressures, and the recent helpful depreciation of the deutsche mark and the franc against the U.S. dollar and some other European currencies, the easing of monetary conditions has helped to contain long-term interest rates in the face of higher bond yields in the United States. All these developments provide good reasons to expect the recovery to gain some momentum. While there is upside potential, however, there remain downside risks, and it is too early to conclude that the process of monetary easing has fully run its course.

In *Italy,* after relatively strong growth in 1995, recovery stalled in 1996 and activity is now expected to remain subdued in 1997, mainly owing to an accelerated pace of fiscal consolidation and the lagged effects of the lira's appreciation. Considerable progress has been made in reducing inflation to the levels of Italy's EU partners and in strengthening the credibility of the authorities' commitment to reduce the budget deficit. This contributed in 1996 to a marked narrowing of the premium in long-term interest rates over those of Germany and to the correction of the earlier excessive depreciation of the lira, which permitted its return to the European exchange rate mechanism (ERM) in November. Lower debt-servicing costs and the strengthening of fiscal plans, including the recent additional package, are expected to bring the fiscal deficit close to the Maastricht reference value in 1997. The authorities have announced the start of a thorough review of pension and welfare spending, which should help ensure that the progress recorded to date is sustained in 1998 and beyond.

The *United Kingdom*'s solid upswing, now in its fifth year, is expected to continue in 1997 on the strength of consumption and a projected pickup in business investment. The recent appreciation of sterling is helping to dampen inflationary pressures and seems to pose no immediate threat to the expansion, but the forces supporting growth may be tilting too much toward domestic demand. Wage increases have picked up as unemployment has continued to fall, and

Box 2. Policy Assumptions Underlying the Projections

Fiscal policy assumptions for the short term are based on official budgets adjusted for any deviations in outturns as estimated by IMF staff and also for differences in economic assumptions between IMF staff and national authorities. The assumptions for the medium term take into account announced future policy measures that are judged likely to be implemented. Both short-term and medium-term projections are based on information available up to the end of March 1997. In cases where future budget intentions have not been announced with sufficient specificity to permit a judgment about the feasibility of their implementation, an unchanged structural primary balance is assumed, unless otherwise indicated. For selected advanced economies, the specific assumptions adopted are as follows (see Tables 4–5, and A15–A16 in the Statistical Appendix for the projected implications of these assumptions).

United States: For the period through FY 1999, fiscal revenues and outlays at the federal level are based on the administration's February 1997 budget proposal, after adjusting for differences between the IMF staff's macroeconomic assumptions and those of the administration. For FY 2000 onward, the federal government's structural primary balance as a proportion of GDP is assumed to remain unchanged from its projected FY 1999 level.

Japan: The projections take account of policies announced in the 1997 budget, in particular an increase in the consumption tax rate from 3 percent to 5 percent and an end to the temporary income tax cut. Reflecting likely moves toward fiscal consolidation, public investment is assumed to total ¥570 trillion between FY1995 and 2004, rather than the ¥630 trillion assumed in the medium-term public investment plan and earlier WEO projections. The projections assume that the 1994 pension reform plan is fully implemented.

Germany: The 1997 revenue and expenditure projections take into account the effects of the government's consolidation package (comprising measures at the federal, state, and local levels, and the social security funds) and the 1997 Tax Act as passed by parliament in December. The difference with the official deficit projection of 2.9 percent is mainly due to a slightly less sanguine view of the macroeconomic environment, the financial position of social security funds, and tax revenues; it also reflects available information on fiscal developments so far in 1997. In 1998, and over the medium term, IMF staff projections assume an unchanged structural primary balance.

France: Budget projections for 1997 reflect the government's plans for the state budget (a freeze of nominal expenditure, some income tax relief, and a special transfer from France Télécom) and assume that the social security expenditure ceilings will be respected. The blocking of F 10 billion in state expenditure announced in early March is also included, as is the expected deterioration in the finances of the unemployment insurance fund. For 1998, it is assumed that the ratio of revenue to GDP drops by 0.3 of 1 percentage point (the revenue ratio in 1997 having been boosted by the special transfer mentioned above) and that most categories of primary expenditure grow in line with potential output. For the medium term, the projections assume an unchanged structural primary balance.

Italy: The projections take into account measures that have already been implemented as part of the 1997 budget and the supplementary "effort for Europe," as well as the additional package announced in March 1997. In the absence of an updated plan for 1998–99 following the strengthening of the 1997 effort, the projections for those years are made on a current services *(tendenziale)* basis and reflect also the phased resumption of tax refund payments postponed from 1997. Projections beyond 1999 are based on an unchanged structural balance.

United Kingdom: The budgeted three-year spending ceilings are assumed to be observed. Thereafter, noncyclical spending is assumed to grow in line with potential GDP. For revenues, the projections incorporate, through the three-year budget horizon, the announced commitment to raise excises on tobacco and road fuels each year in real terms; thereafter, real tax rates are assumed to remain constant.

Canada: Federal government outlays for departmental spending and business subsidies are assumed to conform

there is a risk that inflation will again exceed the authorities' target (of 2½ percent or below) in 1998 and beyond unless further action is taken to rein in demand. This would need to be achieved in the first instance through an early tightening of monetary policy. While the fiscal deficit has been reduced substantially in recent years, the November budget tightened the fiscal stance only slightly further in the near term, and more fiscal action is needed to help restrain demand and alleviate the burden on monetary policy.

Many of the smaller advanced economies have enjoyed robust growth in recent years and several have taken measures to reduce the risk of overheating, generally with considerable success. In fact, official interest rates in *Australia* have declined recently in response to moderating inflation. *Korea* and *Singapore* experienced a moderation of growth in 1996 as a result of a slowdown in exports and, in Korea, some policy tightening. With the transfer of sovereignty over *Hong Kong* to China proceeding smoothly, and apart from the short-term effects of labor unrest in Korea, the prospects for the newly industrialized economies in Asia remain bright, even though their future growth may be somewhat slower than the rapid pace of catch-

to the medium-term commitments announced in the February 1997 budget. Other outlays and revenues are assumed to evolve in line with the IMF staff's projected macroeconomic developments. The projections include a contingency reserve for 1997/98 through 1998/99 and assume a reduction of 10 cents in the employment insurance premium in 1998/99 and a reduction of 5 cents a year thereafter. The fiscal situation of the provinces is assumed to be consistent with their stated medium-term targets.

Australia: Projections are based on the Commonwealth government's 1996–97 midyear economic and fiscal outlook, adjusted for any differences between the economic projections of the IMF staff and the authorities. Unchanged policies are assumed for the state and local government sector from 1997.

Belgium: The 1997 projections are based on the 1997 budget and the IMF staff's macroeconomic projections; an allowance is made for some slippage in social security expenditure, but this is offset by lower-than-budgeted interest payments. For 1998, the decline in the deficit reflects mainly lower interest payments and a partial closing of the output gap. Beyond 1998, the structural primary balance is assumed unchanged.

Israel: The fiscal assumptions are in line with the government's medium-term fiscal plan, which establishes annual targets for the budget deficits until 2001.

Korea: Projections for 1997–2002 assume that the central government budget remains broadly in balance and that small surpluses continue to be recorded at the general government level.

Netherlands: The 1997 projections are based on the 1997 budget and IMF staff estimates for interest rates and economic activity; they assume that a portion of the higher-than-anticipated revenues recorded in 1996 was structural in nature. The 1998 projections reflect the government's expenditure norm, with no further tax cuts. Beyond 1998, the structural primary balance is assumed constant.

Spain: Fiscal projections for 1997 assume that the budget is implemented as passed by parliament but allow for differences in macroeconomic assumptions and some expenditure overruns that are partially offset by lower interest payments. For 1998 and beyond, it is assumed that there is no major change in tax policy, the wage freeze ends, public sector wages grow at roughly the rate of increase of wages in the private sector, and goods and services purchases remain constant as a share of GDP.

Sweden: The medium-term projections are based on the government's multiyear consolidation program approved by parliament in 1995 and augmented by additional measures incorporated into the 1997 budget.

Switzerland: Projections for 1997–2000 are based on official estimates for current services. Thereafter, the general government structural primary balance is assumed to remain constant.

* * *

Monetary policy assumptions are based on the established framework for monetary policy in each country, which in most cases implies a nonaccommodative stance over the business cycle. It is generally assumed that official interest rates will firm when economic indicators suggest that inflation will rise above its acceptable rate or range and ease when indicators suggest that prospective inflation will not exceed the acceptable rate or range, that prospective output growth is below its potential rate, and that the margin of slack in the economy is significant. For the exchange rate mechanism (ERM) countries, which use monetary policy to adhere to exchange rate anchors, official interest rates are assumed to move in line with those in Germany, except that progress on fiscal consolidation may influence interest differentials relative to Germany. On this basis, it is assumed that the London interbank offered rate (LIBOR) on six-month U.S. dollar deposits will average 6 percent in 1997 and 6.1 percent in 1998; on six-month Japanese yen deposits, it will average 1.0 percent in 1997 and 2.8 percent in 1998; and on six-month deutsche mark deposits, 3.3 percent in 1997 and 3.8 percent in 1998. Changes in interest rate assumptions compared with the October 1996 *World Economic Outlook* are summarized in Table 1.

ing up sustained in the past. In *Israel,* which has also been grappling with overheating, the planned tightening of the fiscal stance is needed to relieve the burden on monetary policy, reduce the external deficit to a more sustainable level, and help bring inflation into the low single digits typical of other advanced economies. In Europe, *Ireland* and *Norway* are expected to continue to expand rapidly. In both cases, vigilance is needed to prevent overheating; investments abroad through Norway's "petroleum fund" should help reduce upward pressure on the krone associated with large oil revenues. In *Denmark* and the *Netherlands* also, action may be needed to contain relatively buoyant domestic demand; because of the continued easy monetary stance warranted in Germany, fiscal policy should provide the necessary degree of restraint in both of these ERM countries.

In other EU countries, where margins of slack are still significant, fiscal consolidation is helping to relieve the burden on monetary policy and is improving the economic outlook. In *Spain,* thanks also to an impressive drop in inflation, both short-term and long-term interest rates have come down sharply. In *Sweden* and *Finland,* solid recoveries from serious downturns

early in the decade are set to continue, supported by subdued inflation, improving fiscal positions, and a marked narrowing of interest differentials vis-à-vis Germany. Activity has also picked up in *Austria, Belgium,* and *Portugal*. Outside the EU, there are still no clear signs of recovery in *Switzerland* from a protracted recession that left the economy stagnant in 1996 for the sixth successive year. However, an easier monetary stance and correction of the earlier excessive appreciation of the Swiss franc have improved the prospects for a turnaround.

Developing Countries

In the developing countries as a group, growth picked up to 6½ percent last year from 6 percent in 1995, as stronger activity in Africa, Latin America, and the Middle East offset a moderate slowdown in parts of Asia. Data on trade and industrial production indicate that aggregate activity slowed in the course of 1995 but picked up speed again during 1996. The apparent synchronization of the developing countries' business cycle in 1995–96 with that of the advanced economies contrasts with the experience of the early 1990s when the buoyancy of developing country growth helped maintain global expansion while many advanced economies suffered recessions (see Chart 1). The recent abatement of overheating pressures in many of the most successful developing countries has enhanced the chances of their expansions being sustained, and the growth projection for the developing countries overall in 1997 has been marked up to 6½ percent.

The *Mexican* economy is continuing to recover following the 1995 crisis, and the return of financial market confidence has allowed Mexico to prepay a substantial part of the emergency loans obtained in support of its adjustment efforts. The expansion is expected to maintain its momentum in 1997 provided financial policies and structural reforms remain on track. The recovery in *Argentina* is also expected to continue in 1997, with inflation remaining close to zero. In *Brazil,* growth strengthened in 1996 while inflation fell to 9 percent by the end of the year, the lowest in three and a half decades. But a widening deficit on current account and a policy mix characterized by a weak fiscal stance and tight monetary conditions carry risks. In *Chile,* the most successful economy in the region, inflation fell to a 36-year low of 6½ percent at the end of 1996, and demand pressures have eased in response to tighter monetary policies. Output growth remains strong, however, and the external deficit, affected by the decline in copper prices, is quite large so that further restraint may be warranted. To avoid stimulating capital inflows, fiscal policy should provide the bulk of this restraint.

Among the developing countries in Asia, those that have had to deal with risks of overheating have generally been successful in dampening the growth of domestic demand. The slowdown in the region's export growth in 1996 helped to contain inflationary pressures, although it has exacerbated external imbalances in some cases. *Thailand* saw a significant slowdown in growth in 1996, largely as a result of a disappointing export performance; concerns about the large current account deficit as well as fragilities in the financial system have given rise to exchange market pressures in recent months. *Malaysia* appears to have weathered the slowdown in foreign demand relatively well; the possibility of a rebound in demand pressures in 1997, as well as concerns about asset-price inflation, warrant a cautious policy stance. In *Indonesia,* inflation has begun to diminish and growth has slowed moderately; the reliance on foreign saving will need to be contained through a stronger fiscal position. The *Philippines* saw a further strengthening of economic performance in 1996 and is expected to continue to reap the fruits of its intensified stabilization and reform efforts.

Like many other rapidly growing economies in Asia, *China* has taken measures to reduce overheating, and real GDP growth moderated to just under 10 percent in 1996 with retail price inflation slowing further to 6 percent, down from 22 percent in 1994. The soft landing has set the stage for continued expansion, but sustaining rapid growth with low inflation will require tangible progress in restructuring and raising efficiency in state enterprises (including by diversifying ownership), addressing weaknesses in the financial sector, and enhancing budget revenue. The strong external sector provides the opportunity to accelerate significantly the process of trade liberalization, which is critical for China to benefit fully from the recent and welcome implementation of current account convertibility.

India's quite strong expansion moderated somewhat in 1996, and inflation also slowed, as a result of both policy measures and a marked slowing of export growth in line with trends in the rest of Asia. In 1997, growth is expected to be sustained at a moderate pace, helped by the easing of monetary policy since mid-1996, but limited progress in reducing the fiscal deficit remains a risk for inflation and a constraint on growth. Further trade liberalization, reform of domestic product markets, and enterprise reform are needed to put India on a higher sustainable growth path. In *Pakistan,* which experienced severe balance of payments difficulties in late 1996, there is a continued need for strong stabilization measures and a wide range of structural reforms.

Growth in the Middle East and Europe region in 1996, at 4½ percent, was stronger than expected, partly as a result of economic reforms introduced in recent years, but also reflecting the higher-than-projected level of oil prices. For 1997, expected output growth has also been marked up. The temporary character of the recent tightness in oil markets underscores

the continued need for structural reforms to lessen the dependence on oil revenues and enhance long-term growth prospects. Higher oil revenues and public expenditure restraint contributed to an improvement in economic conditions in *Saudi Arabia* last year, which is expected to continue in 1997. In *Egypt,* recent actions to consolidate macroeconomic stabilization and deepen the process of structural reform should strengthen growth further and promote the reorientation of the economy. *Jordan* is setting a prominent example in the region through its progress with stabilization and reform policies as underscored by declining internal and external imbalances, low inflation, and robust economic growth. In contrast, the economic outlook in *Turkey* remains subject to significant downside risks owing to lax fiscal and monetary policies and rampant inflation.

Africa's growth performance in 1996 was particularly encouraging: real GDP is estimated to have risen by about 5 percent, the strongest growth rate in 20 years, and nearly twice the average growth rate observed since the early 1970s. There are signs that the implementation of stronger macroeconomic and structural policies and improvements in governance have begun to produce higher growth in an increasing number of countries. For example, *Benin, Côte d'Ivoire, Senegal,* and other CFA franc zone countries are seeing continued recovery following the adjustment to a more realistic exchange rate since 1994 and the adoption of appropriate reforms. *Ghana, Kenya, Malawi,* and *Uganda* are also achieving growing success from allowing market forces a greater role in an environment of macroeconomic discipline. In *South Africa,* downward pressure on the exchange rate emerged in 1996, while growth, at 3 percent, was somewhat weaker than expected. Sustained reform and stabilization policies, in accordance with the authorities' announced strategy, would enhance future growth. Stronger oil revenues have improved the near-term outlook for *Nigeria* but medium-term prospects remain uncertain. In *Algeria,* which has shown impressive stabilization gains, public enterprise restructuring and privatization are needed to enhance the medium-term outlook, although the security situation greatly complicates the tasks of economic policy. *Morocco* and *Tunisia* also need to step up the pace of structural reform to further enhance their growth prospects. In both Algeria and Morocco, however, high unemployment, while making economic growth all the more important, also constitutes a difficult social setting for stronger reform efforts. Overall, Africa's recovery remains fragile and, in spite of recent successes, it is still a great challenge for Africa and the international community to reverse the decline in the region's living standards over the past quarter century.

Sharply contrasting economic trends have emerged during the past decade or so in the developing world. Some countries, such as Chile and Malaysia, have benefited considerably from strong macroeconomic policies and outward-oriented, market-based reforms, which are enabling them to integrate rapidly into the global economic and financial system. With their already relatively high per capita income levels, these countries are firmly on the road to joining the ranks of the advanced economies along with the newly industrialized economies. Other emerging market economies like China, Thailand, and Indonesia are similarly showing impressive achievements even though convergence will, of course, take longer given their lower levels of income. The economic success of all of these economies reflects the mutually reinforcing effects of sustained progress in many areas of economic policy. Their major policy challenge for the future is to continue to deregulate product, labor, and financial markets, while guarding against domestic and external imbalances and financial sector fragility. If these conditions are met, the benefits of economic reforms should continue to be reinforced by the forces of globalization.

A large part of the developing world, however, has not yet reaped the benefits of globalization: many countries have seen their living standards grow only modestly and have continued to lose ground in relation to the advanced economies. This is the case, for example, in the Indian subcontinent, and much of the Middle East and Latin America. Although there is no simple recipe for improving economic performance, there are strong indications that these countries have made inadequate progress in improving the policy environment. Policy shortcomings are in many cases not across the board but in some critical areas such as the failure to sustain macroeconomic stability, delays in liberalizing foreign trade, or inadequate progress in deregulating domestic product markets, establishing market-based institutions, and improving governance. Many of these countries are increasingly realizing the need for more comprehensive strategies and are beginning to see the fruits of their efforts as illustrated, for example, by the recent experiences of Argentina, Jordan, the Philippines, and Uganda.

Some of the poorest countries, especially in Africa, have fallen behind not only in relative but also in absolute terms. These countries are facing a general need to open their economies, reform government, establish financial markets, and maintain internal and external financial stability. To help them cope with the enormous challenges they are facing, the international community needs to provide well-targeted assistance and to lessen external debt burdens, which have risen to unsustainable levels in some cases. In addition to special low-cost lending facilities to support the adjustment efforts of the poorer countries, the IMF and the World Bank have launched a joint initiative, which will provide further assistance to help reduce the debt burden of heavily indebted poor countries that have followed sound policies but for whom traditional debt-

relief mechanisms have failed to secure a sustainable external position.

Transition Countries

The transition countries also display sharp contrasts in performance. Those that are the most advanced in the transformation process are now reaping the rewards of comprehensive reform and stabilization policies pursued with determination over several years. These include Poland, the Baltic countries, Croatia, the Czech Republic, Hungary, the Slovak Republic, and Slovenia. Most of these are experiencing relatively robust economic growth, moderate inflation, and promising progress in their reintegration into the world economic and financial system. In fact, several are now experiencing some of the policy challenges that come with successful reforms, including the need to manage large capital inflows, contain the associated external current account deficits, and deal with other signs of overheating. These problems can best be addressed by pursuing strong stabilization policies and continued structural reforms, including privatization and financial market reforms.

Those that are less advanced in the transition are struggling with a number of policy challenges. Several have made good progress, and in Armenia, Azerbaijan, Georgia, Kazakstan, and the Kyrgyz Republic, inflation fell considerably and growth picked up in 1996 with prospects of continued expansion in 1997. In Russia and Ukraine, inflation has also fallen, but a clear turnaround in output has yet to emerge. All of these countries need to consolidate progress with stabilization, including by reforming tax systems, improving revenue performance, redefining public expenditure priorities, and dealing with the pervasive problems of arrears and nonpayment. Greater progress is also generally needed in structural reform, especially privatization, the establishment of market-based institutions, and the strengthening of property rights. Many of these countries also need to deal with fragile banking systems. Measures to address Bulgaria's serious financial crisis are now being implemented in the context of a stabilization program supported by the IMF.

The reintegration of the transition countries into the global economy through trade and financial flows is critical for the success of the transformation process. At the same time, reintegration is bound to take time. Most progress has been made in the liberalization of trade and payments arrangements, which has been reflected in a marked reorientation of trade flows. However, there has been considerable variation across countries in the pace and extent of trade liberalization, and in the ability to take advantage of new market opportunities. Progress in financial market integration is necessarily less far advanced and will require the establishment of a stable, investor-friendly environment. Even so, foreign direct investment already plays an important role in the most advanced transition countries and private portfolio inflows have also increased sharply in a number of cases.

Financial market integration provides both challenges and benefits for the transition countries. Increased financial linkages with the world economy tend to amplify the effects of sound policies by promoting capital inflows and lower interest rates. These benefits can be misused: a country may borrow more merely to increase consumption. But if there is such a lack of self-discipline in policies, open financial markets will eventually impose their own discipline, possibly at considerable cost. This threat should help promote necessary policy changes. Capital inflows also allow the countries in transition to sustain the high levels of investment needed to revitalize industries and replace obsolete capital equipment. At the same time, it needs to be recognized that large-scale capital inflows can complicate macroeconomic management and that there is a need to guard against excessive external current account deficits and changes in investor sentiment. Because of such concerns, liberalization of capital account transactions is likely to be gradual and will depend on progress in other areas.