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October 2000

Focus on Transition Economies

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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 July 18–August 15, except for the currencies participating in the European exchange rate mechanism II (ERM II), which are assumed to remain constant in nominal terms relative to the euro; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary polices in industrial countries, see Box A1); that the average price of oil will be $26.53 a barrel in 2000 and $23.00 a barrel in 2001, 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 6.8 percent in 2000 and 7.4 percent in 2001. 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 through the end of August 2000.

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 (for example, 1997–98 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (for example, 1997/98) 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 (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

In the main text, shaded areas of figures and tables indicate IMF staff projections. In the Statistical Appendix, projections are shown in white.

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.

FURTHER INFORMATION AND DATA

This report on the *World Economic Outlook* is available in full on the IMF's Internet site, *www.imf.org*. Accompanying it on the website is a larger compilation of data from the WEO database than in the report itself, consisting of files containing the series most frequently requested by readers. These files may be downloaded for use in a variety of software packages.

Inquiries about the content of the *World Economic Outlook* and the WEO database should be sent by mail, electronic mail, or telefax (telephone inquiries cannot be accepted) to:

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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 those countries or in connection with the use of IMF resources.

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 David Robinson, Assistant Director of the Research Department, together with Tamim Bayoumi, Chief of the World Economic Studies Division.

Primary contributors to the current issue include John H. Green, Maitland MacFarlan, Peter Sturm, Cathy Wright, Luis Catão, Mark De Broeck, Luca Ricci, Ranil Salgado, and Torsten Sløk. Other contributors include Martin Cerisola, Ximena Cheetham, Markus Haacker, Oleh Havrylyshyn, Prakash Loungani, Christian Mumssen, Ramana Ramaswamy, Thomas Richardson, Julius Rosenblatt, Kevin Ross, Ratna Sahay, Alessandro Zanello, and Harm Zebregs. Mandy Hemmati, Bennett Sutton, Siddique Hossain, and Yutong Li provided research assistance. Gretchen Byrne, Nicholas Dopuch, Toh Kuan, Olga Plagie, Di Rao, and Anthony G. Turner processed the data and managed the computer systems. Lisa Nugent, Marlene George, and Jemille Tumang were responsible for word processing. Jeff Hayden and Jacqueline Irving 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 August 30 and September 1, 2000. 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.

CHAPTER I PROSPECTS AND POLICY CHALLENGES

The outlook for the global economy has continued to strengthen, with GDP growth projected to increase in all major regions of the world. This improvement has been led by the continued strength of the U.S. economy, a robust expansion in Europe, and a nascent—albeit still fragile—recovery in Japan. In emerging markets, economic fundamentals in most countries have strengthened, aided by the consolidation of the recovery in Asia, rebounds from last year's slowdowns in Latin America and the Middle East, and improved activity in Africa. Nevertheless, economic and financial imbalances in the three main currency areas remain large, posing a continued risk to the global expansion, and higher oil prices have become an increasing concern.

The main themes developed in this issue of the World Economic Outlook *include:*

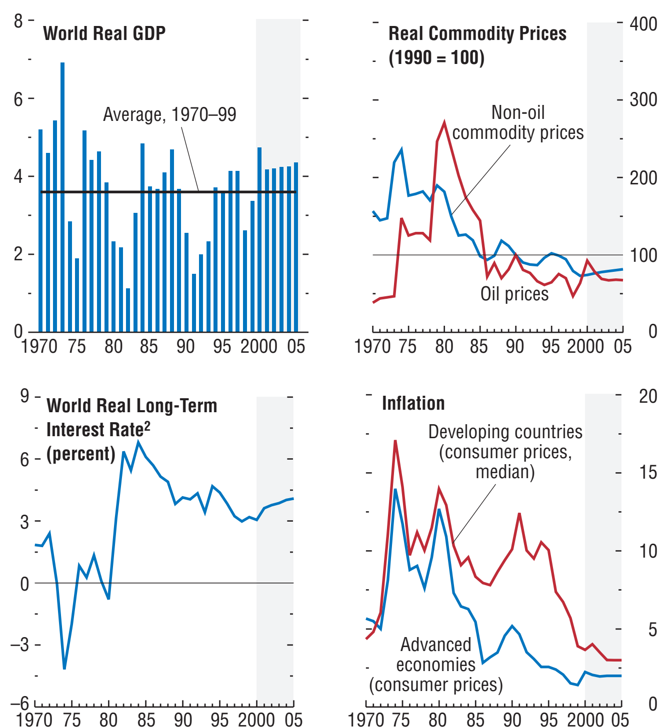
- *The need to continue policies designed to rebalance growth and demand across the major currency areas in an orderly manner;*
- *The progress that has been made in developing market-oriented economies and the necessary supporting institutional structures in the transition economies of Europe and Asia, and the reform agenda for the future; and*
- *The role that greater integration in the global economy—for instance, through accession to the European Union or the World Trade Organization—can play in supporting the reform effort in transition economies.*

The global economic expansion has continued to gain strength, with global output growth now projected at 4.7 percent in 2000, 0.5 percentage points higher than expected in the May *World Economic Outlook* (Figure 1.1 and Table 1.1). Growth is projected to increase in all major regions of the world (Figure 1.2), led by the continued strength of the U.S. economy; the robust upswing in Europe; the consolidation of the recovery in Asia; and a rebound from last year's slowdowns in emerging markets in Latin America and the Middle East and Europe. Activity in Africa is projected to rise further, and the countries in transition are expected to register a second year of solid growth, underpinned by a much better-than-expected performance in Russia. Nevertheless, a number of countries continue to experience serious economic problems—in some cases due to natural disasters and adverse movements in commodity prices—while the HIV/AIDS pandemic poses a severe human and economic threat, particularly in sub-Saharan Africa and parts of Asia.

The slowdown in global activity in 1998 was shallower than previous troughs and has been followed by a rapid recovery (Figure 1.3). This partly reflects the fact that the slowdown originated in emerging market economies, while previous slowdowns were driven by developments in advanced countries accounting for a more substantial share of global activity. However, the rebound also owes much to the concerted efforts of policymakers across the globe. Among the advanced countries, the continued strong expansion in the United States played a critical role in supporting global activity at the height of the crisis, and policies to strengthen growth in both Europe and Japan also supported the recovery. Among most crisis countries, the determined adjustment efforts pursued by policymakers contributed to an early restoration of macroeco-

Figure 1.1. Global Indicators[1]
(Annual percent change unless otherwise noted)

The global recovery continues to strengthen, while inflation remains subdued.



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

nomic stability and a steady improvement in external confidence. The pursuit of sound macroeconomic policies in other major developing countries also played an important role in preventing the crisis from spreading further.

With many advanced economies now growing at rates at or above potential, most central banks have continued to raise policy interest rates. Although headline inflation rates have risen in response to higher energy prices—and inflationary pressures are a concern in some cyclically advanced countries, including the United States and the faster-growing countries in Europe—underlying inflation in most advanced economies remains relatively subdued. In part this reflects the continued margins of slack in some regions of the world, notably Japan and to a lesser extent continental Europe (Figure 1.4), but other factors, including fiscal consolidation and regulatory and technological changes, have also played a role. Inflation is projected to decline in most regions of the developing world, as well as in the transition economies.

While the overall outlook is encouraging, there are significant risks and uncertainties. First, as recent issues of the *World Economic Outlook* have discussed in some detail, a number of economic and financial imbalances continue to exist in the global economy. These include the uneven pattern of GDP and demand growth among the three major currency areas, and the associated imbalances in their external current accounts, including a record deficit in the United States, and surpluses in Japan and in some other major countries (Table 1.2); the apparent misalignments among major currencies, particularly the euro and the U.S. dollar; and the still high level of equity market valuations in the United States and some other countries. Some progress has been made toward resolving these imbalances over the past six months through, among other things, the continued expansion in Europe, some easing of demand pressures in the United States, and a modest decline in stock market valuations in some countries from recent peaks, but the possibility that these imbalances may unwind in a disorderly fashion remains a risk to the global expansion.

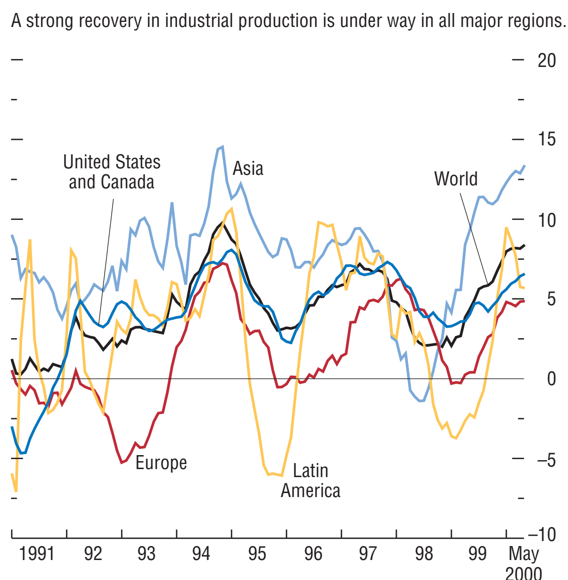
Table 1.1. Overview of the *World Economic Outlook* Projections
(Annual percent change unless otherwise noted)

			Current Projections		Difference from May 2000 Projections[1]	
	1998	1999	2000	2001	2000	2001
World output	**2.6**	**3.4**	**4.7**	**4.2**	**0.5**	**0.3**
Advanced economies	2.4	3.2	4.2	3.2	0.6	0.2
Major industrial countries	2.5	2.9	3.9	2.9	0.6	0.2
United States	4.4	4.2	5.2	3.2	0.8	0.2
Japan	–2.5	0.2	1.4	1.8	0.5	—
Germany	2.1	1.6	2.9	3.3	0.1	—
France	3.2	2.9	3.5	3.5	—	0.4
Italy	1.5	1.4	3.1	3.0	0.4	0.2
United Kingdom	2.6	2.1	3.1	2.8	0.1	0.8
Canada	3.3	4.5	4.7	2.8	1.0	0.1
Other advanced economies	2.0	4.7	5.1	4.2	0.6	0.1
Memorandum						
Industrial countries	2.7	3.0	3.9	3.0	0.5	0.2
Euro area	2.7	2.4	3.5	3.4	0.3	0.2
Newly industrialized Asian economies	–2.3	7.8	7.9	6.1	1.3	—
Developing countries	3.5	3.8	5.6	5.7	0.2	0.4
Africa	3.1	2.2	3.4	4.4	–1.0	–0.1
Asia	4.1	5.9	6.7	6.6	0.5	0.7
China	7.8	7.1	7.5	7.3	0.5	0.8
India	6.3	6.4	6.7	6.5	0.4	0.4
ASEAN-4[2]	–9.3	2.6	4.5	5.0	0.5	0.6
Middle East and Europe	3.1	0.8	4.7	4.1	0.1	0.1
Western Hemisphere	2.2	0.3	4.3	4.5	0.3	–0.2
Brazil	–0.1	1.0	4.0	4.5	—	—
Countries in transition	–0.8	2.4	4.9	4.1	2.3	1.1
Central and eastern Europe	2.0	1.3	3.1	4.2	0.1	—
Excluding Belarus and Ukraine	2.0	1.8	3.8	4.6	0.2	—
Russia	–4.9	3.2	7.0	4.0	5.5	2.6
Transcaucasus and central Asia	2.5	4.6	5.3	4.5	0.4	0.8
World trade volume (goods and services)	**4.3**	**5.1**	**10.0**	**7.8**	**2.1**	**0.6**
Imports						
Advanced economies	5.7	7.6	10.3	7.9	2.5	0.8
Developing countries	0.3	—	10.0	9.0	0.2	0.5
Countries in transition	2.5	–2.9	12.4	8.4	6.3	1.5
Exports						
Advanced economies	3.9	4.8	9.9	7.6	2.7	0.8
Developing countries	3.7	3.5	8.8	7.1	–0.9	–1.2
Countries in transition	6.5	5.0	10.1	6.0	4.2	0.4
Commodity prices						
Oil[3]						
In SDRs	–31.2	36.5	52.0	–13.0	15.5	6.4
In U.S. dollars	–32.1	37.5	47.5	–13.3	12.4	5.9
Nonfuel (average based on world commodity export weights)						
In SDRs	–13.5	–7.8	6.4	4.8	0.4	1.9
In U.S. dollars	–14.7	–7.1	3.2	4.5	–1.7	1.3
Consumer prices						
Advanced economies	1.5	1.4	2.3	2.1	0.4	0.1
Developing countries	10.1	6.6	6.2	5.2	0.5	0.5
Countries in transition	21.8	43.8	18.3	12.5	–1.2	–1.7
Six-month London interbank offered rate (LIBOR, percent)						
On U.S. dollar deposits	5.6	5.5	6.8	7.4	—	0.3
On Japanese yen deposits	0.7	0.2	0.3	0.5	0.1	0.1
On euro deposits	3.7	3.0	4.6	5.1	0.5	0.2

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during July 18–August 15, 2000.
[1]Using updated purchasing-power-parity (PPP) weights, summarized in the Statistical Appendix, Table A.
[2]Indonesia, Malaysia, the Philippines, and Thailand.
[3]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 $17.98 in 1999; the assumed price is $26.53 in 2000 and $23.00 in 2001.

Figure 1.2. World Industrial Production[1]
(Percent change from a year earlier; three-month centered moving average)

A strong recovery in industrial production is under way in all major regions.



Sources: IMF, *International Financial Statistics*; OECD; and WEFA, Inc.
[1]Based on manufacturing data for 32 advanced and emerging market economies representing about 75 percent of world output. Data through 1994 exclude Indonesia.

Second, oil prices have been significantly higher than previously expected, due to both supply constraints in producing countries and the continued strength of global demand. Following the announcement of further supply increases at the OPEC meeting in June, as well as indications that some oil producers would be willing to boost supply further, the oil price fell back within the OPEC target band of $22–$28 per barrel in July. However, since early August prices have rebounded significantly, and as of early September were over 20 percent above the baseline used for the *World Economic Outlook* forecast for the last quarter of 2000 and beyond. At the OPEC meeting on September 10, Ministers agreed to increase production by 800,000 barrels per day (equivalent to 1 percent of global supply). However, in the immediate aftermath of the announcement, prices rose further. While the outlook remains highly uncertain, with many oil producers close to capacity and stocks relatively low, there may still be upside risks to prices in coming months.

A $5 per barrel increase in oil prices (about 20 percent above the *World Economic Outlook* baseline) raises net oil imports by advanced countries by about $40 billion annually compared to the level projected in this *World Economic Outlook*, matched by a corresponding increase in trade balances of oil exporters, mainly in the Middle East. The aggregate impact on other developing country regions—a mix of oil exporters and importers—would be small, but many individual developing countries would be seriously affected, with trade balances deteriorating by more than ½ percent of GDP. Higher oil prices would also have a direct impact on global activity and inflation. Estimates using MULTIMOD, the IMF's econometric model, suggest that a $5 per barrel increase would reduce GDP growth in industrial countries by 0.2 percentage points in 2001, accompanied by higher inflation and interest rates. Output in many developing countries would also be adversely affected, particularly in Asia, which is relatively dependent on imported oil (see Chapter II for a more detailed discussion).

Third, the amount of monetary tightening that may be needed to control inflationary pres-

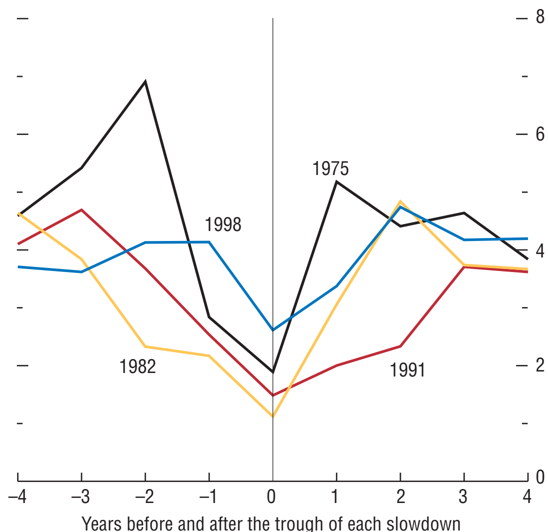
sures in the United States and some other countries remains unclear, especially if the recent increase in oil prices is sustained.

Fourth, as recent experience has shown, the imbalances described above—combined with recent reductions in the depth and liquidity in financial markets—could generate further volatility in mature financial markets.[1] This could in turn spill over to emerging markets, notwithstanding their generally strengthening economic fundamentals. During the recent period of market volatility from March to May, spreads on emerging market debt increased, especially for countries with larger financing needs, and there was a slowdown in gross capital flows (see Chapter II). These pressures appear to have eased, in part reflecting growing evidence of a slowdown in the United States, but further volatility cannot be ruled out, especially if U.S. interest rates to were rise higher than presently expected.

The IMF staff's baseline scenario, which envisages a modest slowdown in global GDP growth to 4.2 percent in 2001, followed by continued strong growth at about the same rate thereafter, is predicated on the assumption that the imbalances in the global economy are resolved in an orderly fashion. Thus, the growth of GDP and demand in the United States are projected to slow rapidly toward potential output growth, while the expansion in Europe continues and Japan's recovery gathers strength; and there is no disorderly correction in equity or foreign exchange markets. This realignment of growth and demand across the major currency areas would facilitate a smooth adjustment in external current account balances, while maintaining continued strong growth for the world as a whole.[2] Given the risks noted above, however, a

Figure 1.3. A Comparison of Global Growth in Recent Slowdowns[1]
(Percent)

The slowdown in activity during the recent crisis has been shallower than in previous episodes and followed by a relatively rapid recovery.



[1]The year zero corresponds to the trough (1975, 1982, 1991, and 1998) in world growth during previous and current world slowdowns.

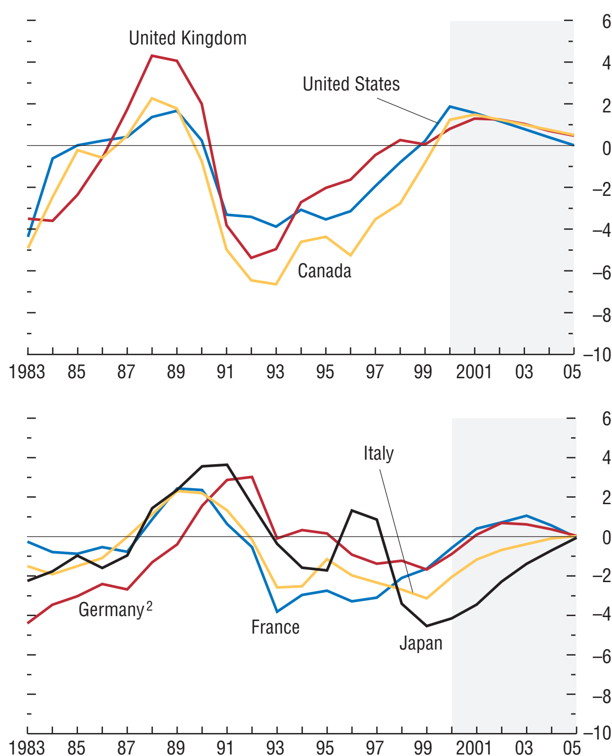
[1]See Chapter II, *International Capital Markets—Developments, Prospects, and Policy Issues* (Washington: IMF, 2000).

[2]While the baseline scenario shows that present levels of current account surpluses would broadly stabilize during 2001–05, this is partly because the projections—like those of many other forecasters, including the OECD—assume that real effective exchange rates remain unchanged. Allowing for the elimination of currency misalignments, current account imbalances would be significantly reduced over the projection period.

Figure 1.4. Major Industrial Countries: Output Gaps[1]

(Actual less potential output, as percent of potential)

Output is above potential in the United States, and to a lesser extent the United Kingdom and Canada, but slack remains in continental Europe and Japan.



[1]Shaded areas indicate IMF staff projections. The estimates of output gaps are subject to a significant margin of uncertainty. For a discussion of approaches to calculating potential output, see Paula R. De Masi, "IMF Estimates of Potential Output: Theory and Practice," in *Staff Studies for the World Economic Outlook* (Washington: IMF, December 1997), pp. 40–46.

[2]Data through 1991 apply to west Germany only.

less benign outcome remains possible. In particular, were investors to revise significantly their views about future U.S. growth and corporate earnings, there would be the possibility of a much more abrupt adjustment in equity markets; such an adjustment could make the United States less attractive to international investors and could lead to a sharp decline in the value of the U.S. dollar. Such a scenario could be triggered either by an unexpected increase in U.S. interest rates in response to rising inflationary pressures—along the lines of the alternative scenario in the last *World Economic Outlook*—or by other factors (such as a reassessment of the extent of U.S. labor productivity growth generated by the "new economy"). As described in an alternative scenario in Appendix I, such a disorderly adjustment could lead to a substantial reduction in demand in the United States, resulting in a sharp slowdown in growth that would spill over—to a lesser extent—to other industrialized countries. It could also have a significant effect on developing countries, particularly those dependent on commodity exports or which have substantial external financing needs (see Chapter II).

To protect against such a scenario, the major currency areas will need to continue to pursue policies directed at achieving an orderly rebalancing of growth and demand. While the United States will need to restrain the growth of domestic demand, Europe and Japan will need to ensure that domestic demand grows rapidly. To illustrate this, Appendix I also sets out a second alternative scenario assuming that, as a result of more rapid structural reforms, Europe and Japan grow ½ percentage point faster for a decade, driven by a combination of higher labor participation and stronger productivity growth (along the lines experienced recently in the United States—see Chapter II). Higher growth rates and increased demand in Europe and Japan would help to support global activity and reduce existing imbalances, thereby promoting a stronger and more sustainable recovery in global output, including in developing countries, particularly in Africa and Asia.

The primary instrument to help facilitate an orderly rebalancing of growth and demand remains the implementation of an asymmetric approach to monetary policy across the three main currency areas. In the United States, monetary policy may need to be tightened somewhat further to restrain demand and inflationary pressures, while pressures to relax fiscal policy should be resisted. In the euro area, the central challenge is to seize the opportunity afforded by the current expansion and to accelerate growth-enhancing fiscal and structural reforms. On the macroeconomic side, fiscal policies will need to focus on faster consolidation during the upswing. Monetary policy should remain flexible, responding appropriately both to risks arising from diminishing margins of slack and potential inflationary pressures from rising oil prices and the weak euro, and remain alert to the possibility of an eventual substantial appreciation of the euro that could unduly tighten the monetary stance. In Japan, where consumer confidence remains weak and deflationary pressures persist, monetary policy should be highly accommodative until clear signs that the recovery has become self-supporting emerge. The government will also need to introduce an early supplementary budget to mitigate the withdrawal of fiscal stimulus coming from a sharp fall off in public investment starting in the second half of the year. As in Europe, continued structural reform is critical to support sustainable long-term growth.

In emerging markets, economic fundamentals have generally continued to improve; external current account positions are projected to strengthen in all major geographical areas (except Asia, which is already running a substantial surplus) and are being increasingly financed by equity rather than debt. Nevertheless, a number of countries—particularly in Latin America—continue to face large gross financing needs, and the ongoing tightening of global financial conditions could make financing for emerging market countries more difficult. Thus, these countries need to take advantage of the economic upswing to continue to strengthen economic fundamentals and reduce vulnerabilities

Table 1.2. Selected Economies: Current Account Positions
(Percent of GDP)

	1998	1999	2000	2001
Advanced economies				
United States	–2.5	–3.6	–4.2	–4.2
Japan	3.2	2.5	2.6	2.6
Germany	–0.2	–0.9	–0.2	–0.0
France	2.7	2.7	2.7	3.4
Italy	1.7	0.7	1.0	1.3
United Kingdom	–0.0	–1.2	–1.5	–2.0
Canada	–1.8	–0.4	1.4	1.0
Australia	–5.0	–5.7	–4.8	–4.9
Austria	–2.3	–2.8	–2.0	–1.8
Finland	5.7	5.2	5.6	5.3
Greece	–3.0	–4.1	–4.9	–4.9
Hong Kong SAR	1.8	5.9	6.9	6.8
Ireland	2.0	0.3	–0.6	–0.9
Israel	–0.9	–2.6	–2.2	–2.9
Korea	12.8	6.1	2.3	0.4
New Zealand	–5.1	–8.1	–6.2	–5.3
Norway	–1.3	3.9	14.3	13.3
Portugal	–7.0	–8.8	–10.4	–10.5
Singapore	25.4	25.0	23.6	22.8
Spain	–0.2	–2.2	–2.2	–1.9
Sweden	2.9	2.6	2.6	2.5
Switzerland	9.1	11.3	10.0	10.3
Taiwan Province of China	1.3	2.5	2.1	2.2
Memorandum				
Euro area[1]	1.3	0.6	0.9	1.3
Developing countries				
Algeria	–1.9	0.0	12.6	10.3
Argentina	–4.8	–4.4	–3.7	–3.6
Brazil	–4.3	–4.6	–3.9	–3.5
Cameroon	–2.7	–4.3	–2.4	–2.8
Chile	–5.7	–0.1	–2.4	–3.1
China	3.1	1.6	1.6	1.3
Côte d'Ivoire	–3.9	–4.0	–5.4	–4.0
Egypt	–3.1	–2.0	–1.8	–1.8
India	–1.7	–0.6	–1.2	–1.3
Indonesia	4.2	3.7	3.7	1.3
Malaysia	12.9	15.8	13.6	7.4
Mexico	–3.8	–2.9	–3.5	–3.7
Nigeria	–8.7	–11.0	2.4	–3.0
Pakistan	–2.7	–3.8	–2.2	–1.5
Philippines	2.4	9.4	8.0	3.8
Saudi Arabia	–10.2	–1.2	6.6	1.6
South Africa	–1.6	–0.4	–0.7	–1.3
Thailand	12.7	9.1	7.2	5.9
Turkey	1.0	–0.7	–3.1	–2.4
Uganda	–5.6	–7.4	–7.9	–7.9
Countries in transition				
Czech Republic	–2.4	–2.0	–3.4	–3.3
Estonia	–9.2	–6.1	–5.9	–6.1
Hungary	–4.9	–4.3	–4.5	–4.4
Latvia	–10.1	–9.7	–8.6	–7.7
Lithuania	–12.1	–11.2	–7.4	–6.9
Poland	–4.4	–7.5	–7.4	–7.0
Russia	0.4	11.3	13.4	7.9
Slovak Republic	–10.4	–5.7	–4.7	–3.9
Ukraine	–3.1	–0.1	–2.1	–1.6

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

to external shocks. In Latin America, the priorities include further fiscal consolidation and reform, supported by measures to improve the operation of labor markets. In Asia, the countries farthest along in the recovery will need to take gradual steps toward a more neutral macroeconomic policy stance, and it will be essential to continue with bank and corporate sector restructuring. A substantial agenda of fiscal and structural reforms also remains in the transition economies, accompanied by the need to develop the institutions and institutional framework required to support a market economy.

Despite the strength of the global recovery, many countries continue to face deep-seated economic problems, and 1.2 billion people still subsist on less than $1 per day. Thus, as noted in a recent United Nations report, "poverty in all its forms is the greatest challenge to the international community." [3] A sustained reduction in poverty requires stronger growth, achieved in a fashion that benefits the poor. The poorest countries will need to focus on improving macroeconomic stability, addressing governance problems, harnessing market forces for development, and promoting domestic ownership of the reform agenda, but much stronger support from the international community is also required.[4] In this connection, the main priorities are to fully fund the enhanced initiative for Heavily Indebted Poor Countries (HIPCs), to allow debt relief to be delivered to the poorest countries in a way that achieves poverty reduction; to reform trade policies discriminating against the poorest countries (especially for agricultural trade); and to reverse the declining trend in some advanced countries' official development aid. Additional international assistance will also be needed to help address the HIV/AIDS pandemic, which has infected more than 20 percent of the adult population in some African countries.

The assessment of global economic conditions continues to be complicated by the global current account discrepancy, which—according to preliminary data—increased sharply in 1999 (see Appendix II for a more detailed discussion). Although the discrepancy is projected to decline in 2000, the staff's projections, in common with those of other forecasters, suggest that it will widen significantly thereafter. To the extent that this reflects an underestimation of future export growth, there could be potential upside risks to global growth in the staff's baseline scenario, particularly in 2001–02.

Can the United States Achieve a "Soft Landing"?

In the *United States*, the current economic expansion has continued apace (Figure 1.5). Following very rapid growth of 7 percent (annualized) in the second half of 1999, GDP growth moderated to 5 percent in the first half of 2000, accompanied by some signs of an easing in domestic demand growth. Fixed investment has remained buoyant, underpinned by strong business confidence and an ongoing drive to invest in new technologies, but consumption growth fell sharply in the second quarter, largely reflecting a decline in durables purchases. Recent economic reports show a mixed picture; housing starts are turning down and employment growth has moderated, but personal consumption expenditures have risen again.

The strength of domestic demand relative to output growth over the past two years has been reflected primarily in a sharp widening of the current account deficit, which has risen from 1¾ percent of GDP in 1997 to 3¾ percent of GDP in 1999 and to 4¼ percent in the first quarter of 2000. With the fiscal surplus increasing, this has entirely reflected the emergence of a large deficit in private sector net savings, reflecting both high

[3]See *A Better World For All*, coauthored by the United Nations, the World Bank, the International Monetary Fund, and the Organization for Economic Cooperation and Development; available on the websites of each organization as well as at www.paris21.org/betterworld.

[4]See "How Can the Poorest Countries Catch Up?," Chapter IV in the May 2000 *World Economic Outlook*, for a detailed analysis.

investment but also a sharp decline in household savings to a record low. Headline inflation has been gradually trending upward, reaching 3½ percent in July, mainly due to higher energy prices; core inflation has risen slightly, dampened by modest wage increases and strong growth in labor productivity, as well as by earlier declines in non-oil import prices. However, there have been signs of underlying price and wage pressures, and non-oil import prices have begun to rise. Business surveys also point to exceptionally tight labor markets and increasing evidence that enterprises are beginning to raise prices.

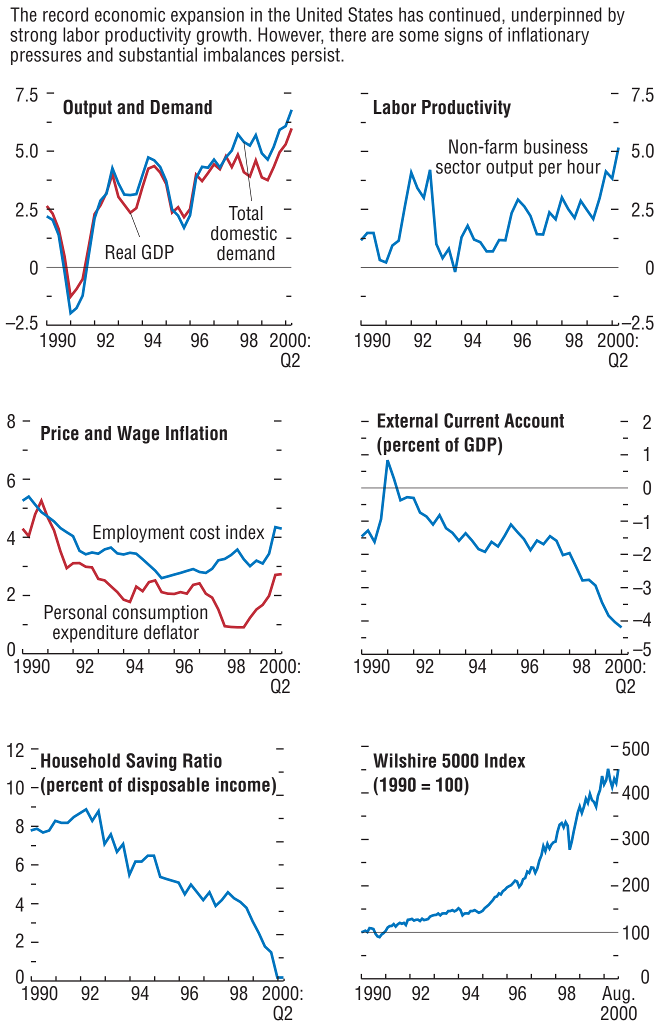
The U.S. expansion’s remarkable strength and record longevity have owed much to the consistent pursuit of sound macroeconomic policies, as well as to the flexibility of the country’s product and labor markets. Since 1995, this strong performance has been underpinned by strong growth in labor productivity, partially linked to rising investment in high technology, which has led some observers to conclude that the United States is now experiencing a “new economy,” in which technology gains allow for an increase in productivity growth. This strong growth in productivity—and the expectation that it will continue—has helped attract substantial capital inflows into the United States, thereby contributing to the appreciation of the U.S. dollar and the widening current account deficit, and has underpinned the high level of equity market valuations, which in turn is associated with the decline in household saving. At this juncture, however, it remains unclear how long higher productivity growth can be sustained; the recent increase may in part reflect a onetime jump in the level of productivity associated with capital deepening, rather than an underlying increase in productivity growth. The evolution of market expectations of the future path of productivity and growth will have important implications for how the imbalances in the U.S. economy are unwound, as well as for the conduct of monetary policy (discussed in more detail in Chapter II).

Despite the uncertainties associated with the new economy, it is clear that over the past three years both demand and supply have grown above

Figure 1.5. United States: Rapid Growth, But Rising Imbalances

(Percent change from four quarters earlier unless otherwise noted)

The record economic expansion in the United States has continued, underpinned by strong labor productivity growth. However, there are some signs of inflationary pressures and substantial imbalances persist.



Sources: Bloomberg Financial Markets, LP; and WEFA, Inc.

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

	Real GDP				Consumer Prices				Unemployment			
	1998	1999	2000	2001	1998	1999	2000	2001	1998	1999	2000	2001
Advanced economies	**2.4**	**3.2**	**4.2**	**3.2**	**1.5**	**1.4**	**2.3**	**2.1**	**6.7**	**6.3**	**5.9**	**5.7**
Major industrial countries	2.5	2.9	3.9	2.9	1.3	1.4	2.2	1.9	6.2	6.0	5.7	5.8
United States	4.4	4.2	5.2	3.2	1.6	2.2	3.2	2.6	4.5	4.2	4.1	4.4
Japan	–2.5	0.2	1.4	1.8	0.6	–0.3	–0.2	0.5	4.1	4.7	5.0	5.3
Germany	2.1	1.6	2.9	3.3	0.6	0.7	1.7	1.5	9.0	8.3	7.9	7.6
France	3.2	2.9	3.5	3.5	0.7	0.6	1.5	1.1	11.7	11.3	9.8	8.8
Italy	1.5	1.4	3.1	3.0	1.7	1.7	2.5	1.6	11.8	11.4	10.7	10.1
United Kingdom[1]	2.6	2.1	3.1	2.8	2.7	2.3	2.0	2.4	4.7	4.3	3.9	4.0
Canada	3.3	4.5	4.7	2.8	1.0	1.7	2.3	2.1	8.3	7.6	6.6	6.5
Other advanced economies	2.0	4.7	5.1	4.2	2.4	1.3	2.4	2.6	8.1	7.3	6.2	5.7
Spain	4.0	3.7	4.1	3.5	1.8	2.2	3.1	2.4	18.8	15.9	14.0	12.6
Netherlands	3.7	3.6	3.9	3.5	2.0	2.0	2.4	3.5	4.1	3.2	2.3	2.0
Belgium	2.7	2.5	3.9	3.0	0.9	1.1	2.2	1.4	9.5	9.0	8.3	7.7
Sweden	3.0	3.8	4.4	3.4	–0.1	0.4	1.4	1.8	6.5	5.6	4.6	4.0
Austria	2.9	2.2	3.5	2.9	0.8	0.5	1.9	2.1	4.7	4.4	3.5	3.5
Denmark	2.5	1.7	2.1	2.1	1.8	2.6	2.9	2.5	6.4	5.6	5.4	5.5
Finland	5.5	4.0	5.0	4.0	1.3	1.3	2.7	2.5	11.4	10.3	9.0	8.2
Greece	3.7	3.5	3.5	3.9	4.5	2.2	2.5	2.8	10.8	11.7	11.5	11.3
Portugal	4.2	3.0	3.4	3.5	2.2	2.2	2.5	2.3	5.0	4.4	4.1	4.0
Ireland	8.9	9.9	8.7	6.9	2.2	2.5	4.8	3.5	7.4	5.6	4.5	4.0
Luxembourg	5.0	5.2	5.1	5.0	1.0	1.0	1.6	1.4	3.3	2.9	2.7	2.3
Switzerland	2.1	1.7	3.0	2.6	0.1	0.8	1.7	1.7	3.9	2.7	2.0	1.9
Norway	2.0	0.9	3.0	2.4	2.3	2.3	3.0	2.5	2.4	3.2	3.6	3.6
Israel	2.2	2.2	4.0	4.0	5.4	5.2	2.1	3.0	8.5	8.9	8.4	8.2
Iceland	4.7	4.5	4.0	2.1	1.7	3.4	4.9	3.5	2.9	1.9	1.8	1.8
Korea	–6.7	10.7	8.8	6.5	7.5	0.8	2.2	3.0	6.8	6.3	4.2	3.5
Australia[2]	5.2	4.4	4.0	3.4	0.9	1.5	4.8	3.3	8.0	7.2	6.7	6.6
Taiwan Province of China	4.7	5.7	6.5	6.0	1.7	0.2	1.6	2.3	2.7	2.9	2.5	2.3
Hong Kong SAR	–5.1	2.9	8.0	4.8	2.8	–4.0	–2.5	2.0	4.7	6.1	4.0	3.1
Singapore	0.4	5.4	7.9	5.9	–0.3	0.1	1.4	2.1	3.2	3.5	2.9	2.5
New Zealand[2]	–0.2	3.4	4.0	3.2	1.6	1.1	2.3	3.3	7.5	6.8	6.4	6.4
Memorandum												
European Union	2.7	2.4	3.4	3.3	1.4	1.4	2.1	1.9	9.5	8.8	8.0	7.5
Euro area	2.7	2.4	3.5	3.4	1.1	1.2	2.1	1.7	10.8	9.9	9.0	8.3

[1]Consumer prices are based on the retail price index excluding mortgage interest. Unemployment rate on a claimant count basis.
[2]Consumer prices excluding interest rate components; for Australia, also excluding other volatile items.

the upper end of reasonable assessments of potential output growth. Against this background, between mid-1999 and early 2000, the Federal Reserve raised interest rates by a cumulative 1¼ percentage points, followed by a further ½ percentage point increase in May 2000; the Federal Open Market Committee did not raise rates at its June or August meetings, but noted that the risks to the outlook continued to be weighted mainly toward conditions that may generate inflationary pressures. Given the lags with which monetary policy affects the economy, and the boost to output and demand provided by the recent rise in equity prices, the bulk of the past monetary tightening has yet to be felt. At the same time, the real appreciation of the U.S. dollar over the past 18 months, as well as higher oil prices, should also exert a contractionary effect on activity. For 2000 as a whole, real GDP growth is projected to average 5.2 percent, falling to about 3.2 percent in 2001 (Table 1.3). Given the ongoing recovery in other regions of the world, this slowdown would be consistent with an orderly resolution of outstanding imbalances without serious disruption to world growth.

Nevertheless, with indicators pointing to continued strong momentum in the U.S. economy, and labor markets still tight, a further increase in

interest rates may be needed in the future to dampen inflationary pressures and to reduce the growth of domestic demand below that of potential output. The extent of such additional tightening, however, remains subject to considerable uncertainty, and it remains to be seen whether, and by how much, the recent slowdown in domestic demand growth will be sustained. Since May, in response to signs that the economy was slowing, markets have substantially marked down estimates of future interest rate increases; there has also been some recovery in equity markets and a decline in mortgage and corporate bond yields. It is possible, however, that these developments could themselves add to pressures on growth and demand later in the year, at a time when labor markets are still very tight. Also, earlier temporary factors that have held down prices—such as declining non-oil import prices—have begun to unwind. In such circumstances, a further tightening of monetary policy might later be needed to restrain inflationary pressures.

To address these concerns, fiscal policy should remain consistent with efforts to reduce demand. Following the substantial fiscal consolidation in recent years, the surplus is projected to increase to 1½ percent of GDP in 2000 (Table 1.4), which will further restrain demand pressures. In the short term, the current fiscal stance should be maintained—and to the extent possible, strengthened—by resisting calls for tax reductions or additional expenditures. Over the longer term, the authorities' intention to substantially preserve the fiscal surpluses in prospect, and to pay down the public debt, will help support national savings, as well as prepare for the coming long wave of unfunded liabilities associated with the retirement of the baby boom generation.

In *Canada*, following a temporary slowdown as a result of the Asian financial crisis, the economy has continued to rebound strongly, aided by buoyant U.S. demand, rising commodity prices, and a competitive exchange rate. GDP grew by 5.1 percent (annualized) in the first half of 2000, driven by booming growth in exports and fixed investment. With most indicators suggesting that the economy still has considerable momentum, GDP growth is projected at 4.7 percent in 2000, before easing to 2.8 percent in 2001 due to the tightening of monetary policy and the anticipated slowing in U.S. growth. Unemployment is projected to decline below 6¾ percent, the lowest level since the mid-1970s, and the external current account is expected to move into modest surplus.

Given the strength of demand, as well as signs that the economy may be rapidly approaching capacity limits, the Canadian authorities have appropriately sought to preempt inflationary pressures by raising interest rates in parallel with U.S. rates so far this year. Even though core inflation is at the lower end of the 1 percent to 3 percent target range and wage increases remain modest relative to productivity growth, slack in the economy is being absorbed quickly; a further moderate tightening of policy may therefore be needed in the future, although this would depend on conditions in Canada, and not necessarily on developments in U.S. rates. On the fiscal side, Canada maintains the largest structural surplus among major industrial countries. Over the medium term, prospective fiscal surpluses should be used to reduce the still high level of public debt and to support ongoing tax reduction.

Maintaining the Expansion in Europe

The expansion in the *euro area* has gathered strength, with GDP growth rising to 3¾ percent (annualized) in the second half of 1999 and continuing at a similar rate in the first quarter of 2000. This rise has been aided by resurgent export growth due to the strengthening global recovery and a highly competitive currency. During the remainder of the year, the expansion is expected to be sustained by high consumer and business confidence and the favorable external environment. For the year as a whole, GDP growth is projected at 3½ percent, with all countries registering above-potential growth rates. The pickup in activity has been accompanied by a substantial decline in unemployment. However, with some slack still remaining in area-wide labor and product markets, underlying

Table 1.4. Major Industrial Countries: General Government Fiscal Balances and Debt[1]
(Percent of GDP)

	1983–93	1994	1995	1996	1997	1998	1999	2000	2001	2005
Major industrial countries										
Actual balance	–3.8	–4.2	–4.1	–3.5	–2.0	–1.4	–1.1	–0.3	–0.3	0.3
Output gap	–0.7	–2.4	–2.5	–2.0	–1.5	–1.5	–1.2	0.1	0.3	0.1
Structural balance	–3.4	–3.1	–3.1	–2.5	–1.3	–0.7	–0.5	–0.6	–0.5	0.2
United States										
Actual balance	–4.9	–3.8	–3.3	–2.4	–1.3	—	0.7	1.4	1.5	1.6
Output gap	–1.2	–3.1	–3.5	–3.1	–1.9	–0.8	0.2	1.9	1.6	—
Structural balance	–4.6	–2.7	–2.1	–1.4	–0.6	0.3	0.6	0.8	0.9	1.5
Net debt	46.0	60.1	59.6	59.2	57.1	53.4	48.8	43.9	40.2	27.1
Gross debt	60.1	72.8	72.9	72.8	70.3	66.6	63.2	57.0	52.1	35.1
Japan										
Actual balance	0.1	–2.3	–3.6	–4.2	–3.3	–4.7	–7.4	–8.2	–6.3	–2.6
Output gap	0.3	–1.6	–1.7	1.3	0.9	–3.4	–4.5	–4.1	–3.4	–0.1
Structural balance	0.2	–1.7	–2.9	–4.5	–3.5	–3.3	–5.5	–6.5	–4.9	–2.5
Net debt	18.2	7.7	13.0	16.4	17.9	30.6	38.2	46.3	51.5	61.0
Gross debt	69.0	82.2	89.7	94.4	99.2	114.2	125.6	136.0	141.7	149.4
Memorandum										
Actual balance excluding Social security	–3.0	–5.1	–6.5	–6.8	–5.9	–6.8	–9.2	–9.5	–7.3	–4.0
Structural balance excluding Social security	–3.3	–4.5	–5.8	–6.9	–5.9	–5.8	–7.9	–8.3	–6.3	–3.8
Germany										
Actual balance[2]	–2.0	–2.5	–3.4	–3.5	–2.7	–2.1	–1.5	1.6	–1.2	–1.2
Output gap	–1.3	0.3	0.2	–0.9	–1.4	–1.2	–1.7	–0.9	0.1	—
Structural balance[3]	–1.0	–2.5	–3.4	–2.7	–1.6	–1.2	–0.6	–0.4	–1.2	–1.2
Net debt[4]	22.0	40.6	49.4	51.1	52.2	52.0	52.3	49.8	48.3	44.4
Gross debt	41.8	50.2	58.3	59.8	60.9	60.7	61.0	58.5	57.0	53.1
France										
Actual balance[2]	–2.0	–5.5	–5.5	–4.2	–3.0	–2.7	–1.8	–1.2	0.3	—
Output gap	0.3	–3.0	–2.7	–3.3	–3.1	–2.1	–1.6	–0.6	0.4	—
Structural balance[3]	–2.4	–3.9	–4.0	–2.4	–1.4	–1.6	–0.7	–0.8	–1.3	—
Net debt	21.6	40.5	45.9	48.1	49.4	49.6	48.8	48.3	48.3	41.4
Gross debt	32.7	48.5	54.6	57.1	59.0	59.3	58.6	58.0	57.0	52.5
Italy										
Actual balance	–10.9	–9.1	–7.6	–7.1	–2.7	–2.8	–1.9	–1.3	–0.9	0.2
Output gap	0.1	–2.5	–1.1	–2.0	–2.3	–2.7	–3.1	–2.0	–1.2	—
Structural balance	–10.9	–7.9	–7.0	–6.0	–1.5	–1.5	–0.3	–0.3	–0.3	0.2
Net debt	79.8	117.2	116.6	115.7	113.4	110.1	108.8	105.1	102.8	90.0
Gross debt	87.1	123.8	123.2	122.2	119.8	116.3	114.9	111.0	108.5	95.0
United Kingdom										
Actual balance[2]	–2.4	–6.8	–5.8	–4.1	–1.6	0.2	1.6	3.6	0.8	–0.9
Output gap	–1.1	–2.7	–2.0	–1.6	–0.4	0.3	0.1	0.8	1.3	0.5
Structural balance[3]	–1.1	–4.2	–4.2	–2.9	–0.9	0.3	1.5	0.9	0.2	–1.2
Net debt	30.8	31.2	37.0	37.6	39.6	40.3	38.3	34.3	31.8	29.7
Gross debt	45.0	48.5	52.0	52.1	50.1	47.4	44.7	40.8	38.2	36.1
Canada										
Actual balance	–7.0	–6.7	–5.4	–2.8	0.2	0.2	2.2	3.0	2.9	1.9
Output gap	–1.9	–4.6	–4.4	–5.3	–3.5	–2.8	–0.8	1.2	1.5	0.5
Structural balance	–5.6	–3.9	–2.9	—	2.1	1.7	2.6	2.4	2.2	1.6
Net debt	38.2	68.7	70.2	69.8	65.2	61.9	75.3	66.7	60.8	43.1
Gross debt	70.4	99.4	102.2	101.9	97.3	95.1	111.6	100.3	92.8	70.2

Note: The budget projections are based on information available through August 2000. The specific assumptions for each country appear in Box A1.

[1]The output gap is actual less potential output, as a percent of potential output. Structural balances are expressed as a percent of potential output. The structural budget balance is the budgetary position that would be observed if the level of actual output coincided with potential output. Changes in the structural budget balance consequently include effects of temporary fiscal measures, the impact of fluctuations in interest rates and debt-service costs, and other noncyclical fluctuations in the budget balance. The computations of structural budget balance are based on IMF staff estimates of potential GDP and revenue and expenditures elasticities (see the October 1993 *World Economic Outlook*, Annex I). Net debt is defined as gross debt less financial assets of the general government, which include assets held by the social security insurance system. Debt data refer to end of year. Estimates of the output gap and the structural budget gap and of the structural budget balance are subject to significant margins of uncertainty.

[2]Includes mobile telephone license receipts equivalent to 2.5 percent of GDP in 2000 for Germany, 1.3 percent of GDP in 2001 for France, and 2.4 percent of GDP in 2000 for the United Kingdom.

[3]Excludes mobile telephone license receipts.

[4]For net debt, the first column refers to 1987–93. Beginning in 1995, the debt and debt-service obligations of the Treuhandanstalt (and of various other agencies) were taken over by general government. This debt is equivalent to 8 percent of GDP, and the associated debt service is equivalent to ½ to 1 percent of GDP.

price pressures have been muted. The headline CPI increased to 2.4 percent by midyear, due largely to rising oil prices and exchange rate pass through. Core inflation, at about 1.3 percent, has remained subdued, aided by moderate wage settlements, falling utility prices as deregulation and privatization take effect, and, in some countries, cuts in indirect taxes.

Since the last *World Economic Outlook*, the euro has been quite volatile, hitting record lows against the U.S. dollar and most other major currencies in mid-May, and again in early September. By early September, the euro had depreciated over 15 percent in nominal effective terms since its inception in 1999, and is below the level that could be justified by medium-term fundamentals. In part, this has reflected the relative cyclical position of the euro area, with growth still considerably slower than in the United States; in addition, relative interest rate differentials and market perceptions of differences in the underlying climate for investment across countries may have played a role (Box 1.1). Given buoyant activity, money and credit developments, rising oil prices, and the weakness of the euro, the European Central Bank has raised interest rates by a cumulative 2 percentage points since late 1999, most recently through a ¼ percentage point increase in late August, to forestall potential pressures on wages and prices. While monetary policy needs to adjust gradually to a less accommodative stance as the recovery proceeds, it will need to remain flexible, responding appropriately to risks arising from diminishing margins of slack and potential inflationary pressures from rising oil prices and the weak euro, but also remaining alert to the possibility that the euro could eventually appreciate substantially from current levels, which could unduly tighten the monetary stance and slow the expansion.

During 1999, growth rates among individual countries in the euro area have continued to differ markedly, which—since monetary policy must be set on the basis of conditions in the euro area as a whole—has posed challenges for policymakers, particularly in the small and faster-growing economies. Over the coming year, differences in growth rates are projected to decline as the recovery in *Italy* and *Germany* catches up with that in *France* and some of the cyclically advanced countries.[5] Nevertheless, substantial differences in underlying cyclical positions are likely to persist for a period. Most of the cyclically advanced countries continue to experience higher than average inflation, rapid growth in domestic credit, sharply rising property prices, and, in *Portugal*, a large current account deficit. In some cases, particularly *Ireland* and possibly the *Netherlands*, relatively clear signs of overheating have emerged. While budgetary positions in these countries are in most cases in surplus, every effort should be made to save the fiscal windfalls arising from higher growth in order to avoid fuelling demand pressures.

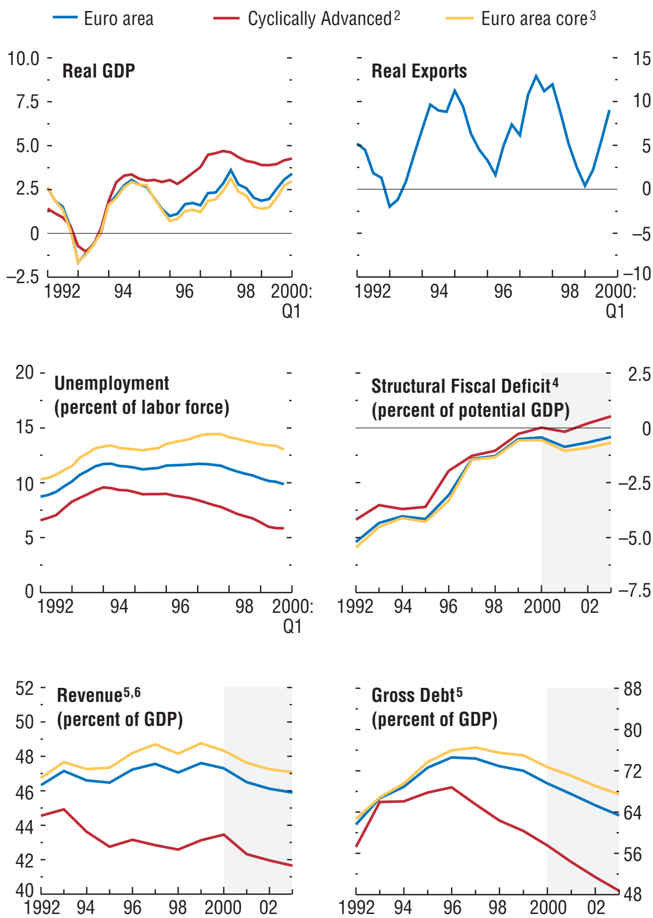
The central challenge in the euro area is to take advantage of the present cyclical upturn to decisively accelerate fiscal and structural reforms. Since 1993, spurred by the convergence requirements under Economic and Monetary Union (EMU), fiscal deficits have been substantially reduced in all euro area countries, and the IMF staff projects that the area as a whole will be close to overall balance by 2003 (Figure 1.6). This is a commendable achievement, but progress has slowed recently, and fiscal consolidation in some countries is not keeping up with the pace of the expansion. At the same time, most countries continue to face heavy tax burdens and high debt stocks, and are ill-prepared to deal with the coming demographic shock from aging populations. Although fiscal situations vary, countries that have high domestic debt or that anticipate a continued structural fiscal deficit in 2003 need to step up deficit reduction. In this connection, a more ambitious deficit reduction path in France would be desirable; and while Italy has announced a welcome strengthening of the fiscal deficit target for 2000, it has left the medium-term deficit targets essentially unchanged. In almost all countries,

[5]The cyclically advanced countries are Finland, Ireland, the Netherlands, Portugal, and Spain.

Figure 1.6. Euro Area: A Strengthening Expansion Will Allow Accelerated Reform[1]

(Percent change from four quarters earlier unless otherwise noted)

A solid expansion is under way, aided by rising exports, and unemployment has fallen significantly. This provides an opportunity to accelerate fiscal reform, given still high revenue and domestic debt ratios.



Sources: European Central Bank; OECD; and WEFA, Inc.

[1]Shaded areas indicate IMF staff projections.

[2]Finland, Ireland, Netherlands, Portugal, and Spain.

[3]Austria, Belgium, France, Germany, Italy, and Luxembourg.

[4]Excludes Luxembourg.

[5]General government.

[6]Excluding mobile telephone license receipts for France and Germany.

however, the central fiscal challenge is to build on ongoing efforts to reduce the tax burden, which remains very high by international standards and undermines incentives and long-term growth prospects. The recent income tax reform in Germany is a major step forward; and the package of tax cuts announced in France is also welcome. Such reforms, however, will need to be undertaken without weakening the underlying fiscal position, underscoring the need for further efforts to reduce noninterest expenditures, supported by reforms of pension and health systems to deal with the pressures from aging populations. Windfall gains, such as from the sale of mobile telecommunication licenses, should be used to reduce domestic debt.

In the past, recoveries in Europe have tended to be choked off at an early stage as entrenched economic rigidities kindled inflationary pressures, requiring early monetary tightening and leading to a steady ratcheting up of unemployment. While this is not an immediate risk, structural reforms to address these rigidities—building on the recent agreements at the Lisbon Summit—are critical to sustain the present expansion over the medium-term. In recent years, many countries have made significant progress in privatization, liberalizing telecommunications and electricity, introducing active labor market programs, and facilitating part time work; there has also been an increase in corporate restructuring, prompted in part by the introduction of the euro. Much remains to be done, however, including eliminating administrative barriers that inhibit competition and business formation and encouraging labor supply (lower labor utilization and participation rates explain the bulk of the difference between per capita GDP in Europe and the United States). Measures to ensure greater wage differentiation, reform social and unemployment benefits, and reduce labor taxation are of particular importance.

In the *United Kingdom,* GDP growth is projected to pick up to 3.1 percent in 2000 from 2.1 percent last year, reflecting a smaller deterioration of the trade balance and continued strong domestic demand growth, bolstered in part by

Box 1.1. Why Is the Euro So Undervalued?

As of early September 2000, the euro has depreciated by over 15 percent in nominal effective terms and by over 20 percent against the U.S. dollar since the start of stage three of Economic and Monetary Union (EMU) on January 1, 1999, defying market expectations and becoming a source of concern for European policymakers. Indeed, on many measures the euro has sunk below earlier historical lows reached in the mid-1980s by its synthetic counterpart.[1]

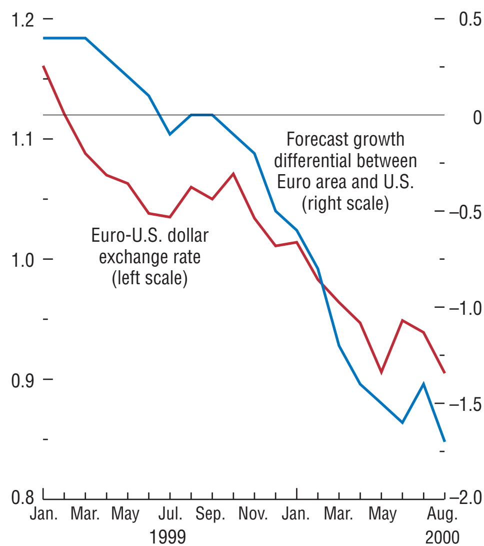
The extent of the euro's depreciation is difficult to fully explain. From the point of view of medium-term fundamentals, the current level of the euro appears to be significantly misaligned, especially against the U.S. dollar, but also against the yen. A number of short-term factors appear to be contributing to the euro's current undervaluation:

The comparative cyclical positions of the euro area and the United States. The less advanced cyclical position of the euro area relative to the United States appears to have contributed to the weakness of the European currency. Certainly, the depreciation of the euro has coincided with a widening of private sector estimates of the differential in growth in 2000 between the euro area and the United States (first Figure). This may partly reflect the impact on markets' expectations of the future path of interest rates on either side of the Atlantic.

Euro area–U.S. interest rate differentials. In a world of high capital mobility, interest rate differentials play an important role in determining the path of exchange rates, as investors shift funds internationally. Over the period through June 1999, the long-term interest rate differential moved in a manner that would tend to weaken the euro against the U.S. dollar, with the differential peaking at about 160 basis points (second Figure). Subsequently, however, long-term interest rate differentials have narrowed by about half, while the euro has remained weak.

[1]Both the real and nominal effective exchange rate of the euro have fallen below the historical low of its (synthetic) counterpart recorded in late 1984. When measured against the U.S. dollar, however, the euro has remained above its low in 1985.

Rolling Forecast for 2000 GDP Growth and the Euro-U.S. Dollar Exchange Rate



Sources: Consensus Economics; and IMF staff calculations.

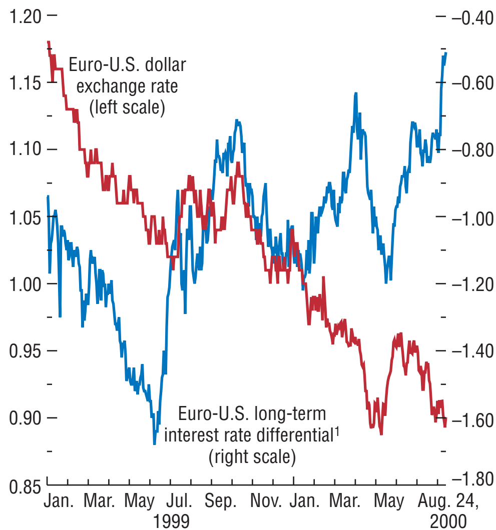
Relative medium- and long-term growth prospects. The strong macroeconomic performance of the U.S. economy over recent years associated with new technology and relatively more flexible product and labor markets has lowered assessments of the medium- to long-term growth potential of the euro area compared to the United States, reducing the attractiveness of the single currency.[2] Large financial outflows, especially foreign direct investment, from the euro area to the United States support the view that the United States is perceived as a more desirable destination for capital investment.

Foreign participation in the euro bond markets. A fourth potential reason for the euro's weakness

[2]See European Commission, Directorate General for Economic and Financial Affairs, "ICT Take-up in Europe and the Prospects for Future Growth" (Brussels: European Commission, 1999); and Paul Schreyer, "The Contribution of Information and Communication Technology to Output Growth: A Study of G-7 Countries," STI Working Paper 2000/2 (Paris: Organization for Economic Cooperation and Development, 2000).

Box 1.1 *(concluded)*

Long-Term Interest Rate Differential and the Euro-U.S. Dollar Exchange Rate



Source: Bloomberg Financial Markets, LP.
[1]Based on 10-year government bond yields.

is the elevated participation of nonresident issuers as the size of the euro area bond market increased following the introduction of the single currency. The share of euro-denominated bonds in global bond issues rose from an average of around 30 percent in 1995–98 to about 45 percent in 1999. Nonresident issuers—who accounted for about half of the new issues—contributed greatly to such an increase. To the extent that these issuers have switched the proceeds into other currencies, particularly U.S. dollars, this would create downward pressure on the euro. The unwinding of long positions acquired by foreigners in the run-up to stage three of EMU may have also contributed to selling pressure.

Market participants' evaluation of euro area policymaking. A final factor often cited by market analysts in explaining the weakness of the euro is adverse perceptions of euro area policymaking. Notwithstanding regular press briefings, some analysts argue that the European Central Bank's communication strategy has lacked clarity. Others express concern that progress on needed structural reforms is still relatively slow, particularly given the constraints in monetary policy implied by a single currency, such that the euro area does not provide as attractive a business environment as the United States.

Euro Area Policies: Potential Costs and Implications

Although the weak euro has helped to jump-start an export-led recovery in the euro area in the aftermath of the 1998 slowdown, a sustained period of currency misalignment would have a number of adverse effects. First, it would cause resources to shift toward the now more profitable traded goods sectors in the euro area and away from such sectors elsewhere. When the exchange rate finally corrected, a corresponding—and possibly costly—reallocation of resources would be required. In addition, by reducing competition in the traded goods sector, a depreciated exchange rate could also reduce the pressure on firms to restructure. Second, prolonged weakness of the euro would hamper adjustment of the existing current account imbalances across the three major currency blocs, which could increase the prospects of a disorderly adjustment in exchange rates, and could fuel a rise in protectionist pressures.

The depreciation of the euro has also significantly complicated the conduct of monetary policy. In the short run, the depreciation of the currency provides a direct boost to the price level through its impact on import prices, and—to the extent it feeds through into wages—may also have a second-round impact on inflation. In addition, by increasing competitiveness, it loosens overall monetary conditions (the IMF's monetary conditions index for the euro area indicates that the depreciation of the currency since the start of 1999 is equivalent to about a 2 percentage point reduction in real short-term interest rates). Given the potential for a future rapid appreciation in the value of the euro, which would correspondingly tighten monetary conditions, monetary policy will therefore need to remain flexible in the period ahead.

the planned expansion in government consumption. Inflation has remained below the Bank of England's 2.5 percent target, owing to subdued wage pressure, falling price-cost margins, and the strength of sterling. Nevertheless, labor market conditions remain tight with the unemployment rate (on a claimant count basis) below 4 percent. Following a cumulative 1 percentage point increase since mid-1999, the Bank of England has left policy rates on hold from February to early September. Further tightening may prove necessary if domestic demand continues to strengthen, or if further depreciation of sterling appears likely to lead to inflationary pressures.

In *Sweden*, GDP growth is projected to rise to 4½ percent in 2000, driven by strengthening domestic demand and a firming up of net exports. Nevertheless, some slack still remains in the economy, wage increases have been moderate, and core inflation is well below the 2 percent midpoint of the target zone. The present stance of monetary policy appears appropriate, but the authorities will need to remain alert to inflation pressures, especially given strong increases in property prices in major cities. Following the remarkable fiscal consolidation in recent years, attention should now focus on reducing the tax burden—among the highest in industrial countries—and on further labor market reform to underpin possible entry to EMU in the future. Activity has also remained strong in *Greece*, which—aided by a stability-oriented economic policy and more recently some recourse to administrative measures to reduce inflation—has successfully met the EMU convergence requirements and will join in 2001. With interest rates falling sharply as EMU entry approaches, and monetary policy losing its potency, Greece needs to strengthen its fiscal position to avoid a resurgence in price inflation and to reduce the very high public debt. This should be accompanied by a bolder and more comprehensive liberalization and deregulation and effective labor market reform.

A solid recovery is also under way in *Denmark, Norway,* and *Switzerland,* all of which experienced among the lowest growth rates in Europe in 1999. In Norway and Denmark, where the slowdown partly reflected policy measures to address overheating, the ensuing rebound has been led by rising exports (for Norway, aided by higher oil prices). Domestic demand is projected to pick up in both countries during 2000, as fiscal policies have now returned to a broadly neutral stance. In *Switzerland*, the recovery has been driven by both exports and domestic demand, aided by an accommodative monetary stance. As the strength of the recovery became apparent, the central bank appropriately moved to tighten monetary conditions, while allowing the franc to appreciate against the euro.

Regaining the Confidence of Japan's Consumers

In *Japan*, following two quarters of output decline, GDP growth rose by 4 percent (annualized) in the first half of 2000. Given the deficiencies in the national accounts, these data must be interpreted cautiously (Box 1.2); analysis of a broad range of indicators suggests that activity may not have been as weak as reported in the second half of 1999, while a significant proportion of the strong first half growth is transitory in nature. Overall, it appears that a modest recovery is under way, supported by strengthening corporate profitability and investment, particularly in the high technology sector. Over the coming year, the recovery is expected gradually to gather momentum, with GDP growth projected at 1.4 percent in 2000 and 1.8 percent in 2001.

The emerging recovery has led to increasing pressure to roll back the exceptional macroeconomic measures that were introduced during the past two years. In August, the Bank of Japan ended the zero interest rate policy, increasing the overnight call rate to 0.25 percent; however, since this was broadly anticipated by the market, there has been only a small increase in short- and long-term market rates. With the fiscal deficit approaching double digit levels and public debt very high, there have also been pres-

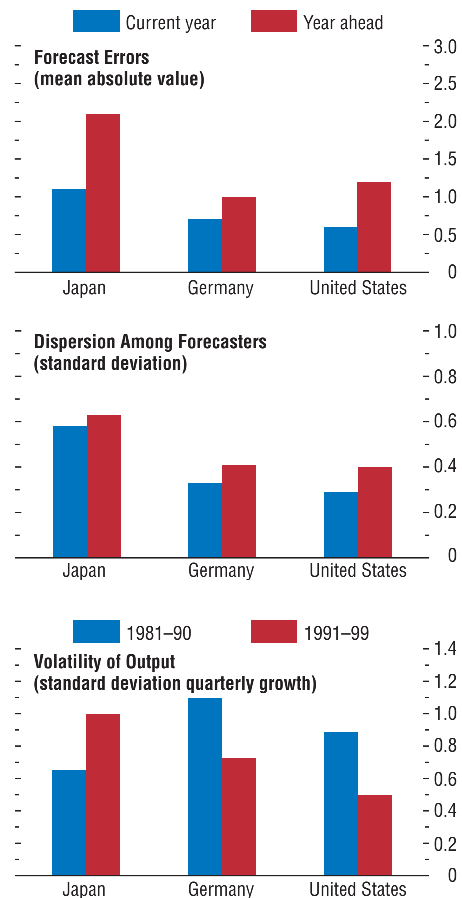
Box 1.2. Risky Business: Output Volatility and the Perils of Forecasting in Japan

How good are forecasters at predicting developments in the economy? The simple answer, based on recent research, is that the track record leaves much to be desired.[1] For *year-ahead* forecasts, the average error in forecasting real GDP growth during the 1990s for a large sample of industrial countries was 1.5 percent. Actual real GDP growth over this same period was 2.3 percent. For *current-year* forecasts made as late as October, the average error declined only to 0.6 percent. Furthermore, only two of the 60 recessions that occurred over this period were predicted a year in advance; two-thirds remained undetected in the April of the year in which the recession occurred.

The forecasts for Japan are even more off the mark than those for other countries, perhaps not surprisingly as the economy has sailed in uncharted waters over much of the 1990s. Among the Group of Three (G-3) countries, for instance, the forecast errors for Japan in the 1990s have been almost twice as large as those for Germany and the United States (see the Figure). There has also been much greater discord among forecasters in their predictions of Japanese growth. The standard deviation of the year-ahead GDP predictions published in the *Consensus Forecast* in April was about 50 percent higher in Japan than in either the United States or Germany, while the standard deviation of current-year output projections made in April was twice as large as in the United States or Germany.

The greater dispersion among forecasters of the Japanese economy is not necessarily an adverse phenomenon if it reflects independent thinking or genuine uncertainty about where the economy is headed. However, it may also be due to the poorer quality of information on which forecasts have to be made. There are also delays involved in procuring data on the Japanese economy—the quarterly national accounts are released about a full month after they come out in the United States, although the delay in relation to Germany is smaller. The higher degree of discord (relative to the other G-3) for current-year Japanese forecasts than for the year-ahead forecasts may reflect the difficulties of procuring timely and reliable data.

Another, less well-known, phenomenon that has complicated forecasting of the Japanese economy has been the large increase in the volatility of output in Japan during the 1990s. Volatility, as measured by the standard deviation of the growth in quarterly GDP, rose over a half in Japan, from 0.65 in the 1980s to unity in the



Sources: Consensus Economics Inc., *Asia Pacific Consensus Forecast;* and IMF staff calculations.

[1] Prakash Loungani, “How Accurate Are Private Sector Forecasts? Cross Country Evidence from Consensus Forecasts of Output Growth,” IMF Working Paper 00/77 (Washington: International Monetary Fund, 2000).

1990s. On the same basis, volatility of output fell significantly in Germany and the United States (see the Figure). Because of this high volatility (caused in part by technical factors, discussed below), forecasters tend to be more split as to whether data movements reflect genuine turning points in demand or are more transient.

Why has volatility of output increased so dramatically in Japan in the 1990s? The answer is a complex one, combining aspects of the way policies, particularly fiscal policies, were formulated and implemented, technical factors relating to the measurement of the national accounts statistics, as well as macroeconomic shocks such as the Asian crisis, the financial turmoil induced by the banking crisis during 1997–98, and the impact of constraints on monetary policy as interest rates approached their zero bound.

There is now a broad consensus that the systematic implementation of stabilization policies in the postwar period reduced output volatility in advanced economies significantly.[2] As in other countries, stabilization policies in Japan also proved successful in reducing output volatility in the postwar period. However, a structural break appears to have occurred in the 1990s when fiscal policy was used aggressively to support domestic demand. Such fiscal activism appears to have contributed to volatility, as public investment fluctuated significantly from quarter-to-quarter and temporary tax cuts were introduced at various times. The preannounced hike in consumption taxes in April 1997 also contributed to output volatility by generating intertemporal substitution of consumption. The effects of the financial turmoil following the failures of some major banks and securities firms during 1997–98 also exacerbated volatility through an impact on precautionary savings.

Measurement problems associated with the Japanese national accounts (and other economic statistics) have also contributed to the volatility of GDP in the 1990s, particularly for private consumption and public investment. In the case of private consumption, seasonal adjustment procedures have failed to take adequate account of a structural shift related, in part, to changes in the pattern of bonus payments—an increasing part of the traditional December bonuses have tended in recent years to spill over into the January of the subsequent year. Consequently, measured private consumption has tended to fall sharply in the last quarter of the year and rise sharply in the first quarter of the subsequent year. Sampling procedures used for computing private consumption have also had a role in explaining the recent discrepancies between the stronger outlook provided by supply-side data compared with demand-side data—the quarterly national accounts in Japan are calculated almost exclusively from the expenditure side. The Household Survey, which is used as the main ingredient for computing private consumption excludes big-spending, single-person households, while the proxy measure used for incorporating such households tends to underweight them. The quarterly path of public investment is computed mainly from the statistics on public construction works, which are often revised substantially, thereby further aggravating the volatility of measured public investment.[3] Finally, the failure of seasonal adjustment procedures to take account of leap year effects has also contributed to volatility—including in the first quarter of this year. In response to these problems, the Japanese authorities have taken a number of steps recently to improve sampling and seasonal adjustment procedures to better reflect underlying trends in the economy.

The problems relating to the quality of Japanese data are not just statistical issues of only technical concern. They constitute another element that exacerbates output volatility by forcing economic decisions to be made under incomplete or misleading information. Furthermore, they make forecasting an even more difficult task in Japan than it is in other countries, introducing a higher level of uncertainty into decisions that have to be based on predictions of the future, creating in turn the potential for a vicious circle.

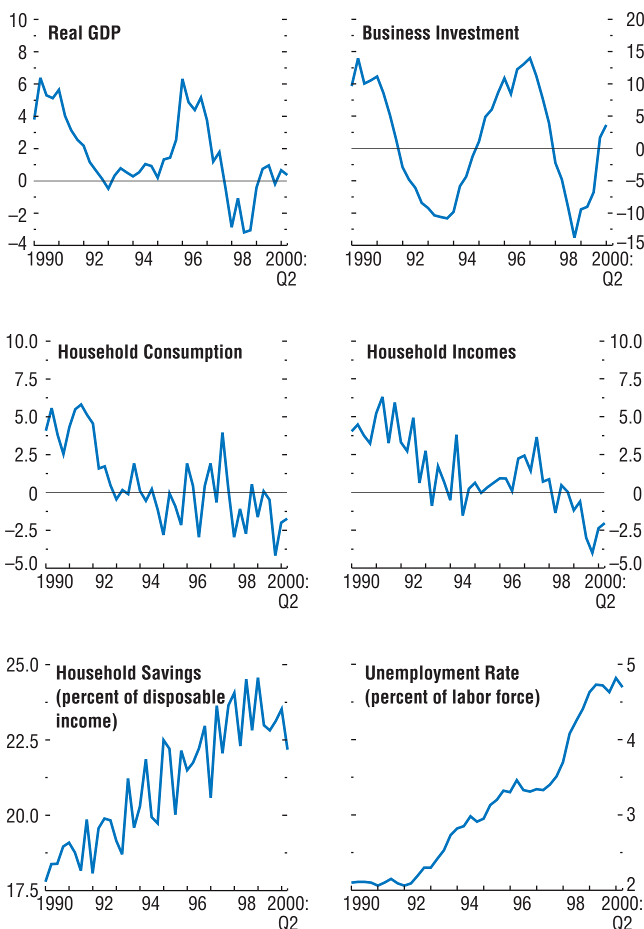
[2]For a more detailed discussion of the evidence and issues, see Christina D. Romer, "Changes in Business Cycles: Evidence and Explanations," *Journal of Economic Perspectives,* Volume 13 (Spring 1999) pp. 23–44.

[3]See OECD, *Economic Outlook,* (Organization for Economic Cooperation and Development, June 2000).

Figure 1.7. Japan: Modest Recovery But Consumption Still Weak

(Percent change from four quarters earlier unless otherwise noted)

A modest recovery is under way, led by rising business investment. But households remain reluctant to spend, due to declining incomes and to precautionary savings in response to higher unemployment.



Source: Nikkei Telecom.

sures for fiscal consolidation. At the same time, however, the recovery remains fragile and subject to downside risks, particularly beyond mid-year, after which—in the absence of additional measures—public investment is expected to fall off sharply. A critical element remains the near-term outlook for private consumption, which has remained weak due to declining household income, and high savings rates in response to ongoing corporate restructuring and high unemployment (Figure 1.7). With retail sales sluggish and only a modest gain in consumer confidence, a sustained recovery in consumer demand is still not assured and could be derailed by adverse macroeconomic developments.

Against this background, it is important that macroeconomic policies remain highly supportive until a self-sustaining recovery is under way. On the fiscal side, timely implementation of a supplementary budget to support public investment beyond mid- 2000 will be important to assure continued recovery. Thereafter, the fiscal stance will need to be flexible, adapting to evolving economic conditions. However, given Japan's high public debt and the future burden of the aging population, the government will need to start laying out the main elements of a flexible fiscal consolidation strategy, with the broad aim of stabilizing and then reducing the debt-GDP ratio over a five- to ten-year horizon; in this context, continued efforts to improve fiscal transparency, including through regular publication of medium-term fiscal projections, are desirable. With a continued large output gap, and deflationary risks not yet dispelled, monetary policy should remain accommodative, and it will be important that the ending of the zero interest rate policy is not seen as foreshadowing an accelerated series of rate increases, which could undermine sentiment and the still fragile recovery.

Structural reform remains essential to ensure a durable economic recovery. Over the past two years, the authorities have taken important steps toward strengthening the banking system, and a number of megamergers have been announced.

However, few banks have yet put forward credible plans to restore core profitability, which remains very low; banks may also be adversely affected by the recent decline in equity prices, and vulnerable to capital losses when long-term bond rates eventually rise. Further efforts to restructure the credit cooperatives and some regional banks, and address remaining gaps in the regulatory and supervisory framework are also needed to allow a smooth transition to partial deposit insurance. Efforts are also urgently needed to strengthen the financial position of life insurers, which has continued to deteriorate.

The restructuring of Japan's corporate sector remains a key to revitalizing the economy and the financial system. Over the last year, a substantial number of corporate restructuring plans have been announced, encouraged by tax and other incentives under the Industrial Revitalization Law and more transparent accounting standards, and takeover and merger activity has substantially increased. Nevertheless, there has been only limited progress in strengthening corporate balance sheets and disposing of nonproductive assets, and it will be critical to avoid backsliding as macroeconomic conditions begin to improve. Early introduction of consolidated corporate taxation, removal of tax impediments for mergers and spin-offs, strengthened corporate governance, and continued progress with regulatory and product market reforms—especially in the telecom sector—are also required.

A number of observers have expressed concern that the continuation of accommodative macroeconomic policies could adversely affect progress with restructuring. For instance, low interest rates could encourage imprudent borrowing and reduce pressures on firms to downsize; at the same time, government credit guarantee programs and public works spending could help prop up economically nonviable enterprises. These are genuine risks, and—especially with regard to bank lending—need to be closely monitored by the authorities; there may also be scope to improve the efficiency and effectiveness of public investment. At the same time, modest macroeconomic tightening seems unlikely to reverse these adverse incentives, while the impact on demand could do further damage to already weak balance sheets. At the present juncture, the dangers arising from a premature withdrawal of macroeconomic support appear greater, especially in view of Japan's gloomy recent history of economic recoveries aborted by macroeconomic shocks.

Latin America and the Caribbean: Recovery and Divergence

Latin America and the Caribbean are continuing to recuperate from the emerging market crises of 1997–98. Growth is being fueled by buoyant exports (particularly to the United States), as well as a recovery in consumer confidence and spending that is occurring despite recent falls in stock prices (see Chapter II). Real GDP, which was basically flat in 1999, is expected to expand by a healthy 4¼ percent in 2000 and 4½ percent in 2001, while inflation is projected to remain quiescent and in single digits in most countries (Table 1.5). The current account deficit for the region (as a ratio of GDP) is expected to narrow somewhat in 2000, reflecting healthy export volumes and some improvement in the terms of trade coming from higher commodity prices. These aggregate trends, however, mask important differences across countries. Several countries, such as Brazil, Mexico, and Chile, are exhibiting more rapid growth than other countries in the region, particularly those where economic and political uncertainties are most acute.

The region's needs for external funds remain sizable, particularly once debt amortization and the relatively closed nature of many of the economies are taken into consideration, although vulnerability indicators have improved, in part because of increases in (relatively stable) foreign direct investment flows, and reserves are not currently under pressure (Figure 1.8). The high level of volatility of capital flows to emerging markets (again, see Chapter II) amplifies the attendant uncertainties. The most important ex-

Table 1.5. Selected Western Hemisphere and Asian Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	1998	1999	2000	2001	1998	1999	2000	2001	1998	1999	2000	2001
Western Hemisphere	**2.2**	**0.3**	**4.3**	**4.5**	**10.2**	**9.3**	**8.9**	**7.0**	**–4.5**	**–3.1**	**–2.9**	**–3.1**
Argentina	3.9	–3.1	1.7	3.7	0.9	–1.2	–0.7	0.5	–4.8	–4.4	–3.7	–3.6
Brazil	–0.1	1.0	4.0	4.5	3.2	4.9	7.5	5.0	–4.3	–4.6	–3.9	–3.5
Chile	3.4	–1.1	6.0	6.8	5.1	3.3	3.2	3.5	–5.7	–0.1	–2.4	–3.1
Colombia	0.5	–4.5	3.0	3.8	18.7	10.9	11.2	8.8	–5.3	–1.1	–1.1	–2.0
Dominican Republic	7.3	8.3	8.4	6.5	4.8	6.5	7.5	8.4	–2.1	–2.9	–5.7	–3.2
Ecuador	0.4	–7.3	0.5	3.5	36.1	52.2	100.6	30.0	–11.0	7.0	3.2	–2.4
Guatemala	5.1	3.5	3.6	3.0	6.6	5.3	7.0	7.6	–5.5	–5.6	–4.7	–4.4
Mexico	4.9	3.5	6.5	4.8	15.9	16.6	9.5	8.2	–3.8	–2.9	–3.5	–3.7
Peru	0.3	3.8	4.0	6.0	7.3	3.5	3.9	3.5	–6.0	–3.6	–3.9	–4.6
Uruguay	4.6	–3.2	2.0	4.0	10.8	5.7	5.2	4.5	–2.1	–2.9	–2.5	–2.0
Venezuela	–0.1	–7.2	2.5	3.0	35.8	23.6	17.0	16.0	–2.7	4.4	7.3	4.7
Asia	**4.1**	**5.9**	**6.7**	**6.6**	**7.5**	**2.4**	**2.4**	**3.3**	**2.2**	**2.0**	**1.6**	**0.9**
Bangladesh	5.0	5.2	5.0	4.5	8.0	6.2	5.8	7.1	–1.2	–1.5	–1.2	–1.2
China	7.8	7.1	7.5	7.3	–0.8	–1.4	0.5	1.2	3.1	1.6	1.6	1.3
India	6.3	6.4	6.7	6.5	13.2	4.7	5.6	6.5	–1.7	–0.6	–1.2	–1.3
Indonesia	–13.0	0.3	4.0	5.0	58.0	20.8	3.2	5.2	4.2	3.7	3.7	1.3
Malaysia	–7.4	5.6	6.0	6.0	5.3	2.8	3.2	3.6	12.9	15.8	13.6	7.4
Pakistan	2.6	2.7	5.6	5.3	7.8	5.7	3.6	5.5	–2.7	–3.8	–2.2	–1.5
Philippines	–0.6	3.3	4.0	4.5	9.7	6.7	5.0	5.9	2.4	9.4	8.0	3.8
Thailand	–10.2	4.2	5.0	5.0	8.1	0.3	1.7	2.6	12.7	9.1	7.2	5.9
Vietnam	3.5	4.2	4.5	5.4	7.8	4.2	0.5	5.6	–3.9	4.4	2.5	0.5
Memorandum												
Newly industrialized Asian economies	**–2.3**	**7.8**	**7.9**	**6.1**	**4.5**	**0.0**	**1.4**	**2.6**	**8.3**	**6.7**	**4.8**	**3.9**
Hong Kong SAR	–5.1	2.9	8.0	4.8	2.8	–4.0	–2.5	2.0	1.8	5.9	6.9	6.8
Korea	–6.7	10.7	8.8	6.5	7.5	0.8	2.2	3.0	12.8	6.1	2.3	0.4
Singapore	0.4	5.4	7.9	5.9	–0.3	0.1	1.4	2.1	25.4	25.0	23.6	22.8
Taiwan Province of China	4.7	5.7	6.5	6.0	1.7	0.2	1.6	2.3	1.3	2.5	2.1	2.2

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

ternal uncertainty for the region is the potential impact of interest hikes in the United States. Historically, activity in Latin America has been particularly susceptible to U.S. monetary policy, reflecting the close economic and financial links with the north and the appetite for external loans. Tighter U.S. monetary policy affects the region through several channels whose importance varies across countries:

- *Higher cost of international borrowing.* Hikes in the federal funds rate are generally magnified in emerging markets, as tighter global monetary conditions reduce the appetite for risk and widen spreads, particularly for higher-risk borrowers. This effect is amplified if the hike in U.S. rates is not anticipated (Box 2.1 of Chapter II).
- *Higher domestic interest rates.* This effect is direct in countries whose exchange rates are pegged to the dollar, most notably Argentina. Other central banks may feel a need to hike rates to counter downward pressure on the currency as capital flows diminish, although this may be mitigated by the inflation-targeting framework now in place in several countries—including Brazil and Mexico—and associated gains in policy credibility.
- *Fewer exports.* As U.S. activity slows, consumers in the U.S. will lower their demand for foreign goods, particularly from close economic partners such as Mexico.

Appendix I to this Chapter reports an alternative scenario that illustrates the consequences of a harder landing in the United States brought

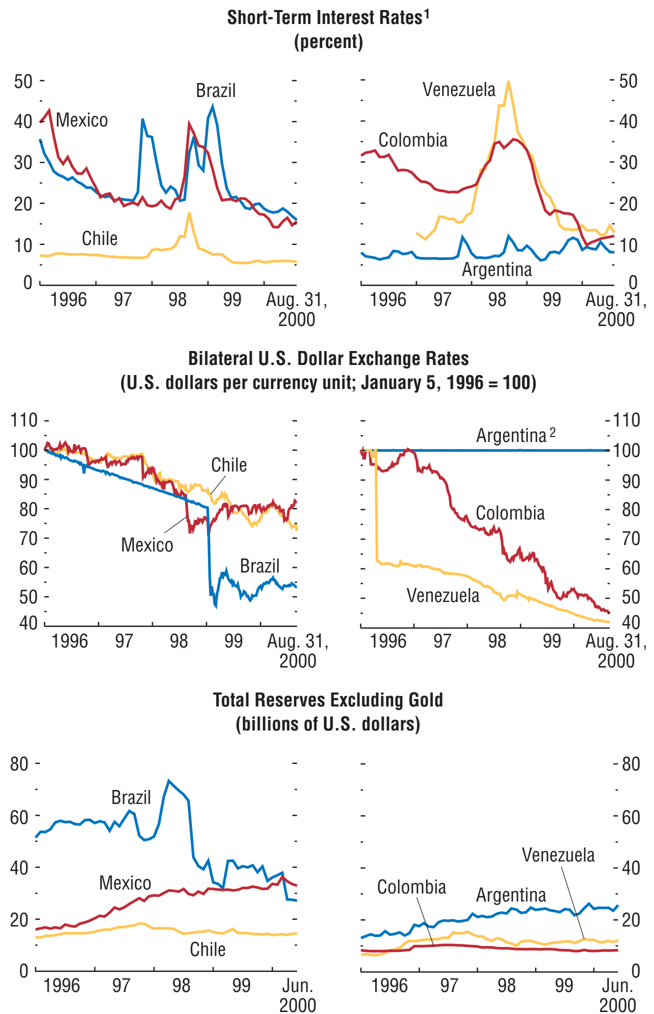
on by greater-than-expected inflationary pressures and tighter monetary policies.

Growth in *Brazil* continues to recover, led by exports, which surged as a result of the depreciation in early 1999. But rising consumer spending and investment have also contributed more recently. Real GDP is now projected to rise by 4 percent in 2000 and 4.5 percent in 2001, while the current account deficit should fall significantly. *Chile* is also experiencing a recovery, supported by buoyant consumer spending. In both countries, confidence has been maintained by responsible macroeconomic policies, including inflation-targeting regimes. In Brazil, this year's targeted public sector primary surplus of 3¼ percent of GDP is expected to be achieved. The budget for 2001 targets a primary surplus of 3 percent of GDP, which is expected to be consistent with a further decline in public debt relative to GDP. In Chile, the government has suggested giving legal status to the objective of maintaining a structural fiscal surplus of 1 percent of GDP.

Mexico's economy continues to expand at a healthy pace, as it has been doing since 1995, backed by prudent monetary policy, as well as higher oil prices, rapid growth in the United States, buoyant consumer spending, and healthy demand for investment goods. Growth is forecast to accelerate to almost 6½ percent in 2000 before falling back slightly in 2001, while inflation is projected to continue to decline as monetary policy is tightened. Higher oil prices are supporting the external position and the fiscal balance; however, procyclical fiscal policy, resulting in a deterioration in the non-oil fiscal balance, is of concern. Progress in needed banking system restructuring has taken place in the last few months, including the passage of new bankruptcy laws, successful asset sales and debt refinancing, and important steps to recapitalize the banking system (through, among other actions, consolidation and associated capital infusions). The new administration is continuing to address remaining vulnerabilities of the banking system, including the high proportion of illiquid assets in banks' balance sheets.

Figure 1.8. Selected Latin American Countries: Financial Developments

Inflation targets in Brazil, Mexico, and Chile have generally resulted in higher short-term interest rates and greater fluctuations in exchange rates. In most countries, reserves have been relatively stable.



Sources: Bloomberg Financial Markets, LP; IMF, *International Financial Statistics*; and WEFA, Inc.

[1]Three-month interbank rate.

[2]Pegged to U.S. dollar.

After a severe recession in 1999, the *Argentine* economy has begun to recover at a still gradual pace that, in the absence of external shocks, is expected to accelerate in 2001. Slower-than-expected recovery has adversely affected government revenue. Earlier this year, the authorities introduced a fiscal package that reduced planned government outlays to minimize the overshoot compared to the targeted deficit. This helped moderate concerns in international capital markets about fiscal slippages, although on average financial conditions remain tighter than in the latter part of 1999. Against these headwinds, real GDP is projected to grow by under 2 percent in 2000 and the current account deficit is anticipated to decline significantly. Continued structural reform in the fiscal area remains a high priority, including passing laws tightening tax administration, modifying revenue sharing arrangements with provinces, and reforming the social security system.

The Andean region, outside of Chile and Peru, was particularly hard hit by the 1998–99 recession. Activity is expanding again, but political uncertainties may slow progress on needed reforms and create pressures to relax macroeconomic policies. Business confidence remains weak in *Colombia,* in part due to continuing internal armed conflict, and the currency has fallen to record lows against the U.S. dollar, while in *Venezuela* the fiscal benefits of higher oil prices are being partially offset by increased spending. *Ecuador* plunged into a major economic and financial crisis in 1999, caused by serious policy slippages and the weakening of oil prices. Real output fell by 7¼ percent, inflation soared, and there was severe damage to the banking system. The government's rehabilitation strategy involves promoting monetary stability through dollarization, strengthening the fiscal position, restructuring household and corporate debt, and recapitalizing the banking system. The shift to dollarization appears to be succeeding, although substantial structural reform will be required to sustain it, and output is projected to rise moderately in the second half of 2000.

In the Caribbean, strong demand for tourism from the United States has helped to support activity. Growth remains strong in *Trinidad and Tobago*, partly reflecting some diversification of the economy into sectors such as manufacturing and services, while *Jamaica* is beginning to recover from a lengthy recession caused by financial sector difficulties and a severe drought. A major issue over the medium term is the appropriate recent moves to increase scrutiny of offshore financial centers, as the financial industry is an important part of the regional economy, particularly for *the Bahamas* (where 20 percent of employment is associated with financial services), *St. Vincent*, and *St. Kitts and Nevis*.

Asia: Continuing Strong Expansion

The rebound from the crisis of 1997–98 is continuing in Asia, with growth projected to rise from 6 percent in 1999 to more than 6½ percent in 2000 and 2001 (see Table 1.5). The rapid recovery of output in 1999 was fueled by continuing monetary and fiscal stimulus, as well as external demand, supported by a recovery in prices of electronics—Asia is now the world's largest supplier of such equipment. Continuing demand for information technology goods is expected to help underpin the expansion, but private domestic demand is projected to become a more important force propelling regional growth in 2000, particularly in the countries most advanced in recovery, where fixed investment is increasing rapidly (Figure 1.9). Activity also continues to be buttressed by continuing robust growth in the region's two most populous economies, China and India.

The recovery of activity in the countries most affected by the 1997–98 crisis is expected to continue, with growth in the countries where the recovery is least advanced still below that in their more advanced counterparts. Despite concern in financial markets about the pace of structural reforms, and more recent political uncertainties, growth in *Indonesia* is expected to accelerate to 4 percent in 2000 and 5 percent in 2001, supported by firm oil prices, while activity in *Korea* is

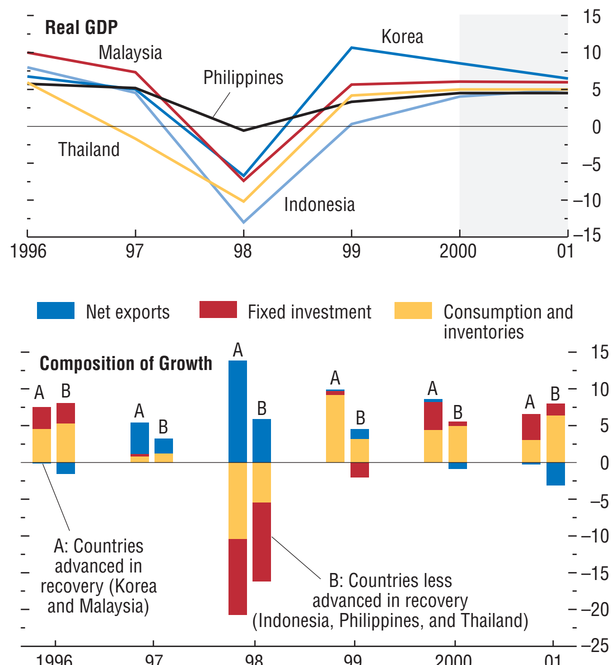
projected to moderate from its recent rapid pace to 8¾ percent in 2000 and 6½ percent in 2001. Fiscal policies have been generally supportive of activity, but are appropriately beginning to move to a more neutral stance. This process, which has already started in Korea, is being initiated in the Philippines this year, while elsewhere it is planned to start in 2001.

The export-led nature of the recovery has led to strong current account positions throughout the region, although surpluses are beginning to fall in response to domestic recovery and higher oil prices (except in Indonesia). External surpluses are helping to insulate parts of the region from some of the financial impact of tighter global monetary conditions, although again the distinction between the cyclically advanced and less advanced is important. Intervention continues to be used to limit the upward pressure on the exchange rate in Korea, and a further appreciation of the won would reduce the burden on interest rate policy in dampening inflationary pressures. In *Malaysia,* which maintains a fixed exchange rate, reserves continue to be strong. With inflation relatively quiescent and economic slack still present, domestic monetary policy remains accommodative in both countries, providing support for activity and assisting balance sheet restructuring in the banking and corporate sectors. By contrast, in economies where there are doubts about the authorities' commitment to structural reform, recoveries have been delayed, real interest rates are higher, and exchange rate pressures have been felt in recent months.

The key to ensuring that the vigorous recovery continues is to maintain the momentum of structural reforms and the attendant recovery in confidence and fixed investment. Although progress is being made in restoring fragile banking systems and restructuring corporate balance sheets, particularly in Korea and Malaysia, bank retrenchments have contributed to slow credit growth. In *Thailand,* about 35 percent of bank loans remain nonperforming and market sentiment has been depressed, reflecting concerns about the pace of debt restructuring as well as

Figure 1.9. Selected East Asian Countries: Real GDP Growth and Its Composition[1]
(Annual percent change)

In the countries most affected by the Asian crisis, growth rates are projected to converge as the recovery in fixed investment broadens.



[1]Data for 2000 and 2001 reflect IMF staff projections.

uncertainty related to the upcoming elections. In Indonesia, legal and political obstacles continue to slow the pace of restructuring, as demonstrated by the annulment of the government takeover of the bankrupt Bank Bali by IBRA, the government's restructuring agency.

Recent data indicate that *China*, the world's most populous economy, continues to grow at a robust pace. Real GDP growth is projected to increase to 7½ percent in 2000, supported by stronger private consumption and exports, and deflationary pressures are projected to diminish. Monetary policy is expected to remain accommodative. On the fiscal side, the authorities have announced a package of additional expenditures; however, buoyant revenues caused by strong activity are shifting policy to a more neutral stance. China's entry into the World Trade Organization (WTO), which will increase external competition in many areas (Box 1.3), underscores the need to accelerate reforms of state-owned enterprises and the banking system, whose financial situations remain difficult. A key element in this effort will be to ensure that the enterprises taken over by asset management companies are effectively restructured. Given that the Chinese economy is undergoing major structural changes, including the prospective WTO accession, a more flexible implementation of the current exchange rate arrangement (possibly involving a wider band) will be desirable at an appropriate time. The growth rate in *Hong Kong SAR* is expected to slightly exceed that in the mainland in 2000, as consumption and investment continue to recover despite continuing high levels of real interest rates caused by broad-based deflation of goods and asset prices.

India's economic performance has been remarkable in recent years, despite the adverse effects of the regional crisis on exports and the more recent hike in world oil prices, and growth is projected to rise to around 6¾ percent this year, reflecting continued strength in the information technology sector and a rebound in agricultural production. Nonetheless, significant policy challenges need to be addressed in order to sustain high growth and facilitate poverty reduction over the medium term. The fiscal situation has deteriorated markedly in recent years—with the overall public sector deficit estimated to exceed 11 percent of GDP in fiscal year 1999/2000—crowding out private sector investment and constraining funds for infrastructure and social programs. Against this backdrop, the central government's fiscal year 2000/01 budget, signs of continued fiscal stress among the states, and delays in bringing fuel prices to import parity suggest the risk of little or no fiscal adjustment in the coming year. The large government borrowing requirement has complicated the conduct of monetary policy, and the central bank raised interest rates in July in the face of exchange rate weakness and a rebound in inflation. Structural reforms in the agricultural and industrial sectors are also needed to reduce the role of government and allow the private sector to reap the full benefits of the growing globalization of goods and capital markets. In *Pakistan*, nonagricultural activity continues to be weak, and disappointing levels of tax revenue have put pressure on the fiscal position. The external sector remains fragile; reserves have continued to decline from already low levels and the Pakistani rupee has come under significant pressure following the depreciation of other regional currencies. As in India, unshackling the economy from government regulation and moving ahead forcefully with structural reform would help promote export-led growth and increase confidence both at home and abroad.

In *Australia* and *New Zealand*, the monetary policy tightening launched in late 1999 has contributed to a slowing of domestic demand. The momentum in these economies, however, is expected to be maintained by rising external demand, supported by depreciated exchange rates, accelerating growth in the rest of the world, and a pickup in some commodity prices. The rebalancing of demand from domestic to external sources and the recovery of commodity prices is expected to reduce large existing current account deficits—in New Zealand the current account deficit reached a record high of 8 percent

Box 1.3. China's Prospective WTO Accession

After 14 years of negotiations, China has reached bilateral agreements on the terms of its entry to the World Trade Organization (WTO) with most of the trade partners participating in accession negotiations, including the United States and the European Union. Over the past two decades, the opening up of the external sector has been a key element of China's economic reforms, which have now entered a critical stage, with a focus on the interlinked reforms of the state-owned enterprise and financial sectors. WTO accession could prove to be a watershed for reform. It promises to increase foreign direct investment, remove protection from inefficient industries, and spur the development of the legal and regulatory framework necessary for a market economy. It will also serve as an impetus to domestic banks to accelerate their restructuring efforts and improve efficiency. To meet the challenges of international competition, a further acceleration of reform—accompanied by a strengthening of the social safety net and narrowing regional disparities—has become even more urgent.

Content of the China-U.S. Bilateral Agreement

So far, only limited information has become available to assess the economic impact of China's accession to the WTO, but the bilateral agreement with the United States (which has been made public) is widely regarded as the core of the likely final agreement. The main details of the China-U.S. agreement are:

- China will reduce tariffs on nonagricultural products (which account for 95 percent of total imports) from about 17 percent to 9.4 percent by 2005, and lower tariffs on agricultural products to 17 percent by January 2004;[1] eliminate quotas and nontariff restrictions on industrial products by 2005; introduce a tariff rate quota system in agriculture; and provide full trading and distribution rights to foreign firms.
- China will significantly expand market access in the services sector, including by eliminating geographic and other restrictions in most key sectors by 2005; increasing foreign ownership limits in telecommunications (50 percent by 2002), life insurance (50 percent on accession), and securities (49 percent by 2003); and giving full national treatment to foreign banks (within five years after accession). Some of these phase-in periods were reportedly accelerated in the EU negotiations.
- The United States will eliminate quotas on China's textile imports under the WTO Agreement on Textiles and Clothing (previously known as the Multi-Fiber Arrangement) by 2005, subject to anti-surge provisions, which are yet to be specified) through 2008, and give China Permanent Normal Trade Relations (PNTR) status.

It is possible that WTO accession could take place in 2000, but to complete the accession process China needs to conclude a few more bilateral agreements, finish multilateral negotiations consolidating all the bilateral agreements into a single protocol of accession, and modify its laws and regulations to be consistent with its obligations under the WTO and the protocol of accession. It is therefore likely that the economic impact of China's entry to the WTO will not begin to be felt until 2001.

Potential Economic Impact

The IMF staff's projections—while subject to large uncertainties—suggest the macroeconomic impact of accession should be manageable in the near term, and that there will be considerable long-term gains. With the affected sectors accounting for only a small portion of output and

[1]There is some uncertainty with regard to the tariff reductions implied by WTO accession, because the base rate of applied tariffs is not known with certainty, nor is it clear whether the new tariff levels are simple or weighted averages. For the calculations of the economic impact of WTO accession, the following World Bank estimates of weighted average tariffs in 1998 are used: 20 percent for agricultural products and 18½ percent for manufactures (corresponding simple averages are estimated to be 18 percent and 17½ percent, respectively).

Box 1.3 *(concluded)*

China: Differences Between WTO and Non-WTO Scenarios

	2001	2002	2003	2004	2005
			(Deviation in percentage points)		
Real GDP growth	–0.3	0.1	0.6	0.6	0.8
			(Deviation in billions of U.S. dollars)		
Current account balance	0.2	–5.7	–12.4	–21.0	–10.5

Source: IMF staff estimates.

trade, the initial adverse impact on GDP growth and the external current account should be small. Indeed, the structure of China's trade suggests that WTO accession is likely to affect only about 40 percent of present trade flows, since the remaining 60 percent is processing trade, which is largely exempt from tariffs. (Trade, defined as the sum of exports and imports, is about 40 percent of output.) Nevertheless, between 2000 and 2004, the external current account could weaken—relative to a baseline scenario in which China does not accede—as tariff reductions will result in higher import demand (see the Table). In 2005, however, this trend should begin to be reversed as the quota elimination under the WTO Agreement on Textiles and Clothing will provide a boost to exports of textiles and apparel. Any deterioration in the external current account should be largely offset by higher foreign direct investment—especially in the services sector—so that the overall balance of payments may not be greatly affected and will effectively remain in surplus.

In the immediate future, WTO accession will increase competitive pressures in a number of sectors, including agriculture, automobiles, certain capital intensive sectors (including telecommunications), and the banking system. As the effects of increased competition feed through into efficiency gains, total factor productivity growth should rise, reversing the decline witnessed in recent years. Moreover, from 2005, China's textile sector will benefit significantly from the elimination of quotas.

While output growth is expected to fall only slightly in the first year following accession relative to baseline, labor market pressures—especially in the labor intensive agricultural sector—and income distribution problems could increase in the next few years, underscoring the need to strengthen the social safety net and to develop rural and inland regions. One study estimates that an additional 2 percent of the workforce—comprising 13 million workers in rural areas and about 1¼ million workers in urban areas—will need to be reemployed in other sectors over the next five years.[2] Nevertheless, employment growth should pick up over time, as the positive effects of trade liberalization are felt. Additional challenges will come from the need to address rural/urban and coastal/western income disparities.

Given the size of China's economy, the impact of its entry to the WTO is expected to extend beyond the mainland. The boost in China's exports will benefit Hong Kong SAR, because of its reliance on entrepôt trade to and from the mainland, although, as the mainland ports become more efficient, Hong Kong SAR's entrepôt role is likely to diminish. In addition, structural reforms related to WTO accession will increase the mainland's demand for services (such as financial, accounting, and legal services), which Hong Kong SAR is well positioned to provide. Over the longer term, however, Hong Kong SAR may face increased competition as a financial center from Shanghai.

[2]Shoukang Li and Fan Zhai, "China's WTO Accession and Implications for National and Provincial Economies" (unpublished; People's Republic of China: Development Research Center of The State Council, October 1999).

Table 1.6. Commonwealth of Independent States and Countries on the European Union Accession Track: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	1998	1999	2000	2001	1998	1999	2000	2001	1998	1999	2000	2001
Commonwealth of Independent States	**–2.7**	**2.7**	**5.6**	**3.8**	**25.0**	**70.8**	**22.9**	**16.2**	**–1.6**	**6.8**	**9.2**	**5.2**
Russia	–4.9	3.2	7.0	4.0	27.7	85.9	18.6	13.8	0.4	11.3	13.4	7.9
Armenia	7.2	3.3	4.5	6.0	8.7	0.7	0.8	3.0	–20.6	–14.8	–13.4	–12.3
Azerbaijan	10.0	7.4	5.0	7.9	–0.8	–8.3	2.2	3.0	–32.8	–15.9	–12.6	–21.5
Belarus	11.6	–2.4	–6.3	–0.6	73.0	293.7	156.0	83.0	–5.9	–2.2	–7.6	–6.3
Georgia	2.9	3.3	4.0	5.0	3.6	19.1	4.6	7.5	–15.1	–11.7	–9.9	–6.8
Kazakhstan	–1.9	1.7	5.0	4.0	7.3	8.4	13.2	7.5	–5.6	1.1	4.9	2.2
Kyrgyz Republic	2.1	3.6	4.0	4.2	10.3	35.7	22.7	14.6	–19.8	–16.3	–11.2	–9.8
Moldova	–6.5	–4.4	—	4.0	7.7	39.3	28.5	12.5	–17.3	–1.5	–3.2	–3.1
Tajikistan	5.3	3.7	5.0	5.0	43.2	27.6	17.2	7.3	–9.3	–3.4	–3.2	–4.8
Turkmenistan	5.0	16.0	15.9	6.4	16.8	23.5	13.9	35.0	–27.7	–16.0	–9.7	–30.5
Ukraine	–1.9	–0.4	2.5	3.5	10.6	22.7	26.0	14.7	–3.1	–0.1	–2.1	–1.6
Uzbekistan	4.3	4.4	3.0	3.0	29.0	29.1	26.2	21.6	–0.8	–0.1	–0.3	0.1
European Union accession track	**2.4**	**–0.3**	**4.1**	**4.8**	**35.6**	**25.8**	**23.2**	**10.4**	**–2.9**	**–3.9**	**–4.7**	**–4.3**
Bulgaria	3.5	2.4	4.5	5.0	22.3	2.1	7.9	4.5	–0.5	–5.4	–4.6	–3.9
Cyprus	5.0	4.5	4.8	4.3	2.2	1.8	5.4	5.6	–6.7	–2.6	–2.3	–2.1
Czech Republic	–2.2	–0.2	2.3	3.2	10.6	2.1	4.9	4.1	–2.4	–2.0	–3.4	–3.3
Estonia	4.7	–1.1	4.0	6.0	8.2	3.3	3.0	2.7	–9.2	–6.1	–5.9	–6.1
Hungary	4.9	4.5	5.5	5.0	14.3	10.0	8.3	6.5	–4.9	–4.3	–4.5	–4.4
Latvia	3.9	0.1	4.0	6.0	4.7	2.4	3.5	2.7	–10.1	–9.7	–8.6	–7.7
Lithuania	5.1	–4.1	2.5	4.0	5.1	0.8	1.6	2.1	–12.1	–11.2	–7.4	–6.9
Malta	3.1	3.5	3.2	4.3	2.4	2.5	2.5	2.5	–4.9	–3.7	–3.9	–3.7
Poland	4.8	4.1	5.0	5.5	11.8	7.3	9.5	6.9	–4.4	–7.5	–7.4	–7.0
Romania	–5.4	–3.2	1.3	3.0	59.1	45.8	40.2	19.4	–7.2	–3.8	–3.9	–3.8
Slovak Republic	4.4	1.9	2.4	3.5	6.7	10.7	12.1	6.0	–10.4	–5.7	–4.7	–3.9
Slovenia	3.9	4.9	4.5	4.6	8.0	6.1	7.5	5.0	—	–2.9	–2.3	–2.5
Turkey[3]	3.1	–5.0	4.5	4.8	84.6	64.9	46.5	17.0	1.0	–0.7	–3.1	–2.4

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]For consumer price inflation, projections for 2000 and 2001 are based on program targets.

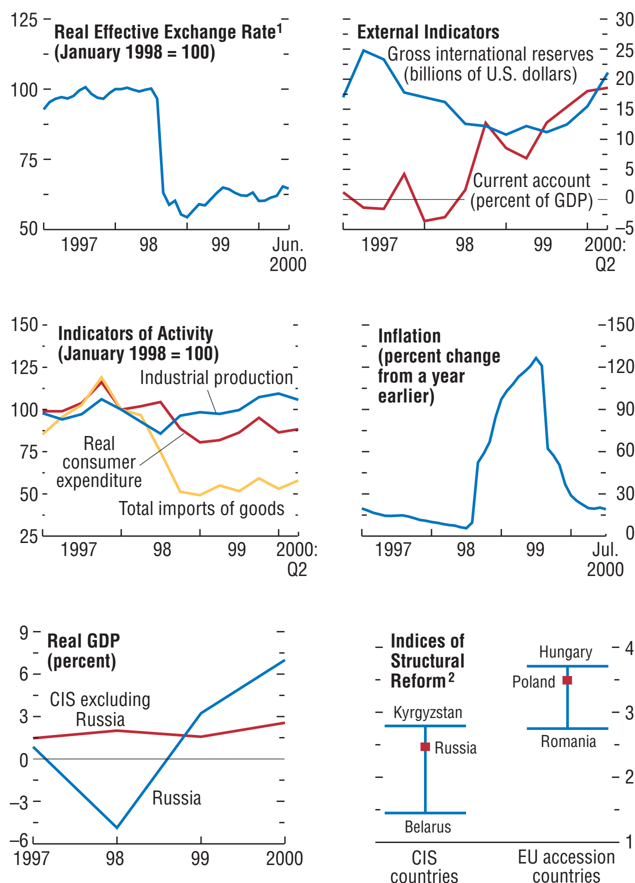
of GDP in 1999 and continues to be a concern in currency markets. Key structural policy initiatives in Australia include reforms of the business tax regime, the introduction of a uniform goods and services tax to replace a wide range of indirect taxes, and additional labor market reforms. Following a long period of wide-ranging reforms aimed at increased flexibility, openness, and market-orientation, the new government in New Zealand is contemplating a somewhat different course, including a greater role for industrial policy, increased trade union power, higher income taxes, and a freeze in unilateral tariff reductions.

Commonwealth of Independent States: Will Macroeconomic Improvements Accelerate Structural Reform?

The Russian economy has proved much more buoyant than anticipated, as the benefits from higher world oil prices and a competitive exchange rate have started to be felt in the broader economy. Greater-than-expected Russian domestic demand and (in some cases) higher world energy prices are providing support for most of the rest of the Commonwealth of Independent States (CIS) (Table 1.6). Progress on structural and institutional reforms generally remain well behind

Figure 1.10. Russia: Signs of a Strong Recovery

Rising oil prices and a depreciated exchange rate have strengthened Russia's external position, leading to a recovery in activity. Russia's revival is supporting activity elsewhere in the Commonwealth of Independent States (CIS), but reforms still lag compared to countries being considered for EU membership.



Sources: European Bank for Reconstruction and Development, *Transition Report 1999* (London: EBRD, 1999); IMF, *International Financial Statistics;* and IMF staff calculations.

[1]Defined in terms of relative consumer prices based on 1988–90 trade weights.

[2]This is an average of eight indices of structural reform produced by EBRD, as linearized by the staff. A value of 1 indicates no change from conditions under central planning, while 4⅓ indicates a structure equivalent to a typical advanced economy.

the norm set by central and eastern Europe, although conditions vary across countries (see Chapter III). Improved short-term macroeconomic prospects and the associated increase in government revenues provide an opportunity for more rapid progress on the often costly structural reforms needed to secure longer-term prosperity. Unfortunately, in some cases the opposite result appears to be occurring, with the cyclical upswing reducing the commitment to fundamental change.

The *Russian* economy is continuing its rapid recovery from the financial crisis of 1998 (Figure 1.10). After expanding by 3.2 percent in 1999, real GDP growth accelerated further in early 2000 and is now above pre-1998 crisis levels. Much of the growth in 1999 was driven by favorable terms of trade shocks whose benefits were initially expected to be temporary—namely, rising prices of energy exports and import compression due to the crisis-induced real exchange rate depreciation (real imports fell by almost 30 percent in 1999). In the event, however, improving external earnings seeped through to the domestic economy. Investment and non-oil exports began to strengthen during 1999, followed more recently by increased consumption and imports. Rising real wages, reductions in arrears, and lessening use of barter all point to continued improvements in activity. Real growth is now forecast at 7 percent in 2000 and 4 percent in 2001, much stronger than in the May *World Economic Outlook.*

Higher energy prices, import compression, and increasingly buoyant growth in non-energy exports have resulted in a strong external position. The current account surplus in 1999 was more than 10 percent of GDP and is expected to rise in 2000, and capital flight, while still sizable, appears to be falling. The central bank has been resisting the associated upward pressure on the exchange rate through large-scale intervention, and has found it increasingly difficult to sterilize such interventions. Some further nominal appreciation of the ruble should be considered to deal with the strong balance of payments position and to offset inflationary pressures. On the fiscal

front, the buoyancy of output and energy prices has led to a dramatic improvement in the financial position of all levels of government.

Longer-term economic prospects continue to depend upon accelerating the slow pace of structural reform. The new 18-month reform plan of the government has many encouraging features, including measures to accelerate enterprise restructuring, strengthen the investment climate, and a tax policy reform package. However, implementation remains crucial. For example, it will be important to ensure that any net revenue costs of tax reforms are offset by expenditure restraints, particularly as the budget is likely to be burdened by significant reform-related expenditures in the coming years, including the costs of bank restructuring. Little progress has been achieved in shutting down insolvent banks, and the financial review of the government-owned saving bank (Sberbank) has yet to be completed. Other priorities include a revision of the bankruptcy law and measures to reduce barter and arrears caused, at least in part, by the use of the energy sector as a vehicle for off-budget subsidies to loss-making enterprises and underfunded social institutions.

The revival of activity in Russia is particularly benefiting close trading partners, such as *Ukraine*. Indeed, Ukraine is expected to grow for the first time since the start of transition, but progress on structural reform remains slow. It will be important to ensure that the banking system is restructured in an effective manner, cash collection in the energy sector increased, and the privatization program proceeds transparently. The successful completion of a private debt restructuring in April has helped to stabilize the external position, although the outlook remains difficult. Structural reforms are even less advanced in *Belarus*, where macroeconomic stability remains elusive, with inflation projected to remain in triple digits through 2000.

Elsewhere in the region, *Kazakhstan*, *Azerbaijan*, and *Turkmenistan* have received boosts from higher prices of energy and other commodities. In Kazakhstan the consequent improvement in the external position and recent discovery of significant additional oil reserves has led to significant repayment of external debt (including all obligations to the IMF) and to a diminished appetite for structural reforms. Other countries in the region are less well placed to benefit from higher commodity prices, and many continue to suffer from more fundamental weaknesses. In particular, high levels of external debt and the slow pace of structural reforms continue to hobble economic activity in *Georgia, the Kyrgyz Republic, Moldova,* and *Tajikistan* (see Chapter III).

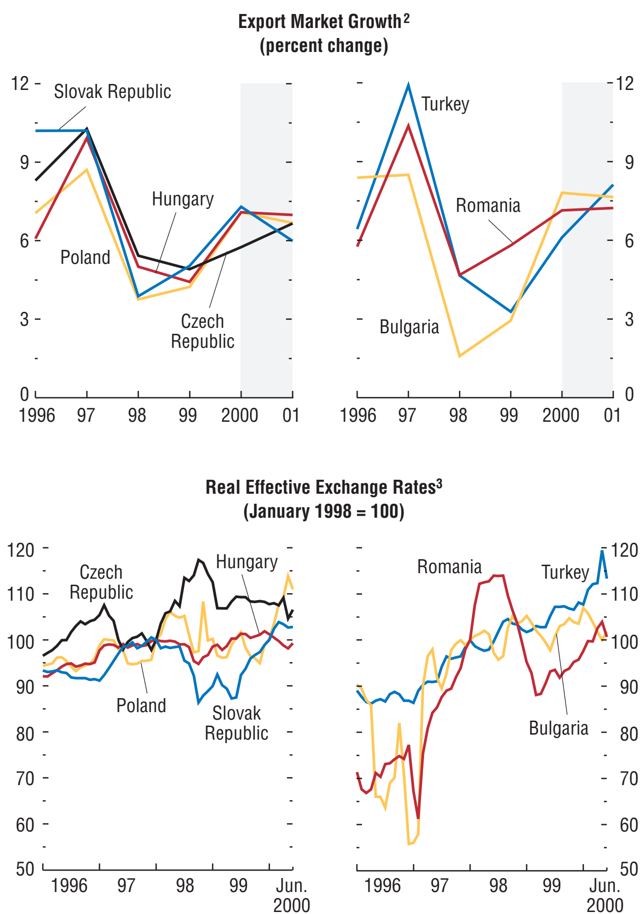
Sustaining the Momentum in Countries on the European Union Accession Track

Economic activity is expected to strengthen in 2000 and 2001 in the countries on the European Union (EU) accession track, with increasing and positive output growth and declining or moderate (single-digit) inflation in nearly all of the countries (see Table 1.6). The recovery in activity after the crises of the past few years has been bolstered by the upswing in exports to western Europe, as growth has strengthened there, and by better-than-expected performances in Russia and the other CIS countries, which have helped to improve confidence in the region (Figure 1.11). The stronger outlook can also be attributed to generally sound macroeconomic policies and to progress made on structural reforms.

Nevertheless, the relatively large—and in some instances, growing—external current account deficits in most of these countries have raised concerns. In part, these deficits reflect sizable capital inflows that have led to the appreciation of the real exchange rate and made monetary policy more difficult, as well as the rise in oil prices. Accommodative fiscal policies also contributed to the deficits in a few instances. To reduce the vulnerability of these economies to a reversal in financial market sentiment, particularly as capital accounts are liberalized as part of the EU accession process, countries need to ensure fiscal and monetary discipline and continue progress on structural reforms—particularly, in the development of

Figure 1.11. Selected European Countries: Export Market Growth and Real Effective Exchange Rates[1]

Export market growth has accelerated for EU accession countries, many of which face rising real effective exchange rates.



Source: IMF staff estimates.
[1]Shaded areas indicate IMF staff projections.
[2]Growth of partner country goods imports excluding oil.
[3]Defined in terms of relative consumer prices based on 1988–90 trade weights.

the financial sector and other institutions, as well as in privatization, labor market adjustment, and business restructuring. The major medium- and longer-term challenges facing most of the countries as they prepare for full membership in the European Union are discussed further in Chapter IV.

Growth is projected to increase to over 5 percent in Hungary and Poland in 2000 and 2001 after a very mild slowdown in 1999. The stronger-than-expected growth in *Hungary* has been fuelled by exports and investment, as well as by sound macroeconomic policies and substantial progress in structural reforms. The current account deficit has narrowed against a background of strong export growth and a tightening of fiscal policy. Meanwhile, in the face of strong demand, the pace of disinflation has stalled—after the inflation rate had fallen from 14 percent in 1998 to under 10 percent earlier this year. The official objective of achieving annual average inflation of 6 to 7 percent in 2000 is likely to be missed and the authorities may need to tighten monetary conditions through, among other measures, greater exchange rate flexibility, accompanied by fiscal tightening to avoid additional pressure on the external current account.

In *Poland*, output growth has been strong and the current account deficit has remained at 7½ percent of GDP in the first four months of this year, while inflation overshot its end-1999 target by 2 percentage points and the general government deficit exceeded its 1999 target by 1 percent of GDP. In response, the Monetary Policy Council has raised interest rates sharply since late 1999. In April, the central bank removed its exchange rate trading band and allowed the zloty to float freely to maintain its sole focus on inflation targeting. International reserves remain relatively high at more than seven months of imports and 350 percent of short-term debt, and the banking sector, which is largely foreign owned, remains sound. However, with the current account deficit projected to remain above 7 percent of GDP through the end of 2000 and perhaps beyond, the authorities

need to follow through on proposed plans to reduce the general government deficit, which was 3¾ percent of GDP in 1999.

In the other accession candidates, where the slowdown in economic activity was more severe in recent years, output growth is expected to rebound in 2000 and generally increase further in 2001. Among these countries, Bulgaria and the Slovak Republic suffered relatively mild slowdowns in 1999, while the Baltic countries suffered sharper, although also short-lived, slowdowns largely because of closer trade ties with Russia. In *Bulgaria*, which is projected to grow almost 5 percent annually in 2000 and 2001, the relatively strong performance reflects substantial macroeconomic reforms since 1997 that have been underpinned by the currency board arrangement and complemented by progress in structural reforms—particularly, wage restraint in state enterprises, enterprise restructuring, and privatization. In the *Slovak Republic*, the slowdown in GDP growth in 1999 was limited by strong export growth—reflecting gains in competitiveness associated with the depreciation of the koruna in the first half of the year and strong productivity growth in exporting industries. With the government deficit likely to increase this year, further tightening of macroeconomic policies may be needed. In the Baltic countries—*Estonia*, *Latvia*, and *Lithuania*—the economic recoveries that generally began in the latter part of 1999 are projected to continue in 2000 and 2001. The slowdown in activity was deeper in Lithuania because of the relatively large appreciation of the exchange rate (which is pegged to the U.S. dollar) in effective terms and greater reliance on trade with Russia, and because an earlier period of expansionary fiscal policies has resulted in the need for greater fiscal adjustment.

After three consecutive years of negative growth, output is also projected to rebound in the Czech Republic and Romania. The recovery in the *Czech Republic* has been aided by accommodative monetary and fiscal policies, although the ongoing restructuring of the banking and traditional corporate sectors continues to act as a drag, partly by contributing to a credit crunch and high unemployment. In *Romania*, the rebound follows a determined adjustment effort in 1999—including large corrections of the fiscal accounts and the exchange rate—that has significantly strengthened the external position. The recent financial sector problems in both of these countries, however, highlight the need to continue to implement structural reforms as well as maintain macroeconomic discipline to ensure lasting and durable recoveries.

Following the recession last year, output growth in *Turkey* is projected to rebound in 2000. The recovery is attributable to several factors, including reconstruction following the earthquakes, stronger growth in exports to western Europe and Russia, a rebound in tourism, falling interest rates, and improving business and consumer confidence. Underpinning many of these factors has been the successful initial implementation of an ambitious IMF-supported stabilization program that has already achieved a higher-than-targeted primary consolidated government surplus, a rapid reduction in real interest rates, and falling inflation.[6] Nonetheless, partly because of rising oil prices, inflation in the first few months of the program was higher-than-targeted and the external current account deficit has widened more rapidly than expected. To mitigate any risks stemming from the higher-than-programmed inflation and from an increasing current account deficit, the government has decided to lock in additional fiscal savings that are projected to arise in 2000 and ensure that primary fiscal expenditures do not increase in real terms in 2001. In addition, the government intends to press forward with the structural reform agenda—including banking sector reform, reduction of agriculture support programs, and privatization of some public enterprises.

[6]See Box 2.1, "Turkey's IMF-Supported Disinflation Program," in the May 2000 *World Economic Outlook* for a more detailed description of the program.

Table 1.7. Selected Middle Eastern and 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]			
	1998	1999	2000	2001	1998	1999	2000	2001	1998	1999	2000	2001
Middle East[3]	**3.1**	**2.8**	**4.8**	**3.6**	**9.3**	**7.9**	**7.4**	**7.1**	**–6.1**	**1.0**	**8.3**	**4.6**
Egypt	5.6	6.0	5.0	4.5	4.7	3.8	2.9	3.0	–3.1	–2.0	–1.8	–1.8
Iran, Islamic Republic of	2.2	2.5	3.4	4.0	20.0	20.4	16.0	13.0	–2.2	5.0	7.7	3.4
Jordan	1.7	1.6	3.0	3.5	3.1	0.6	2.5	3.1	0.3	5.2	3.4	1.5
Kuwait	2.0	–2.4	3.6	2.0	0.5	1.9	1.5	2.5	10.0	16.5	28.7	24.4
Saudi Arabia	1.6	–1.0	3.5	2.9	–0.2	–1.2	1.0	1.9	–10.2	–1.2	6.6	1.6
Africa	**3.1**	**2.2**	**3.4**	**4.4**	**9.1**	**11.8**	**12.7**	**8.6**	**–4.8**	**–3.9**	**–0.8**	**–2.0**
Algeria	5.1	3.3	4.3	4.2	4.9	2.6	1.0	2.0	–1.9	0.0	12.6	10.3
Cameroon	5.0	4.4	4.2	5.3	–0.0	2.9	2.0	2.0	–2.7	–4.3	–2.4	–2.8
Côte d'Ivoire	4.5	2.8	2.2	4.5	4.5	0.7	2.5	2.5	–3.9	–4.0	–5.4	–4.0
Ghana	4.7	4.4	4.0	4.5	19.3	12.4	14.7	10.0	–4.7	–10.6	–8.5	–4.9
Kenya	2.1	1.5	1.6	3.3	6.6	3.5	5.2	5.0	–4.8	–3.2	–4.0	–6.8
Morocco	6.8	–0.7	2.4	5.0	2.7	0.7	2.3	2.0	–0.4	–0.8	–2.3	–1.6
Nigeria	1.9	1.1	3.5	3.6	10.0	6.6	5.1	6.9	–8.7	–11.0	2.4	–3.0
South Africa	0.6	1.2	3.0	4.0	6.9	5.2	4.7	5.9	–1.6	–0.4	–0.7	–1.3
Tanzania	3.3	4.6	5.2	5.6	12.6	7.9	5.7	4.4	–14.2	–14.8	–15.3	–15.4
Tunisia	5.0	6.2	5.0	6.0	3.1	2.7	3.5	3.0	–3.4	–2.0	–3.4	–3.5
Uganda	5.5	7.8	5.0	6.1	5.8	–0.2	6.3	5.6	–5.6	–7.4	–7.9	–7.9

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Middle East and Europe *World Economic Outlook* grouping excluding Cyprus, Malta, and Turkey.

Middle East and Africa: Recovering but Vulnerable to Commodity Price Cycles

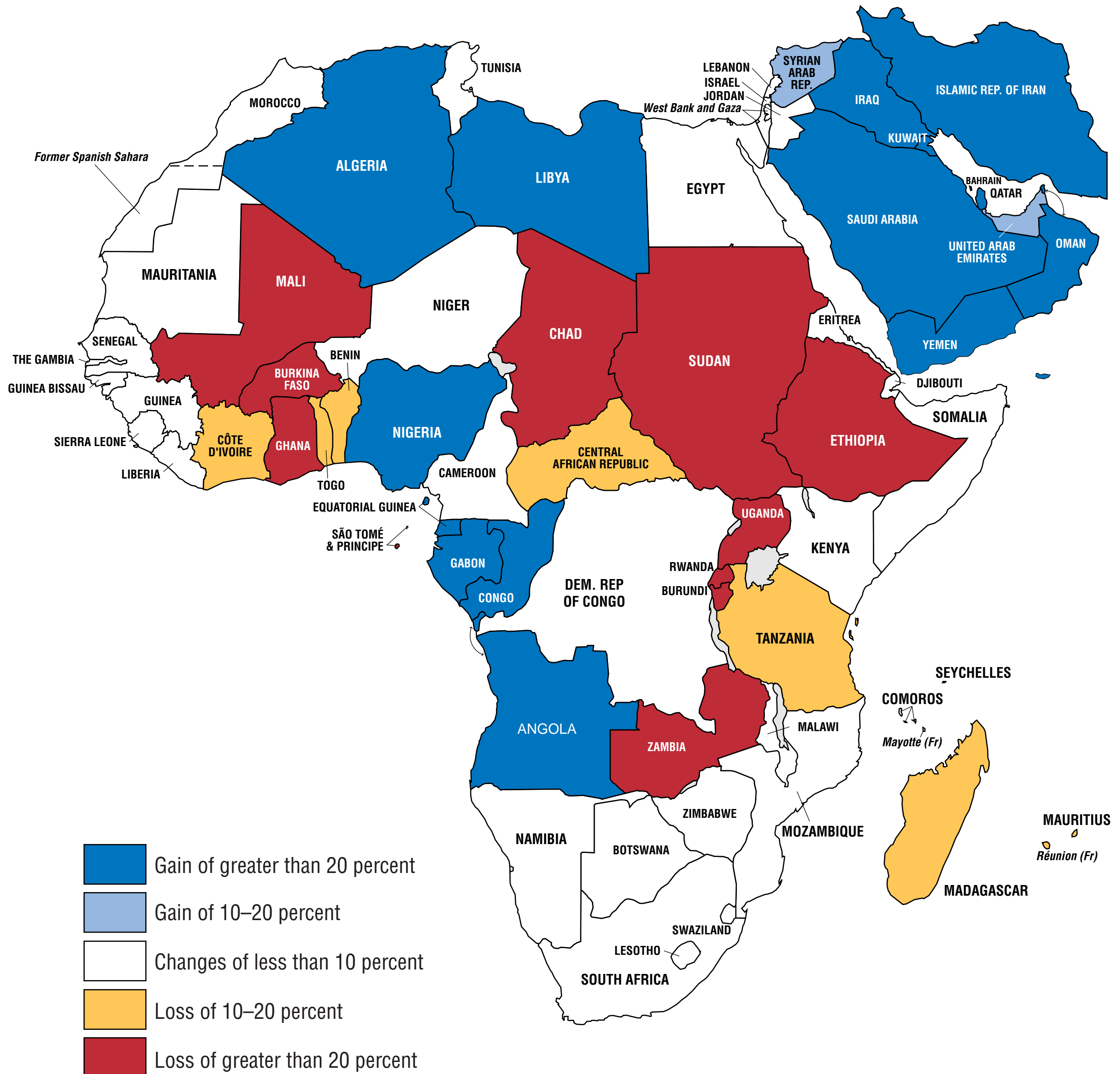
In recent years, economic developments in many Middle Eastern and African countries have been shaped importantly by external factors, including changes in commodity prices and growth in export markets. During 1999–2000, the rebound in world oil prices, as well as recent increases in OPEC oil production quotas, have boosted economic activity and prospects for most of the oil-producing countries in the Middle East and Africa (Table 1.7 and Figure 1.12). The rise in oil prices and oil output have led to stronger fiscal and external balances in these countries and also to improved confidence and greater domestic demand. Many of the non-oil-producing countries in the region, however, have faced substantial terms-of-trade losses as export prices of nonfuel commodities and other primary goods remain generally depressed, particularly in real terms, while oil import prices have risen (see Chapter II for a more detailed discussion). Nonetheless, growth in a number of these countries has rebounded in the past year because of appropriate macroeconomic policies and reform efforts that have made economic activity more broad based and allowed these countries to benefit from stronger export market growth. By contrast, in countries that have followed poor policies and in some instances suffered other adverse shocks—including armed conflicts and drought—economic performance has been weak.

The recent fluctuations in commodity prices again highlight the vulnerability of almost all of the countries in the region to changes in prices of primary goods. Reforms continue to be needed to liberalize and diversify these economies and to encourage broad-based, labor-intensive growth led by the private sector, focused on industries in which these countries have a comparative advantage. In addition, in some countries, fiscal policy needs to be conducted in a less procyclical fashion so as not to exacerbate the boom and bust cycles in these commodity-dependent countries.

The international community will need to continue to bolster these efforts through ongoing

Figure 1.12. Africa and the Middle East: Terms of Trade Impact of Commodity Price Changes[1]

Terms of trade have improved substantially for oil-exporting countries but have deteriorated for many other countries, particularly in areas of central Africa that rely on nonfuel commodity exports.



[1]Calculated based on the change in commodity prices for 2000 relative to the 1995–97 average, weighted by the commodity's share in total trade.

support for debt relief and the HIPC initiative, as well as increasing efforts to open their markets to the products of poor countries—such as reducing import restrictions on agricultural products and textiles—and to reverse the downward trend in advanced countries' official development assistance. Of growing concern are the potentially catastrophic human and economic consequences of the HIV/AIDS epidemic in Africa (Box 1.4). Government, society, and the international community will need to expand substantially efforts to address the threat from this and other infectious diseases through effective education, health, and other social programs.

In the Middle East, economic growth among the Gulf oil exporters is projected to turn positive in 2000 and remain so in 2001. Despite the improvement in growth prospects, as well as external and fiscal balances, many of these countries are pressing ahead, albeit sometimes slowly, with structural reforms to boost the non-oil private sector that were initiated when much lower oil prices threatened macroeconomic stability. For example, in *Saudi Arabia*, the government is restructuring and corporatizing the telecommunication and utility sectors to make them more attractive to private investment, as well as revising laws and regulations to improve the business environment and attract foreign investment and expertise. In *Kuwait*, a package of structural reforms aimed at laying the foundation for higher private sector-led growth and employment creation has been partially passed by parliament. In the *Islamic Republic of Iran*, although the external and fiscal positions improved sharply owing to the rise in oil prices, output growth remains constrained by structural distortions, and unemployment and inflation remain high. Promised reforms, which are being implemented at a cautious pace, will focus on encouraging private sector investment as the primary source of growth and employment through more market-based exchange rate and interest rate policies and by opening up to foreign investment.

Annual output growth in *Egypt* is projected to slow in 2000 while inflation, currently about 3 percent, remains in check. Until recently, rapid domestic credit growth and unfavorable external developments—including the appreciation of the effective exchange rate as a result of the de facto peg to the U.S. dollar—had led to pressures on the external accounts, substantial loss of external reserves, and illiquidity in the foreign currency market. With a tightening of fiscal and credit policies and an improved external environment more recently, the pressures on the external accounts have declined somewhat, and the loss of foreign reserves has slowed. A continuation of the recent tightening of monetary and fiscal policies is needed to further ease the pressures on the balance of payments, while progress on structural reforms, which has slowed, will need to be accelerated to support continued rapid growth.

In *Israel*, the modest economic recovery now under way is projected to strengthen further in the next two years, led by exports, particularly from the high technology sector. Growth in private domestic demand is also expected to increase because of improved confidence and lower interest rates, with monetary policy being gradually eased as inflation remains below or near the lower bound of the 3 to 4 percent inflation target. In view of the still high public debt (103 percent of GDP), continued progress with fiscal consolidation is needed.

Annual output growth in Africa is projected at 3½ percent in 2000, rising to 4½ percent in 2001, spurred by rebounds in South Africa and the oil-exporting countries, as well as continued strength in some of the smaller economies. In *South Africa*, the continent's largest economy, the economic recovery, while still fragile, is gaining momentum, with output on track to grow 3 to 4 percent in each of the next two years. The rebound has been supported by a strengthening of public finances, improvements in external competitiveness, and the expansion in world output. The rand has come under some pressure since the beginning of this year largely as a result of the fallout from the turbulence in Zimbabwe and decreased relative bond yields, but progress continues to be made in reducing the net open forward position of the Reserve Bank, which has

Box 1.4. The Economic Impact of HIV/AIDS in Southern Africa

At the end of 1999, 33.6 million people were living with HIV/AIDS, of which some 25 million are in Africa. Within this, the highest rates of infection are in southern Africa. The Joint United Nations Program on HIV/AIDS (UNAIDS) estimates that about 36 percent of the adult population in Botswana, 25 percent in Zimbabwe and Swaziland, and 20 percent in South Africa and Zambia are infected; this compares to a prevalence rate of 8.6 percent for sub-Saharan Africa and 1.1 percent for the world as a whole. By 2010, the U.S. Census Bureau predicts that life expectancy will fall from about 60 years to around 30 years for the worst affected countries, and that the rate of population growth will stagnate or turn negative for several countries in the subregion (see the Table).[1] The social and economic implications will be far reaching and long-lasting, both through the huge toll in human lives and the dislocation of society that will result. In particular, the epidemic is affecting the social structure of local communities by disrupting existing social networks and traditional support mechanisms. It is also creating a generation of orphans—which could reach up to 10 percent of the population in some countries—who may grow up without the support and guidance of adults.

This box briefly discusses the potential macroeconomic implications of the HIV/AIDS pandemic, which will also be extremely serious. As discussed below, there will be substantial effects on a broad range of economic variables, including GDP growth, poverty and income inequality, labor supply, domestic saving, productivity, and human, physical, and social capital.[2] Since HIV/AIDS has a long incubation period, the impact of the disease will be gradual, and its full effects in most countries have yet to be felt.

Initially, the main impact will be felt in the public sector, as health care and other expenditures increase, revenue bases are eroded, and public sector workers are lost. The Table provides estimates of the demand in 1999 (based on local health standards) for HIV/AIDS-related health services in some of the affected countries; these are substantial, accounting for between 20 and 90 percent of health budgets. Even if only a proportion of HIV/AIDS patients are treated, the strains on the health sector as a whole will be severe and will likely lead to increased rationing of treatment for both HIV and non-HIV related illnesses. It is important to note that these estimates do not include the cost of modern combination therapies. If the latter could be made available to even 10 percent of those infected with HIV at an annual cost of $5,000 each, the total cost would range from 1.6 percent of GDP (South Africa) to 14.5 percent of GDP (Mozambique). This could only be financed with considerable outside assistance.

HIV/AIDS will have a number of other direct effects on the public sector. The early loss of qualified employees will result in a decline in productivity and the quality of public services, and countries will find it difficult to replace highly trained public servants such as doctors and teachers who fall victim to HIV/AIDS. In addition, the costs of absenteeism will be significant. In some countries, government employees may take up to one year of sick leave. This is likely to result mainly in a deterioration in the quality of public services, rather than an increase in personnel costs, as staff are not replaced speedily. The impact on public sector pension funds will also be substantial. While fewer government employees will reach retirement age, so pension expenditures will decline—by up to 3 percent of the public sector payroll in the worst affected countries—death-related benefits and pensions for surviving dependents may well rise to 5 percent of the government wage bill.[3] Other social spending will also rise, most importantly for the growing num-

[1]U.S. Bureau of Census, *World Population Profile 2000* (Washington: U.S. Bureau of Census, 2000).

[2]For further details, see Markus Haacker, "The Economic Impact of HIV/AIDS in Southern Africa" (unpublished manuscript; Washington: International Monetary Fund, 2000).

[3]Overall, pension funds report that between 30 percent and 70 percent of payouts have been related to HIV/AIDS.

Box 1.4 *(concluded)*

The Economic Impact of AIDS in Southern Africa
(1999, unless otherwise noted)

	HIV Prevalence *(percent of population, age 15–49)*	Estimated AIDS Deaths	Demand for AIDS Health Services[1] *(percent of GDP)*	Health Expenditure 1994–98 *(percent of GDP)*
Botswana	35.8	24,000	1.8	2.0
Lesotho	23.6	16,000	0.9	4.8
Malawi	16.0	70,000	0.8	. . .
Mozambique	13.2	98,000	0.6	1.0
Namibia	19.5	18,000	1.3	3.8
South Africa	19.9	250,000	0.7	3.0
Swaziland	25.3	7,100	0.9	2.3
Zambia	20.0	99,000	1.3	2.8
Zimbabwe	25.1	160,000	1.6	2.2

Sources: UNAIDS, *Report on the Global HIV/AIDS Epidemic* (Geneva: UNAIDS, 2000); and IMF staff estimates.
[1]Estimated cost of treating all AIDS patients at local standards. In practice, costs may be reduced by rationing.

ber of orphans (in Botswana, for example, orphan allowances will exceed 1 percent of GDP by 2010). Over the longer term, there are also likely to be adverse effects on tax revenues, putting further pressure on the fiscal position.

As in the public sector, HIV/AIDS affects the private sector through lower productivity and costs related to labor turnover, a shrinking labor supply, and medical, pension, and death-related benefits. While there are few empirical studies of the impact of HIV/AIDS at the company level, those that are available suggest that AIDS-related absenteeism is very significant, in addition to the costs of training and recruitment and of medical and death-related benefits. Overall, AIDS-related costs corresponding to 50–100 percent of an infected employee's salary seem realistic. Costs tend to be higher in sectors where employees require extensive training and in companies offering generous pension schemes. For example, a study conducted by Metropolitan Life for the manufacturing sector in South Africa suggests that, owing to AIDS, the cost of death-related benefits across all employees will more than double between 1997 and 2007 (from 5.5 percent to 12 percent of total payroll).

The HIV/AIDS epidemic will have a large impact on the supply of labor and human capital. Current estimates suggest that some southern African countries will lose over one-quarter of their skilled and educated population. These losses will result in a decline in productivity and in the effectiveness of public administration. Some evidence also suggests that children of AIDS victims may have to drop out of school, in order to care for sick relatives or because their families can no longer afford schooling. This will affect the supply of human capital in the longer run.

Investment and physical capital may also decrease because of HIV/AIDS, as domestic saving may fall and external saving may decline unless an increase in foreign aid offsets the likely decrease in foreign direct investment. Empirical evidence suggests that domestic saving will fall because of the epidemic.[4] Public saving will likely suffer from an increase in the public deficit (as detailed above) and private nonhousehold saving may suffer from a decrease of business profits (especially due to lower labor productivity). The impact on household saving is less clear, although on balance it may also decline because of the increase in the dependency ratio. Microeconomic studies indicate that households that care for an AIDS patient are dissaving, because of increased medical spend-

[4]An econometric analysis of developing countries by the World Bank shows that the domestic saving rate is negatively correlated with the level of the HIV prevalance rate. See World Bank, "Economic Analysis of HIV/AIDS," Annex 5 in *Multisectoral HIV/AIDS Program* (Washington: World Bank, forthcoming).

ing and decreased income when ill adult family members can no longer work. Precautionary saving may increase, however, in other households because of the increased risk of contracting AIDS-related diseases.

The implications of HIV/AIDS for GDP growth will clearly be substantial, both through the direct impact on labor supply, human capital, and saving, but also through a decline in total factor productivity. Recent studies suggest that annual GDP growth rates may drop by 1–2 percentage points, although the impact will not be uniform across countries and will depend, among other factors, on the health infrastructure, the stock of human and physical capital, and the composition of output.[5] Calculations by IMF staff produce broadly similar results. This analysis suggests that GDP per capita in 2010 may be about 5 percent lower in the worst affected countries than it would be without the impact of HIV/AIDS, although this certainly underestimates the welfare cost because GDP per capita does not account fully for the human, social, and pecuniary costs of HIV/AIDS. Given the extent of the crisis faced by many of the countries—including the danger of macroeconomic instability as the fiscal position deteriorates, the potential disruption to established economic and social relationships, and the adverse impact on internal and external confidence—it is quite possible that the impact will in practice be significantly more severe.

[5]See John T. Cuddington and John D. Hancock, "The Macroeconomic Impact of AIDS in Malawi," *Journal of African Economics*, Vol. 1, pp. 1–28 (May 1995); and Channing Arndt and Jeffrey D. Lewis, "The Macro Implications of HIV/AIDS in South Africa: A Preliminary Assessment" (unpublished; Washington: World Bank, 2000).

Moreover, poverty and income inequality are likely to increase because of HIV/AIDS. The epidemic creates a vicious cycle by reducing economic growth, which leads to increased poverty, which, in turn, facilitates the rapid spread of HIV/AIDS, as household food and health spending declines, thereby reducing resistance to opportunistic infections. In addition to reducing income and wealth in households affected by HIV/AIDS, the epidemic is likely to increase income inequality by increasing the scarcity of skilled labor, leading to relatively higher wages for skilled labor. Wages for unskilled labor are unlikely to rise because of the large pool of unemployed workers and potential migrant workers from rural areas.

The HIV/AIDS problem in southern Africa is already of enormous dimension, and—as noted above—it is clear that these countries will require considerable external assistance to address it. To prevent the situation from deteriorating further, it will be critical to reduce the rate of new infections. The experiences of countries such as Uganda (where the infection rate has declined substantially following extensive efforts by the government) and Senegal (where early public awareness efforts have helped keep the infection rate low) suggest that highly publicized prevention campaigns, supported by strong political commitment, early education programs (particularly for girls), treatment of infected pregnant women with anti-viral drugs just before they give birth, and measures targeted at high-risk groups (such as migrant or sex workers) can be successful in reducing the incidence of new HIV infections. Taking measures to limit the further spread of the disease must therefore be a central priority, both in southern Africa and in other countries, including those that—so far—remain relatively unaffected.

helped reduce the risk premium on South African investments and boost economic activity. Improvements in productivity growth have helped dampen the potential inflationary impact of the economic recovery. Nevertheless, some cost-push pressures have been evident as a result of the depreciation of the rand, a flood-related surge in food prices, and the rise in oil prices. The Reserve Bank is being careful in ensuring that these developments do not under-

mine confidence in the inflation-targeting framework. In the longer term, continued implementation of key structural reforms—including in the areas of privatization and labor market practices—will enhance private and foreign investment and promote improvements in productivity so as to raise annual growth to the rate of 5 percent or more that is needed to reduce unemployment significantly.

Algeria and Nigeria, like other oil producers, have benefited from higher oil prices, with significant improvements in fiscal and external balances, along with higher oil-sector output growth. In addition, in *Algeria*, the private industrial sector, which is still relatively small despite extensive liberalization in the mid-1990s, has expanded rapidly in recent years. Unemployment, however, remains high because of, among other things, structural weaknesses in various sectors and rapid labor force growth. The new government plans to accelerate reforms, including restructuring and privatizing public sector companies, restructuring the banking sector, reducing government intervention in the economy, and enacting judicial, housing, and land reforms. In *Nigeria*, the current government has made strides in tackling corruption, restoring macroeconomic stability, and improving relations with creditors. Limited institutional capacity, however, may make the implementation of further structural and governance reforms difficult. Sharply increased fiscal expenditures need to be used productively—in particular for poverty reduction programs such as education and health—and a significant portion of the increased fiscal revenues should be saved. These moves should help avert a real currency appreciation and provide a cushion for when revenues are pressured by lower oil prices.

Output growth is projected to remain strong in *Cameroon*, *Ghana*, *Mozambique*, *Tanzania*, and *Uganda*, as these countries have begun to reap some of the benefits of macroeconomic and structural reforms. In Mozambique, where floods caused substantial damage earlier this year, the government has drawn up a comprehensive reconstruction plan that will be implemented with generous and timely international support, while in Tanzania and Uganda, economic activity has withstood weak prices for their main exports—coffee and cotton for Tanzania and coffee for Uganda. (A food shortage caused by the failure of seasonal rains also hampered Tanzania.) Growth in these countries has remained resilient, despite adverse shocks, largely because output has become more broad based and governments and the international community have been responsive. In addition, Cameroon, as well as a number of other countries in the CFA franc zone, has benefited from depreciation of the exchange rate (which is pegged to the euro) in effective terms.

Elsewhere, by contrast, adverse shocks and, in some instances, poor policies have hurt economic prospects, with activity projected to weaken or remain sluggish in, for example, *Côte d'Ivoire* (adverse shocks include weak cocoa prices and a significant slowdown in disbursements of external assistance, partly the result of the *coup d'etat*), the *Democratic Republic of Congo* (war), *Eritrea* (drought and war), *Ethiopia* (drought and war), *Kenya* (drought and weak export prices), *Morocco* (drought), and *Zimbabwe* (political turbulence). First and foremost, in some of these countries, efforts will need to be made to end and prevent armed conflicts and restore political stability. Reform efforts aimed at macroeconomic stability, improved governance, sound institutional arrangements, openness to trade, and efficient investments in infrastructure, education, and health also will need to be expanded to broaden development and support growth and poverty reduction.[7]

The Transition Process

It has been 20 years since China began the process of reform and opening up to the outside

[7]See Chapter IV of the May 2000 *World Economic Outlook* for a more extensive discussion of the challenges in sustaining and promoting income growth and poverty reduction in the poorest countries.

world, and over 10 years since the Berlin Wall came down and economies from Prague to Vladivostok started their transition to market-based systems. This *World Economic Outlook* focuses on the transition process, with Chapter III discussing the overall experience—including that of China and other east Asian transition economies—and Chapter IV focusing on accession to the European Union, the major policy issue for many European transition countries. Much has been achieved since the start of transition, with many of the countries involved now enjoying the benefits of a stable macroeconomic environment. Great strides have also been made in the difficult task of creating the infrastructure for a market economy almost from scratch. Strikingly, distinguishing transition economies from developing countries at similar levels of development can be difficult, although this is less true for the CIS countries.

Outside of east Asia, however, the transition process has generally been more difficult than anticipated. Output fell rapidly in the early years of transition while poverty has increased significantly. By contrast, the rapid growth experienced in the east Asian transition economies has led some to suggest that a more gradual approach to reforms and later sequencing of privatization would have produced better results. However, the more gradualist strategy adopted in east Asia was dependent on the structure of these economies. The difficult task of reforming state-owned enterprises could be delayed because they were a relatively small segment of the economy, while market reforms in the large agricultural sector rapidly increased incomes and provided a pool of labor for new businesses. Such an approach was not available in other transition economies, with their large enterprise sectors in need of rapid reform and agricultural sectors of limited size. In addition, the fastest-growing areas in the east Asian economies—agriculture, exports, and small enterprises—were also the ones in which reforms were most radical. Finally, reforms in east Asia were implemented in a relatively stable political climate, without the disruptions associated with strife and the dissolution of state structures.

That being said, the structural policies that were followed elsewhere in pursuit of transition were not always ideal. The need for creating an institutional infrastructure to support the nascent market economies was recognized from the beginning, but in practice it was not always given the attention it required, particularly if the macroeconomic situation appeared stable. In addition, the evidence from countries outside of east Asia does appear to indicate that the most effective privatization schemes involved ensuring that the sale of large enterprises to the private sector was accompanied by measures to create effective corporate governance structures and competition safeguards.

Another striking feature of the transition process has been the better performance of the countries of central and eastern Europe and the Baltics that are now candidates for accession to the EU compared to the CIS. This partly reflects more favorable starting conditions, proximity to western European markets, and greater progress in structural and institutional reforms, itself reflecting the CIS countries' lesser experience with market institutions and more limited initial access to external financing. In addition, however, in many CIS countries the difficult process of implementing structural and institutional reforms has been slowed by the influence of vested interests. By contrast, in the EU accession candidates the requirements for accession helped create consensus on potentially divisive reforms. In China, WTO entry is performing a similar role. A major challenge for the CIS countries is to find a similarly effective focal point, either external or domestic, to promote needed structural and institutional reforms.

Even with such a focal point, much remains to be done in the transition countries that are being formally considered for EU accession, including continuing progress on building the infrastructure of a market economy and ensuring adequate enforcement and implementation of its essential principles and practices. At the same time, accession also provides challenges for existing EU members, including agreeing to reforms on such contentious issues as revised internal

voting procedures and reforming the Common Agricultural Policy. It now seems questionable whether the European Union will admit new members by the end of 2002, as originally planned. Rapid agreement on such reforms would benefit existing members of the European Union, as well as ensuring that entry of qualified accession candidates will not be delayed.

Appendix I: Alternative Scenarios

The baseline forecast in this *World Economic Outlook* contains a scenario in which many of the imbalances currently facing the world economy are gradually eliminated while existing differences in growth rates of potential output are maintained. This appendix reports on two alternative scenarios constructed using MULTIMOD, the IMF's multicountry macroeconomic model, that explore the consequences of different outcomes. The first scenario discusses consequences of a more precipitous elimination of global imbalances (a "harder" landing in the United States).[8] The second scenario examines the effects of an acceleration of growth in Europe and Japan associated with more vigorous structural reforms that reduce current differences in the rate of growth of potential output across the major currency areas.

A "Harder Landing" in the United States

In the baseline forecast, the U.S. monetary authorities are able to engineer a smooth deceleration in activity that gradually brings the economy back to potential while inflation remains contained. While this is an entirely plausible projection, it needs to be acknowledged that forecasters in general have great difficulties in projecting cyclical turning points and also tend to underestimate the size of future movements in output. In the alternative scenario reported here, it is assumed that greater-than-expected inflationary pressures in the United States lead to a tightening of monetary policy and a fall in stock market prices in the United States and abroad, as well as a depreciation in the dollar, and to slower global growth. It should be recognized, however, that there are other potential triggers of the financial turbulence at the heart of the scenario. For example, a reassessment of the extent of future productivity growth generated by the "new economy" could produce a similar response in asset markets even with no further moves by the U.S. Federal Reserve.

The "harder landing" scenario assumes that the U.S. economy experiences greater-than-expected inflationary pressure in late 2000, and that over the same period growth in U.S. domestic demand is also stronger than in the baseline. This evidence of overheating causes the U.S. Federal Reserve to tighten policy by more than is currently anticipated, to squeeze current and future inflation out of the system.[9] Some time in early 2001, this in turn causes financial markets to fundamentally reevaluate prospects for the U.S. economy, with expectations of the future growth of profits scaled back significantly. As a consequence, the U.S. stock market is assumed to fall by about 20 percent, with significant effects on the confidence of both consumers and producers.

The downgrade in the assessment of U.S. prospects by financial markets has several ramifications for the rest of the world:

- The dollar is assumed to depreciate as the United States becomes less attractive to international investors, reducing the capital flows that have been financing the record current account deficit. Given the weakness of the single European currency (euro) and the existence of significant capital flows

[8]This scenario is similar to one reported in the May 2000 *World Economic Outlook*, although the results differ both because of a slightly different formulation of the underlying disturbance and because of changes in MULTIMOD, including a different monetary policy reaction function.

[9]Both scenarios assume that the monetary authorities in the United States and elsewhere target inflation in a forward-looking manner and that the fiscal authorities let automatic stabilizers operate but take no other discretionary actions.

from the euro area to the United States (see Box 1.1), it is assumed that the value of the dollar falls by about a fifth versus the euro, and by about one-tenth versus the yen and the currencies of other industrial countries.

- The fall in the U.S. stock market (and confidence) is assumed to lead to more muted reductions in other advanced countries through international linkages across capital markets.[10] Again, these effects are assumed to be somewhat larger in the euro area (about a half of the size of the impact in the United States) than for Japan—whose stock market appears less correlated with the U.S. markets than countries in Europe—and other industrial countries (about a quarter of the size of the impact in the United States).

The results of this scenario are reported in Table 1.8. After stronger growth in 2000, real GDP growth in the United States—the epicenter of the financial market uncertainties—falls to 1¼ percent, a decline of slightly less than 2 percentage points, relative to baseline, in 2001. The response of domestic demand is somewhat larger, reflecting the impact of lower asset prices. Although initially somewhat limited by the need to contain inflationary pressures, easier monetary policies support a gradual recovery in activity over the next few years. By the end of the simulation, however, domestic demand remains significantly below baseline, reflecting the impact of reductions in wealth and the real value of the dollar, while reduced investment over the intervening period also leads to lower output. The current account improves throughout the simulation, rising by about 1 percent of GDP by 2004 relative to baseline.

The reduction in external demand from the United States depresses output in other advanced economies. By contrast, domestic demand remains relatively stable as the impact of the fall in wealth is offset by monetary easing, although in Japan the zero floor on interest rates constrains the degree of the policy response. The euro area experiences the most significant fall in output relative to baseline, reflecting the larger adjustment of the currency against the dollar (which also explains the larger deterioration in the region's current account balance) and domestic asset prices.

Table 1.8. Alternative Scenario: Harder Landing

(Percent deviation from baseline unless otherwise specified)

	2000	2001	2002	2003	2004
World GDP	**0.1**	**–1.1**	**–1.2**	**–0.7**	**–0.4**
United States					
Real GDP	0.3	–1.9	–2.1	–1.1	–0.7
Real domestic demand	0.4	–2.9	–3.3	–2.2	–1.7
CPI inflation	0.3	0.8	–0.7	–1.0	–0.8
Short-term interest rate	0.7	–0.9	–2.3	–1.8	–1.0
Real effective exchange rate	0.1	–10.4	–9.2	–9.1	–9.3
Current account ($ billion)	–11.5	15.9	81.2	118.2	133.8
Euro area					
Real GDP	0.1	–1.3	–1.4	–1.0	–0.5
Real domestic demand	—	0.2	0.1	0.2	0.4
CPI inflation	—	–1.6	–0.8	–0.9	–1.0
Short-term interest rate	0.1	–2.0	–2.7	–2.6	–2.6
Real effective exchange rate	–0.1	10.2	8.3	7.8	7.6
Current account ($ billion)	4.4	–26.5	–47.5	–58.6	–65.4
Japan					
Real GDP	0.1	–0.8	–0.9	–0.3	–0.2
Real domestic demand	—	–0.4	–0.4	–0.1	—
CPI inflation	—	–0.3	–0.5	–0.5	–0.5
Short-term interest rate	0.1	–0.2	–0.3	–1.0	–0.8
Real effective exchange rate	–0.3	2.6	3.0	2.7	2.4
Current account ($ billion)	3.3	–4.3	–19.1	–30.2	–27.1
Other industrial countries					
Real GDP	0.1	–0.5	–0.5	–0.1	0.1
Real domestic demand	—	0.1	0.4	0.6	0.8
Current account ($ billion)	5.0	–28.5	–39.6	–37.5	–37.3
Developing countries					
Real GDP	0.1	–0.5	–0.7	–0.5	–0.3
Domestic demand	0.2	–1.4	–1.3	–0.7	–0.4
Current account ($ billion)	–1.3	43.7	25.8	10.4	0.1
Memorandum items					
Real domestic demand					
Africa and others[1]	0.1	–1.2	–0.9	–0.3	–0.1
Asia	0.2	–1.3	–1.3	–0.8	–0.4
Latin America	0.2	–2.0	–1.8	–1.0	–0.5
Net creditors	—	–0.2	–0.3	–0.3	–0.3
Real GDP					
Africa and others[1]	—	–0.1	–0.2	–0.2	–0.1
Asia	0.2	–0.6	–0.7	–0.3	–0.1
Latin America	—	–0.4	–0.8	–0.9	–0.8
Net creditors	0.1	–1.0	–0.9	–0.4	–0.1

[1]Includes countries not in other groups.

[10]See Chapter II of this *World Economic Outlook* and Chapter III of the May 2000 *World Economic Outlook* for a further discussion of this topic.

Developing countries are adversely affected by these developments in the industrial countries through a number of channels. The first is the direct impact of weaker activity in industrial countries on the demand for their exports. This is amplified by a fall in the real price of oil and nonfuel commodities coming from lower demand in the advanced world, which produces a negative terms-of-trade shock that further reduces domestic demand. In addition, financial turbulence and reduced export earnings constrain private external capital flows in the short term, creating more import compression, although over time the beneficial effects of lower borrowing costs due to easier monetary policies in the advanced countries reverse this effect.[11] For developing countries as a whole, the impact on output is relatively limited—real GDP falls by about ¾ percent compared to baseline and then recovers—but the reduction in domestic demand is about twice as large.

The effects of these forces vary by region. The negative impact is largest for Latin America, the region that is most exposed to a deceleration in U.S. activity and the vagaries of international capital flows, as well as having significant exports of commodities.[12] Asia is also affected by a slowdown in the United States through trade linkages, but the region as a whole is better placed to weather the impact of reduced capital inflows because of its stronger external position. Africa is relatively insulated from the direct effects of U.S. activity and private sector capital flows, and indeed benefits slightly from the appreciation of the euro given that Europe is the continent's major trading partner. However, output and demand fall compared to baseline because of the exposure of the continent to lower real commodity prices. Falling real oil prices also help explain the reduction in output in net creditor countries relative to baseline (essentially high income Middle Eastern oil exporters), where adverse movements in the terms of trade reduce activity and demand.

More Buoyant Growth in the Euro Area and Japan

A striking development of the last decade has been the divergence in performance among the major currency blocs. While U.S. growth has generally outperformed expectations, and estimates of the growth rate of potential output have been revised upwards, the opposite has occurred for Europe and Japan.[13] The baseline projection assumes that the rate of growth of potential output in the euro area and Japan stays relatively constant over the forecast period. It remains a distinct possibility, however, that the acceleration in performance seen in the United States over the latter half of the 1990s—based on flexible labor markets and new technologies—could be repeated over the next few years elsewhere. In particular, more aggressive reforms of continental European labor markets and a more conducive environment for Japanese economic restructuring could provide the basis for a sustained increase in the potential growth rate of these regions. Higher potential growth is also assumed in these simulations to lead to a significant appreciation of the euro and the yen, as market participants reevaluate the attractiveness of these regions for investment, leading to greater capital inflows and a deterioration in the external position.

The impact of increasing the rate of growth of potential output in the euro area and Japan from 2001 by ½ percent for 10 years is shown in

[11]MULTIMOD does not, however, incorporate the impact of falls in stock markets in advanced countries on domestic capital markets in developing countries.

[12]MULTIMOD only distinguishes between net debtor and net creditor developing countries. Results for separate groups of net debtor countries—Latin America, Asia, and Africa (which includes other countries)—were created by allocating the aggregate impact based on the geographic pattern of trade, the importance of commodities in total trade, and exposure to private capital markets.

[13]See "Growth Divergences in the United States, Europe and Japan: Trend or Cycle?" in the October 1999 *World Economic Outlook* for further discussion of these issues.

Table 1.9. Real output rises at about the new rate of potential growth in these regions, so that by 2004 it is around 2 percent above baseline.[14] Inflationary pressures remain subdued due to the increase in supply, which allows monetary policy to be mildly expansionary. Together with higher asset prices from higher expected growth, this means that domestic demand rises by more than output, particularly in the euro area. These effects continue to accumulate up to and beyond 2004, providing increasing benefits to the two regions.

The benefits to output in other industrial countries coming from faster growth in the euro area and Japan also build steadily over time. The boost comes largely from external demand, reflecting the real depreciation of the U.S. dollar and other currencies that form the counterpart to the appreciation of the euro and the yen. The increases in output compared to baseline are somewhat smaller for the United States than for the other industrial country group, reflecting the closer trade links of industrial economies in Europe and the Asia-Pacific region with the euro area and Japan. On the domestic side, more depreciated exchange rates lead to higher inflation that, in turn, requires somewhat tighter monetary policies and results in a fall in real domestic demand compared to baseline. Finally, more competitive exchange rates in the United States and elsewhere lead to a strengthening of the underlying external position.

Developing countries also benefit from higher growth in the euro area and Japan. Higher output in the industrial countries raises the demand for imports from the developing world, with an additional boost through higher commodity prices, while capital flows to emerging markets are relatively unaffected as higher investment in the euro area and Japan is largely financed domestically or from the other industrial countries. The benefits from faster growth largely accrue to Africa and Asia, with African countries gaining from their relatively close trade contacts to Europe and higher commodity prices, while growth in developing countries in Asia is boosted by the expansion of activity in Japan. The impact on Latin American developing countries is more limited, reflecting their great sensitivity to U.S. interest rates.

Table 1.9. Alternative Scenario: Faster Growth in Euro Area and Japan

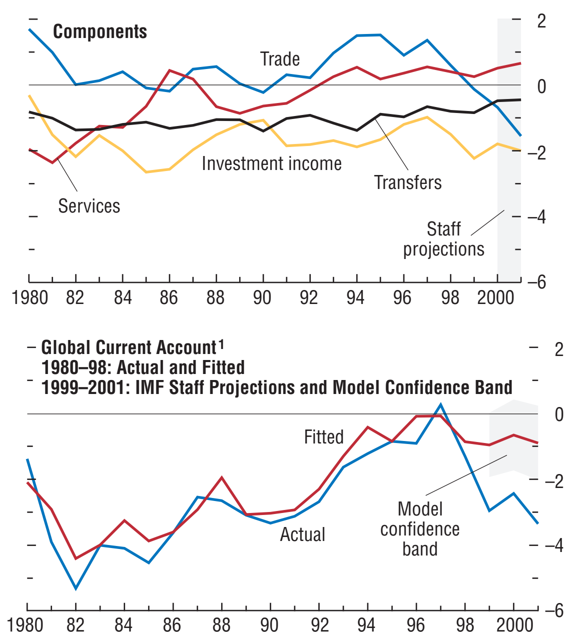
(Percent deviation from baseline unless otherwise specified)

	2000	2001	2002	2003	2004
World GDP	**—**	**0.2**	**0.5**	**0.8**	**1.0**
United States					
Real GDP	–0.1	0.2	0.3	0.3	0.4
Real domestic demand	–0.1	–0.1	–0.3	–0.4	–0.5
CPI inflation	0.1	0.2	0.3	0.3	0.4
Short-term interest rate	0.3	0.1	0.8	0.9	0.8
Real effective exchange rate	–1.0	–3.1	–4.7	–4.8	–4.7
Current account ($ billion)	2.1	8.2	19.6	31.7	45.2
Euro area					
Real GDP	0.1	0.2	1.1	1.5	1.9
Real domestic demand	0.3	0.7	2.0	2.7	3.2
CPI inflation	–0.2	–0.5	–0.5	–0.4	–0.4
Short-term interest rate	–0.5	–0.4	–0.8	–0.9	–0.6
Real effective exchange rate	1.0	3.4	5.0	5.2	5.2
Current account ($ billion)	–2.6	–4.9	–24.0	–40.1	–52.2
Japan					
Real GDP	0.1	0.3	1.0	1.5	2.0
Real domestic demand	0.2	0.5	1.4	2.0	2.7
CPI inflation	–0.1	–0.2	–0.1	–0.1	—
Short-term interest rate	–0.2	–0.2	–0.2	–0.1	0.2
Real effective exchange rate	0.9	3.1	4.2	4.2	4.1
Current account ($ billion)	3.6	6.8	3.4	–3.2	–11.2
Other industrial countries					
Real GDP	–0.1	0.3	0.3	0.5	0.9
Real domestic demand	–0.2	–0.3	–0.7	–0.8	–0.6
Current account ($ billion)	2.9	6.1	17.0	26.7	32.0
Developing countries					
Real GDP	—	0.1	0.2	0.2	0.3
Domestic demand	—	0.1	0.2	0.3	0.4
Current account ($ billion)	0.2	–6.8	–4.0	–3.6	–4.7
Memorandum items					
Real domestic demand					
Africa and others[1]	—	0.1	—	0.2	0.4
Asia	—	0.1	0.2	0.4	0.6
Latin America	—	0.2	0.2	0.2	0.2
Net creditors	—	—	—	—	—
Real GDP					
Africa and others[1]	—	—	0.1	0.2	0.4
Asia	—	0.1	0.3	0.4	0.5
Latin America	—	—	0.1	0.1	—
Net creditors	—	0.1	0.2	0.2	0.3

[1]Includes countries not included in other groups.

[14]There are some limited benefits in 2000, before the increase in potential output occurs, as asset markets anticipate the benefits of higher growth.

Figure 1.13. Global Current Account Discrepancy
(Percent of global imports of goods)



[1]The shaded area reflects the model confidence band for 1999–2001, and IMF staff projections of actual for 2000–01. The fitted values and the model confidence band are based on a paper by Jaime Marquez and Lisa Workman, "Modeling the IMF's Statistical Discrepancy in the Global Current Account." See text and their paper for details.

Appendix II: The Global Current Account Discrepancy

In principle, since the exports of one country are the imports of another, the current account balances of all countries in the world should sum to zero. In practice, however, this is not the case (see Figure 1.13, upper panel). Since the mid-1970s, the sum of all countries' current account balances has—except in 1997—been negative, giving the world in aggregate a measured current account deficit. In 1998, the last year for which complete data are available, this global current account discrepancy was about 1 percent of world imports, but preliminary data suggest that it increased sharply to 3 percent of world imports in 1999. Such a large and variable current account discrepancy is of particular concern at a time when substantial external current account imbalances in the three main currency areas are a major policy issue.

What are the underlying causes of the global current account discrepancy? While this is—by definition—a matter of great uncertainty, some clues can be found from examining the various components of the global current account (each of which should in principle also sum to zero). As Figure 1.13 shows, since the mid-1980s, the largest contributor has been a substantial deficit on the investment income account, with smaller, but still significant deficits on the transfers account. In contrast, the global trade account has been in surplus over much of the period, with the large increase in 1993 reflecting a change in European data collection practices. A recent paper by Jaime Marquez and Lisa Workman at the U.S. Federal Reserve Board, drawing on earlier work of the IMF, finds that the reasons for the measured discrepancies in the various accounts may include the following factors:[15]

[15]Jaime Marquez and Lisa Workman, "Modeling the IMF's Statistical Discrepancy in the Global Current Account" (unpublished; Washington: Federal Reserve Board, July 2000); *IMF Committee on Balance of Payments Statistics: 1998 Annual Report* (Washington: International Monetary Fund, 1999); and *Report on the World Current Account Discrepancy* (Washington: International Monetary Fund, 1987).

- *Transportation delays.* Exports can be recorded in one time period while the corresponding imports are recorded in the next because of time spent in shipment. Since the value of trade is generally expanding, this would tend to give rise to a positive discrepancy in the global trade balance.
- *Asymmetric valuation.* The same good or service can be recorded at different export and import values. This can occur when different exchange rates are used to value the same transaction or when exports are recorded at a subsidized price but the corresponding import is recorded at the market price.
- *Data quality.* Trade data quality can vary across countries causing an under reporting of credits or debits and discrepancies in the global accounts for goods, services, and income flows. This may be an especially large problem for transportation services and workers' remittances.
- *Underreporting of investment income.* Investment income is difficult to capture and therefore may go underreported in the balance of payments. The growth of offshore financial centers is making it more difficult for statistical agencies to track financial transactions.

To test these hypotheses, Marquez and Workman developed and estimated a model of the discrepancy for each element of the current account. As the lower panel of Figure 1.13 indicates, the model describes developments through 1998 reasonably well. The reduction in the global current account deficit in the mid-1980s is explained in part by falling interest rates, the rise in U.S. imports (which are thought to be better measured than other countries' imports), and the pickup in world trade growth (proxying the impact of transportation delays). The continued reduction in the global discrepancy after 1992 reflects the change in European data collection methods mentioned above. The apparent sharp deterioration in the current account discrepancy in 1999, however, falls somewhat outside of the model's confidence band (as measured by two standard deviations on each side of the model's expectation). This could suggest that the preliminary data for 1999 overstate the discrepancy, or that other factors that are not captured in the model have become important—for instance, valuation effects associated with exchange rate swings, or possibly changes in the quality of euro area current account data following the introduction of the euro in January 1999.

While the past global current account discrepancy is given, economic forecasters face a difficult challenge in projecting the current account discrepancy in the future. As discussed in past issues of the *World Economic Outlook*, the IMF global economic projections—along with those of most other forecasters—have tended to display a significantly rising discrepancy over time, often attributed to export pessimism. In producing the *World Economic Outlook* projections, the IMF staff follow an interactive procedure, under which a sharply widening global current account discrepancy triggers a reassessment of country projections. Nevertheless, in this *World Economic Outlook,* the projected global current account deficit falls outside of the confidence band of the Marquez–Workman model.[16] This may partly reflect the large and so far unexplained deterioration in 1999. An analysis of the components of the projected discrepancy shows that this is primarily due to the trade account, suggesting that the forecast may continue to exhibit some export pessimism. Correspondingly, there would be upside risks to GDP growth, and—if this export pessimism were in countries that face capacity constraints—to inflation as well. There is also a smaller widening in the projected deficit on the investment income account, which may reflect some underestimation of investment income receipts in creditor countries as a result of rising interest rates.

[16]For this exercise, the Marquez–Workman model is simulated over 1999–2001 using IMF staff projections for the necessary exogenous assumptions. These include the world price of oil, interest rates, global imports, and the U.S. share of global imports.