CHAPTER 2

COUNTRY AND REGIONAL PERSPECTIVES

Against the backdrop of the global outlook discussed in Chapter 1, this chapter analyzes prospects and policy issues in the major industrial countries and in the main regional groupings of emerging market and developing countries. More extensive discussion of country and regional issues may be found in the IMF's *Regional Economic Outlooks* to be issued in parallel with this report, and in individual country reports available from the IMF website.

United States and Canada: Inflationary Pressures Are Beginning to Rise

Following exceptionally strong growth in early 2006, the pace of expansion in the United States has subsequently moderated. The advance GDP estimate for the second quarter suggests that growth slowed to 2.9 percent, from 5.6 percent in the first quarter. Private consumption growth weakened against the background of higher interest rates, a cooling housing market, high gasoline prices, and lackluster employment gains. Business investment in equipment and software was also surprisingly weak, but net exports contributed positively to growth as imports slowed. For the year as a whole, growth is projected at 3.4 percent, before slowing to 2.9 percent in 2007 (0.4 percentage points below that expected at the time of the April 2006 *World Economic Outlook;* see Table 2.1). Underlying this forecast is the expectation that consumption and residential investment growth will slow further as the housing market weakens, but that business investment should rebound against the background of strong profits and limited spare capacity. Risks, however, are slanted to the downside.

The most likely source of headwinds in the short term is the housing market. Rising house prices have provided a significant boost to consumption, residential investment, and employment in recent years, but the market now looks overvalued and, as mortgage rates have risen, activity has slowed. Mortgage applications have declined sharply from their peak, the supply of homes on the market is rising, homebuilder confidence has fallen to a 15-year low, and house price appreciation has slowed.[1] A further cooling of the market would dampen residential investment and consumption, including through a decline in confidence, a drop in home equity withdrawal, and lower employment in the real estate and related sectors.[2] The impact of slowing house price appreciation on consumption would be reinforced by a further decline in equity prices or an increase in gasoline prices.

Despite the recent slowing in growth, inflationary pressures have begun to edge up as excess capacity in product and labor markets has diminished (and actually been eliminated on some measures), energy prices have risen and begun to feed through into some other prices (particularly transportation), and the restraining effect that globalization has had on inflation in recent years has faded (Figure 2.1).[3]

[1]The year-on-year increase in the price of a new single family home slowed from over 11 percent in September 2005 to 1½ percent in July 2006. The sales price of existing homes, as measured by the Office of Federal Housing Enterprises Oversight (OHFEO), has so far decelerated less dramatically, from a peak of 14 percent in June 2005 to 10 percent in the second quarter of 2006, but other more frequent measures of existing home prices have slowed sharply.

[2]See Box 1.2 of the April 2006 *World Economic Outlook* for an analysis of house prices in industrial countries and the possible impact of a sharp slowing in house price appreciation in the United States on growth. Specifically, the analysis suggested that a slowing in the rate of real house price appreciation from 10 percent to zero could reduce growth in the United States by up to 2 percentage points after one year.

[3]See Chapter III of the April 2006 *World Economic Outlook* for an analysis of the impact of globalization on inflation.

Table 2.1. Advanced Economies: Real GDP, Consumer Prices, and Unemployment

(Annual percent change and percent of labor force)

	Real GDP				Consumer Prices				Unemployment			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
Advanced economies	**3.2**	**2.6**	**3.1**	**2.7**	**2.0**	**2.3**	**2.6**	**2.3**	**6.3**	**6.0**	**5.6**	**5.5**
United States	3.9	3.2	3.4	2.9	2.7	3.4	3.6	2.9	5.5	5.1	4.8	4.9
Euro area[1]	2.1	1.3	2.4	2.0	2.1	2.2	2.3	2.4	8.9	8.6	7.9	7.7
Germany	1.2	0.9	2.0	1.3	1.7	2.0	2.0	2.6	9.2	9.1	8.0	7.8
France	2.0	1.2	2.4	2.3	2.3	1.9	2.0	1.9	9.6	9.5	9.0	8.5
Italy	1.1	—	1.5	1.3	2.3	2.3	2.4	2.1	8.1	7.7	7.6	7.5
Spain	3.1	3.4	3.4	3.0	3.1	3.4	3.8	3.4	11.0	9.2	8.6	8.3
Netherlands	2.0	1.5	2.9	2.9	1.4	1.5	1.7	1.8	4.6	4.9	4.5	3.9
Belgium	2.4	1.5	2.7	2.1	1.9	2.5	2.4	1.9	8.4	8.4	8.2	8.2
Austria	2.4	2.0	2.8	2.3	2.0	2.1	1.8	1.7	4.8	5.2	4.8	4.6
Finland	3.5	2.9	3.5	2.5	0.1	0.8	1.5	1.5	8.8	8.4	7.9	7.8
Greece	4.7	3.7	3.7	3.5	3.0	3.5	3.6	3.5	10.5	9.9	9.7	9.5
Portugal	1.2	0.4	1.2	1.5	2.5	2.1	2.6	2.2	6.7	7.6	7.7	7.6
Ireland	4.3	5.5	5.8	5.6	2.3	2.2	2.8	2.5	4.5	4.3	4.3	4.2
Luxembourg	4.2	4.0	4.0	3.8	2.2	2.5	2.8	2.3	3.9	4.2	4.5	4.7
Japan	2.3	2.6	2.7	2.1	—	–0.6	0.3	0.7	4.7	4.4	4.1	4.0
United Kingdom[1]	3.3	1.9	2.7	2.7	1.3	2.0	2.3	2.4	4.8	4.8	5.3	5.1
Canada	3.3	2.9	3.1	3.0	1.8	2.2	2.2	1.9	7.2	6.8	6.3	6.3
Korea	4.7	4.0	5.0	4.3	3.6	2.7	2.5	2.7	3.7	3.7	3.5	3.3
Australia	3.5	2.5	3.1	3.5	2.3	2.7	3.5	2.9	5.5	5.1	5.0	5.0
Taiwan Province of China	6.1	4.1	4.0	4.2	1.6	2.3	1.7	1.5	4.4	4.1	3.9	3.7
Sweden	3.7	2.7	4.0	2.2	1.0	0.8	1.6	1.8	5.5	5.8	4.5	4.3
Switzerland	2.1	1.9	3.0	1.9	0.8	1.2	0.9	1.2	3.5	3.4	2.6	2.5
Hong Kong SAR	8.6	7.3	6.0	5.5	–0.4	0.9	2.3	2.5	6.9	5.7	4.6	4.0
Denmark	1.9	3.2	2.7	2.3	1.2	1.8	1.8	2.0	6.4	5.7	4.8	4.9
Norway	3.1	2.3	2.4	2.8	0.4	1.6	2.3	2.0	4.5	4.6	3.9	3.9
Israel	4.8	5.2	4.1	4.4	–0.4	1.3	2.8	2.0	10.3	9.0	8.7	8.5
Singapore	8.7	6.4	6.9	4.5	1.7	0.5	1.8	1.7	3.4	3.1	2.7	2.7
New Zealand[2]	4.4	2.3	1.3	1.7	2.3	3.0	3.8	3.4	3.9	3.7	3.9	4.5
Cyprus	3.9	3.7	3.5	3.8	2.3	2.6	3.0	2.3	3.6	5.2	3.0	3.0
Iceland	8.2	5.5	4.0	1.0	3.2	4.0	6.1	4.5	3.1	2.1	1.5	1.9
Memorandum												
Major advanced economies	3.0	2.4	2.9	2.5	2.0	2.3	2.6	2.3	6.3	6.0	5.7	5.6
Newly industrialized Asian economies	5.9	4.5	4.9	4.4	2.4	2.2	2.2	2.2	4.2	4.0	3.7	3.4

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

Headline and core (excluding food and energy) CPI inflation rates have moved higher—indeed the core CPI increased by 3.5 percent (annualized rate) during May–July 2006, the fastest pace since mid-1995—and inflation expectations have risen, albeit modestly. Wage gains has also accelerated, and with productivity growth slowing, unit labor cost growth has picked up.

Against this background, the Federal Reserve increased the Federal funds rate by 25 basis points to 5.25 percent at its June policy meeting but left rates unchanged at its August meeting, while cautioning that inflation risks remain. The future path of the monetary policy stance is now dependent on what incoming data suggest about the balance of the competing risks to growth and inflation. Nevertheless, given the importance of keeping inflation expectations firmly in check, some further policy tightening may still be needed. There will also be a premium on the Federal Reserve clearly communicating its policy intentions, and a more explicit statement of its medium-term inflation objective may be helpful in this regard.

With the U.S. current account deficit expected to reach nearly 7 percent of GDP next year, boosting national saving in the United States—through fiscal consolidation

Table 2.2. Advanced Economies: Current Account Positions
(Percent of GDP)

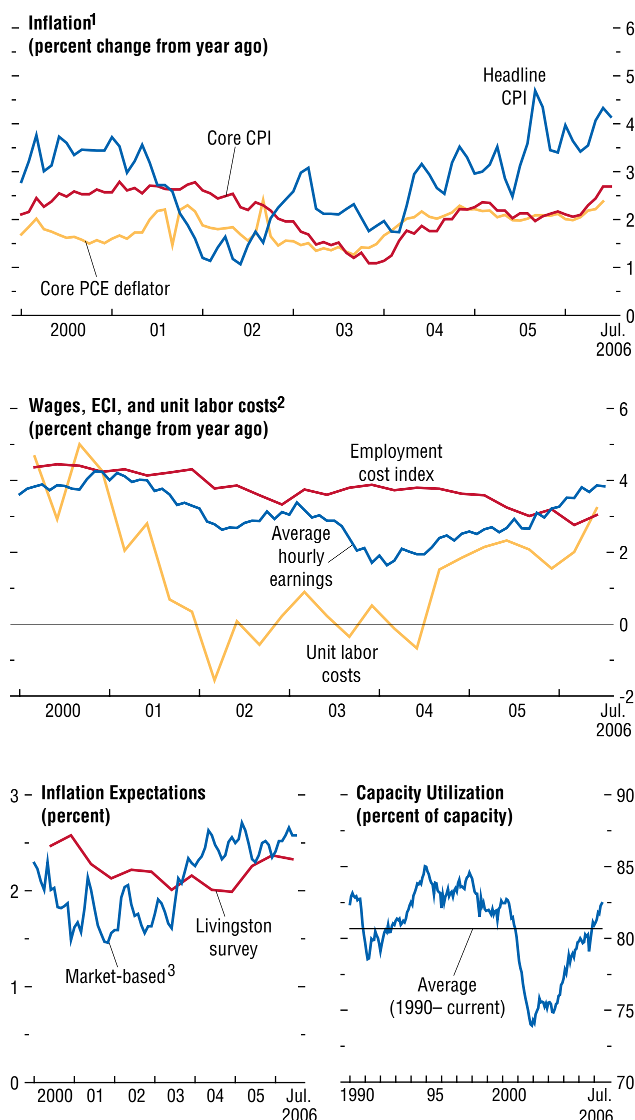
	2004	2005	2006	2007
Advanced economies	**–0.8**	**–1.4**	**–1.6**	**–1.7**
United States	–5.7	–6.4	–6.6	–6.9
Euro area[1]	0.9	—	–0.1	–0.2
Germany	3.7	4.1	4.2	4.0
France	–0.3	–1.6	–1.7	–1.7
Italy	–0.9	–1.6	–1.4	–1.0
Spain	–5.3	–7.4	–8.3	–8.7
Netherlands	8.9	6.3	7.6	7.9
Belgium	3.4	2.7	2.8	2.7
Austria	0.2	1.2	1.5	1.7
Finland	7.8	5.1	5.1	4.6
Greece	–6.2	–7.8	–8.1	–8.0
Portugal	–7.3	–9.3	–9.8	–9.6
Ireland	–0.6	–2.6	–3.0	–3.2
Luxembourg	10.5	9.7	8.2	8.2
Japan	3.8	3.6	3.7	3.5
United Kingdom	–1.6	–2.2	–2.4	–2.3
Canada	2.1	2.3	2.0	1.9
Korea	4.1	2.1	0.4	0.3
Australia	–6.3	–6.0	–5.6	–5.3
Taiwan Province of China	5.7	4.7	5.8	5.9
Sweden	6.8	6.0	5.8	5.6
Switzerland	14.1	13.8	13.3	13.3
Hong Kong SAR	9.5	11.4	8.7	7.8
Denmark	2.3	3.0	2.2	2.3
Norway	13.6	16.8	19.9	22.2
Israel	2.6	2.9	1.2	1.0
Singapore	24.5	28.5	28.5	27.3
New Zealand	–6.7	–8.9	–9.6	–9.1
Cyprus	–5.7	–5.8	–4.6	–3.5
Iceland	–10.1	–16.5	–12.5	–4.4
Memorandum				
Major advanced economies	–1.6	–2.2	–2.4	–2.6
Euro area[2]	0.6	–0.3	–0.1	–0.1
Newly industrialized Asian economies	7.0	6.0	5.0	4.9

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

and increased private saving—is a key component of the multilateral strategy to reduce global imbalances (Table 2.2). Encouragingly, recent fiscal performance has been better than expected, largely because of unexpected revenue buoyancy, the permanency of which remains to be seen. The U.S. administration now expects to achieve its goal of halving the federal deficit by FY2008, a year ahead of schedule. Nevertheless, much remains to be done, given that a number of factors not fully reflected in the administration's forecast could boost the deficit (including pressures to curtail the rising impact of the

Figure 2.1. United States: Are Inflationary Pressures Building?

As excess capacity in product and labor markets has diminished, inflation in the United States has begun to edge up.



Sources: Haver Analytics; OECD, *Economic Outlook;* and IMF staff calculations.
[1]Core CPI excludes food and energy. PCE refers to personal consumption expenditure.
[2]Wages as average hourly earnings of total private industries, employment cost index of civilian workers, and unit labor costs of non-farm business sector.
[3]Differential between 10-year nominal treasury note yield and treasury inflation-protected securities (TIPS).

Alternative Minimum Tax, or AMT, and the costs of the ongoing military operations in Iraq and Afghanistan). Setting a more ambitious deficit reduction path—for example, a goal of achieving budget balance (excluding social security) over the next five years, requiring fiscal consolidation of some ¾ percent of GDP a year—would help provide a firmer basis for the United States to face future demographic pressures, put the budget in a stronger position to respond to future economic downturns, and help reduce global imbalances. The likely impact that this accelerated fiscal consolidation would have on growth—both domestically and overseas—in the short term could be partly mitigated if it were part of joint policy action to tackle global imbalances and if it provided scope for an easier monetary policy stance (see Chapter 1, Box 1.3).

The focus of fiscal consolidation appropriately remains on the expenditure side, although the unprecedented and back-loaded compression of discretionary non-defense spending already assumed in the budget will make further savings difficult. Revenue measures therefore should not be ruled out, particularly initiatives that broaden the revenue base—including a reduction in tax preferences, such as for mortgage interest and other proposals by the President's Commission on Tax Reform—or help achieve other objectives, such as higher taxes on energy that would lower oil consumption. Fiscal consolidation needs to be supported by entitlement reform to put the Social Security and Medicare systems on a sustainable long-term footing in the face of population aging and rising health care costs.

Regarding private saving, some increase is already built into the projections as the housing market slows. In terms of policies, the administration has introduced health saving accounts that should raise incentives for household saving. Recently passed pension legislation will also help in this regard, both by making it easier for employers to offer defined-contribution (401(k)) plans that require employees to "opt-out" rather than "opt-in," which should lead to higher enrollment in such plans, and by requiring companies to reduce funding gaps in their defined-benefit pension plans. Moving to a tax system with a greater reliance on a consumption tax rather than taxes on income would also increase incentives to save, while greater transparency about likely future shortfalls in the social security system and in private pension plans may increase awareness of the need for higher saving to ensure adequate retirement income.

The Canadian economy continues to perform robustly, benefiting from its strong macroeconomic policy framework and the boom in global commodity prices. The main risks to the outlook are external, including the possibility of a sharper-than-expected slowing in the U.S. economy and a disorderly adjustment of global imbalances that could result in a substantial further appreciation of the Canadian dollar. With wage growth decelerating and CPI inflation well contained, the Bank of Canada recently halted the process of monetary tightening that had begun in September 2005. A strong fiscal position remains at the center of the new government's economic policies, with the FY2006/07 budget including welcome commitments to lower public debt (to 25 percent of GDP by FY2013/14), contain expenditure growth, and reduce the tax burden on the corporate sector.

Western Europe: Structural Reforms Remain the Key to Stronger Growth

Economic activity in Western Europe is strengthening. In the euro area, the recovery has gained further traction, with real GDP growth accelerating to 3.6 percent (annualized rate) in the second quarter of 2006. Growth is increasingly being driven by domestic demand, particularly investment. Second quarter growth accelerated in Germany—helped by a boost from the World Cup—and France, and remained robust in Spain. In the United Kingdom, where the economic cycle is more advanced, growth was around 3 percent in the first half of 2006. Robust employment creation and the stabilization of

the housing market underpinned consumption spending, while investment remained strong.

Looking forward, recent indicators suggest that the pace of expansion in the euro area should be sustained during the second half of 2006, and real GDP growth is now projected at 2.4 percent for the year as a whole, up from 1.3 percent in 2005, before slowing to 2 percent in 2007. Corporate investment is expected to remain buoyant—among the three largest economies, this pickup should be strongest in Germany, where profitability has recovered and corporate restructuring is well advanced, and weakest in Italy where corporate debt is still rising and profitability is weaker. Consumption growth is expected to be more moderate given modest employment and wage growth (the announced 3 percentage point increase in the VAT rate in Germany is expected to boost consumption in late 2006 and reduce it in early 2007). In the United Kingdom, growth is expected at 2.7 percent this year and next, broadly in line with potential.

There are a number of uncertainties to the outlook. On the upside, robust business confidence in the euro area could generate stronger-than-expected investment and employment growth. On the downside, against the background of large global imbalances, Europe remains exposed to the possibility of sharp currency appreciation that could undercut exports and investment in the traded goods sector and impose capital losses on holders of U.S. dollar assets. Further increases in energy prices would reduce disposable incomes and slow consumption, while recent falls in equity markets, if sustained, could also weigh on business and consumer confidence going forward. Lastly, house prices in Spain, Ireland, and the United Kingdom still look elevated, and could come under pressure in a rising interest rate environment.

A critical challenge for Europe is to ensure that the current cyclical upswing translates into a sustained and long-lasting expansion so that it can deal effectively with the domestic problems it faces—particularly the need to strengthen fiscal positions ahead of the onset of population aging—and contribute to an orderly unwinding of global imbalances. Over the past decade, growth in Europe has fallen short of that in the United States (although some individual countries have outperformed the United States). Although increases in labor utilization have been similar—with a stronger rise in the employment ratio in Europe offset by a larger decline in hours worked—productivity growth has declined in Europe while it has increased in the United States (Figure 2.2). The decline in productivity growth in Europe is widespread across sectors, reflecting extensive product and labor market regulations that limit competition and impede the movement of resources between industries in response to technological change and globalization. Indeed, in the United Kingdom where labor and product market reforms are relatively advanced, productivity growth has been stronger. The productivity growth differential with the United States, however, has been particularly large in three sectors—manufacturing, financial services (and more so if the insurance subsector is excluded), and retail/wholesale—where substantial gains have been achieved in the United States as a result of industry consolidation and the greater use of information technology.[4]

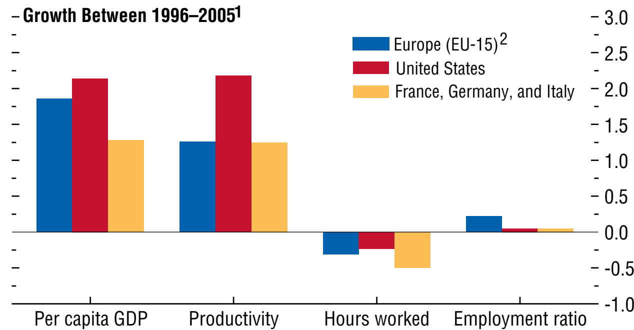
Under the Lisbon Strategy, EU countries have agreed to address existing impediments to stronger productivity growth, but implementation needs to be accelerated, particularly in sectors where productivity growth in Europe is lagging.[5] For example, under the European Commission's

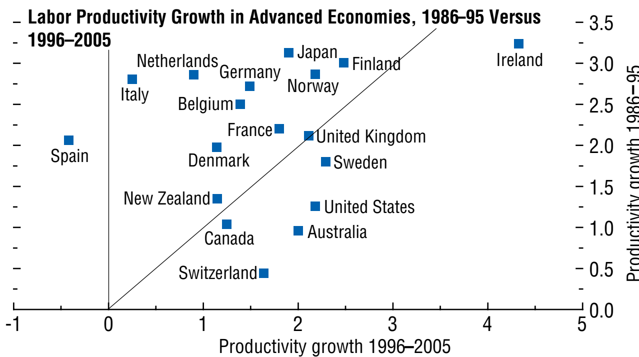
[4]See Inklaar, O'Mahony, and Timmer (2005) and Timmer and van Ark (2005), for detailed analyses of how differences in producing and using information technology have affected productivity differentials between the United States and Europe. On the other hand, Gordon and Dew-Becker (2005), argue that the productivity slowdown in Europe is too widespread to be solely due to IT.

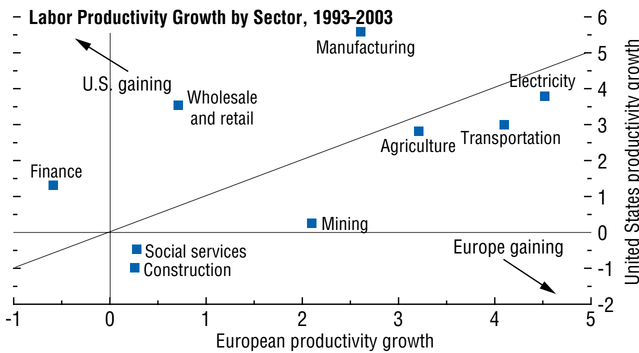
[5]Chapter IV In the April 2003 *World Economic Outlook* ("Unemployment and Labor Market Institutions: Why Reforms Pay Off") found that labor and product market reforms could increase real GDP in the euro area by 10 percent in the long run. A report by the European Commission (2005) found that the implementation of reforms in the Lisbon strategy could increase potential growth in the European Union by around ¾ percentage point a year.

Figure 2.2. Western Europe: Boosting Productivity Is the Key to Stronger Growth
(Percent change)

Labor productivity growth in Europe has been disappointing over the past decade. Europe has underperformed in the manufacturing, financial services, and retail sectors compared to the United States.







Sources: OECD, *Economic Outlook;* and IMF staff calculations.
[1]Employment ratio defined as employed persons as a percent of working age population.
[2]Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

Financial Services Action Plan considerable progress has been made in the integration and harmonization of the financial sector, but further steps are needed to reduce barriers to competition across Europe. These include speeding up the integration of payments, clearing, and settlement systems, reducing obstacles to cross-border mergers—including by reducing differences in legal, regulatory, and supervisory frameworks across countries—reducing state involvement in the financial system, and integrating mortgage markets. In the retail sector, the easing of regulations that limit the establishment of new stores and impede cross-border competition would boost efficiency.

Fiscal outcomes in the euro area were generally better than expected in 2005, with the aggregate deficit declining by ½ percent of GDP. A more modest fiscal adjustment is expected this year based on published budgets, and two countries (Italy and Portugal) are expected to have fiscal deficits in excess of 3 percent of GDP. In Italy, the fiscal situation is particularly difficult, with the general government deficit projected at 4 percent of GDP this year, although strong revenue growth provides scope to achieve a better outcome if expenditure is firmly controlled. Turning to 2007, on current policies little change is projected in the deficit, and achieving the targeted reduction to 2.8 percent of GDP will depend on the implementation of structural fiscal reforms covering key expenditure areas.

The current upswing provides an important opportunity for policymakers to make progress in further reducing fiscal deficits. Under the reformed Stability and Growth Pact (SGP), most countries in the euro area are aiming for budget balance or even a small surplus over the medium term. Yet how such consolidation will be achieved remains largely unspecified, and firm plans still need to be put in place to give credibility to these commitments. Welfare reforms and reductions in the government wage bill are key, not only to lower deficits, but also to provide room to cut taxes on labor and thereby boost employment. In Spain, while the budget is in surplus, a tighter short-term fiscal policy

stance would help contain existing demand pressures.

Population aging will put heavy pressure on pension and healthcare spending over the medium term, with European Commission estimates suggesting that age-related spending will rise by close to 4 percent of GDP by 2050. Reforms to pension systems are under way in France, Germany, and Italy—yet more will be needed. An important dynamic of pension reforms is that demographic change—by increasing the political weight of older persons who may have the most to lose—could make the implementation of such reforms more difficult in the future.

Turning to monetary policy, with inflation running above its "below but close to" 2 percent objective, credit growth remaining strong, and the economic recovery solidifying, the European Central Bank has appropriately withdrawn monetary stimulus, raising interest rates by a cumulative 100 basis points since December. Looking forward, further interest rate increases will likely be needed to maintain price stability over the medium term if the expansion develops as expected. But, with underlying inflationary pressures still well contained—unit labor costs are subdued, core inflation (excluding food and energy) is around 1½ percent, and inflation expectations are well-anchored—policymakers can afford to be cautious in tightening the monetary policy stance, all the more so given the risk of euro appreciation and weaker growth in the United States.

In the United Kingdom, after holding its policy rate constant for a year, the Bank of England raised its rate in early August by 25 basis points to 4.75 percent. Future monetary policy decisions are delicately balanced. While risks to aggregate demand are skewed to the downside, particularly in 2007, there is also a possibility that energy price increases may yet give rise to second-round effects on inflation. On fiscal policy, the budget deficit is expected to narrow slightly, reflecting strong revenues from higher energy prices and the booming financial sector. Over the medium term, fiscal consolidation will depend critically on restraint of current spending, the plans for which are being developed as part of the 2007 Comprehensive Spending Review. The fiscal position in the United Kingdom is less sensitive to population aging than elsewhere in the European Union, but with the public pension being considerably less generous than in other European countries, concerns have centered on whether individuals are saving enough to provide an adequate retirement income. As suggested by the Pensions Commission, the introduction of a national defined contribution scheme with automatic enrollment and low operating costs may be useful to boost private savings.

Japan: Monetary Policy Adjusts to the End of Deflation

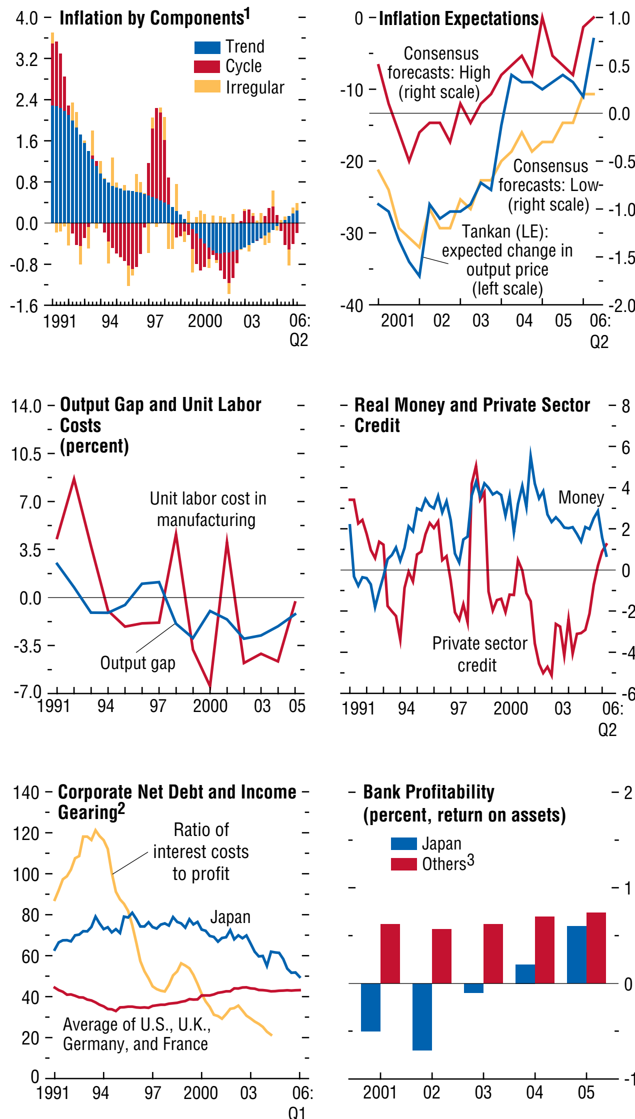
In Japan, after a solid first quarter, real GDP growth eased in the second quarter of 2006, owing primarily to inventory decumulation, a sharp contraction in public investment, and drag from net exports. Nevertheless, the expansion remains well-founded as private final domestic demand, the main driving force since 2005, has grown at a solid pace. Private fixed investment in particular continues to be buoyant, underpinned by robust profits and a turnaround in bank credit, while private consumption is increasing at a more moderate rate, as labor income gains have been modest. Growth is projected at 2.7 percent for 2006 as a whole, moderating to just above 2 percent in 2007. The near-term risks to the outlook are broadly balanced. On the upside, growth could be boosted by stronger-than-expected domestic demand, as confidence remains high and the pace of household income growth may pick up with the continued expansion. On the downside, the economy is vulnerable to adverse external developments, including a further rise in oil prices, a cooling U.S. economy, or a sharp appreciation of the yen against the backdrop of a disorderly unwinding of global imbalances.

Indications are growing that after seven years of falling prices, Japan has finally escaped from

Figure 2.3. Japan: Balancing Inflation and Deflation Risks

(Percent change from a year ago unless otherwise stated)

The future path of policy interest rates in Japan needs to balance risks of deflation against those of rising inflation. Measures of expected future inflation suggest that inflation remains well anchored at low levels. At the same time, some deflation risks remain.



Sources: Bank of Japan; Consensus Economics, Inc.; Haver Analytics; IMF, *International Financial Statistics;* and IMF staff calculations.

[1]Derived with a bandpass filter.

[2]Corporate net debt, expressed as percent of GDP, defined as financial liabilities less financial assets of the nonfinancial corporate sector. Ratio of interest costs to profit, expressed in percent, measured as four-quarter moving average.

[3]Averages of return on assets for Canada, France, Germany, Italy, Spain, the United Kingdom, and the United States.

entrenched deflation. Year-on-year changes in the headline and core CPI have been positive in recent months, with core inflation at about ¼ percent. Producer prices have led the CPI transition by about one and a half years because of global price increases for raw materials and industrial supplies. While the GDP deflator continues to decline on a year-on-year basis (although primarily reflecting higher prices of commodity imports), changes in the final domestic demand deflator have begun to enter positive territory.

With the expansion now well established and favorable prospects for low, but steady, inflation in 2006–07, the normalization of monetary policy has become the key near-term macroeconomic policy challenge. Since March 2006, the Bank of Japan has largely reversed the extra-injection of bank liquidity under its former policy of quantitative easing. The nominal policy rate, which was raised to 25 basis points in mid-July after having been pegged at zero since early 2001, will eventually have to be raised further to more normal levels. However, with actual inflation barely positive and estimates of trend inflation—a measure of expected average inflation—just above zero, risks of a relapse into deflation in response to an adverse shock, such as a substantial slowing in global growth, cannot be ignored (Figure 2.3). The future path of the policy interest rate, therefore, needs to carefully balance the risks of a return to deflation against those of the possibility of accelerating inflation. The risks of the latter at this stage appear limited given that inflation expectations are anchored at very low levels, unit labor cost growth is subdued, and the very rapid expansion of base money until recently has not translated into strong broad liquidity and/or credit growth.

Against this background, the Bank of Japan appropriately plans to err on the side of caution and raise policy rates gradually. In support of such an approach, it would be helpful for the Bank of Japan to define its medium-term inflation goals clearly so as to avoid any uncertainty about its intentions. Recently, the central bank has reported that the "understanding of price

stability among members of the Policy Board" is annual CPI inflation of 0 to 2 percent. This range, however, is not a target to be achieved over a pre-set time horizon, and it will be reviewed annually. As inflation becomes established, it would be desirable for the range (or its floor) to rise over time since a lower bound of zero for the range would leave open a risk that adverse disturbances could push the economy back into deflation. In addition, more explicit communication on the risks and policies at the lower end of the current range for inflation would guide market expectations and further clarify the Bank of Japan's policy intentions.

Restoring fiscal sustainability is the key medium-term macroeconomic policy challenge. Despite fiscal adjustment during 2003–05—the deficit (excluding social security) was reduced by about 3 percentage points to 5.3 percent of GDP in 2005—gross and net public debt continue to rise and, at around 180 and 90 percent of GDP, respectively, are among the highest in industrial countries. Current fiscal policy plans aim to achieve a primary surplus for the central and local government by FY2011. This adjustment, however, would not be sufficient to stabilize net government debt over the six-year period, given current estimates of potential output growth, which are depressed by the low rate of labor force growth (see Chapter 3, Box 3.1). IMF staff estimates suggest that an additional adjustment of about 2 percent of GDP over this period would be necessary to stabilize net debt, an important objective given the high public debt ratios and prospects of growing pressures on expenditure from the rapidly aging population. While adjustment measures so far have been concentrated on the expenditure side, future efforts likely would need to include some revenue measures. Raising the consumption tax rate, which is currently low by international standards, and broadening the income tax base would help to generate revenues with the least adverse effects on underlying growth.

Structural fiscal reforms should be complemented by broader reform efforts aimed at raising productivity growth. If appropriately designed, such a package would have a mutually reinforcing impact on fiscal sustainability. The priorities are reforms of government financial institutions—the impending privatization of Japan Post is a welcome step forward; steps to strengthen competition in the services sector (e.g., by facilitating market access in the retail sector); and enhanced labor market flexibility (including through higher female labor force participation, and increased pension portability to bolster mobility across firms and sectors). It will also be important to fully complete the financial and corporate sector reform agenda. Leverage in the nonfinancial corporate sector has declined substantially, but it remains high by international standards—especially in small and medium-size enterprises outside the manufacturing sector—and higher corporate profitability partly reflects very low nominal interest costs. Similarly, while balance sheets of large banks have improved with declines in nonperforming loans, progress by regional banks has been more limited, and bank profitability, while improved, remains below average in international comparison.

Emerging Asia: China's Growth Spurt Benefits the Region but Carries Risks

Growth continues to run above 8 percent in emerging Asia, with much of the momentum due to vibrant expansions in China and India (Table 2.3). In China, real GDP grew by 11.3 percent (year-on-year) in the second quarter of 2006, with a renewed acceleration in investment growth and surging net exports. In the newly industrialized economies (NIEs), growth has strengthened since mid-2005 with a pickup in exports, especially of electronic goods due to rapid growth in China and the strong global economy. In contrast, growth has started to slow in most of the ASEAN-4 countries, owing mainly to the effects of higher oil prices and monetary policy tightening in response to rising inflation.

The outlook is for continued strong growth of 8¼ percent in 2006–07—about ½ percentage point higher than projected at the time

Table 2.3. Selected Asian Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless noted otherwise)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
Emerging Asia[3]	**8.5**	**8.5**	**8.3**	**8.2**	**3.9**	**3.4**	**3.6**	**3.5**	**3.9**	**4.7**	**4.3**	**4.2**
China	10.1	10.2	10.0	10.0	3.9	1.8	1.5	2.2	3.6	7.2	7.2	7.2
South Asia[4]	**7.8**	**8.2**	**7.9**	**7.2**	**4.2**	**4.8**	**6.0**	**5.6**	**0.3**	**–1.5**	**–2.2**	**–2.8**
India	8.0	8.5	8.3	7.3	3.9	4.0	5.6	5.3	0.2	–1.5	–2.1	–2.7
Pakistan	7.4	8.0	6.2	7.0	4.6	9.3	7.9	7.3	1.8	–1.4	–3.9	–4.6
Bangladesh	6.1	6.2	6.2	6.2	6.1	7.0	6.8	6.1	–0.3	–0.5	–0.3	–0.7
ASEAN-4	**5.8**	**5.1**	**5.0**	**5.6**	**4.6**	**7.5**	**8.6**	**4.5**	**4.0**	**2.8**	**3.1**	**3.0**
Indonesia	5.1	5.6	5.2	6.0	6.1	10.5	13.0	5.9	0.6	0.3	0.2	0.6
Thailand	6.2	4.5	4.5	5.0	2.8	4.5	4.9	2.6	4.2	–2.1	–0.8	–1.3
Philippines	6.2	5.0	5.0	5.4	6.0	7.6	6.7	5.0	1.9	2.4	2.4	1.7
Malaysia	7.2	5.2	5.5	5.8	1.4	3.0	3.8	2.7	12.6	15.2	15.6	15.7
Newly industrialized Asian economies	**5.9**	**4.5**	**4.9**	**4.4**	**2.4**	**2.2**	**2.2**	**2.2**	**7.0**	**6.0**	**5.0**	**4.9**
Korea	4.7	4.0	5.0	4.3	3.6	2.7	2.5	2.7	4.1	2.1	0.4	0.3
Taiwan Province of China	6.1	4.1	4.0	4.2	1.6	2.3	1.7	1.5	5.7	4.7	5.8	5.9
Hong Kong SAR	8.6	7.3	6.0	5.5	–0.4	0.9	2.3	2.5	9.5	11.4	8.7	7.8
Singapore	8.7	6.4	6.9	4.5	1.7	0.5	1.8	1.7	24.5	28.5	28.5	27.3

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

of the last *World Economic Outlook*—reflecting more favorable global economic conditions, continued high growth in China, and moderate deceleration in India after the strong momentum in 2005 and early 2006. Growth in the NIEs is set to slow, especially in 2007, when growth in the import demand of advanced economies is projected to decelerate. In contrast, a modest rebound in activity is expected in the ASEAN-4 countries as the factors behind the recent slowing recede.

The near-term risks to the outlook are broadly balanced for the region, albeit with some differences across countries, depending on external and financial vulnerabilities on the one hand and on the exposure to growth in the advanced economies on the other. On the upside, there is the possibility of even faster-than-projected growth in China—if the recent pace is maintained—and in India. A higher growth rate in China would elevate growth elsewhere in the region—but especially in Hong Kong SAR, Indonesia, Korea, the Philippines, Singapore, and Thailand—given the strengthening intra-regional trade linkages (Figure 2.4). On the downside, risks include the possibility of an investment boom-bust cycle in China and its regional impact, higher oil prices, the heightened threat of protectionist action in advanced economies following the deadlock of the Doha Round, an outbreak of an avian flu pandemic, and slower growth in the advanced economies, especially Japan and the United States. The latter remain the final destinations for a substantial share of the region's final goods exports, and business cycle fluctuations in the United States and Japan still affect the region to a considerable degree, especially in the NIEs. In addition, tighter monetary policy to head off inflationary pressures may lower growth prospects in the region. The region would also be vulnerable to a deterioration in international financial market conditions, although, compared to other market regions and their own past, most economies in emerging Asia generally now seem better positioned to weather such a deterioration. External vulnerabilities in particular have been substantially reduced throughout the region, given per-

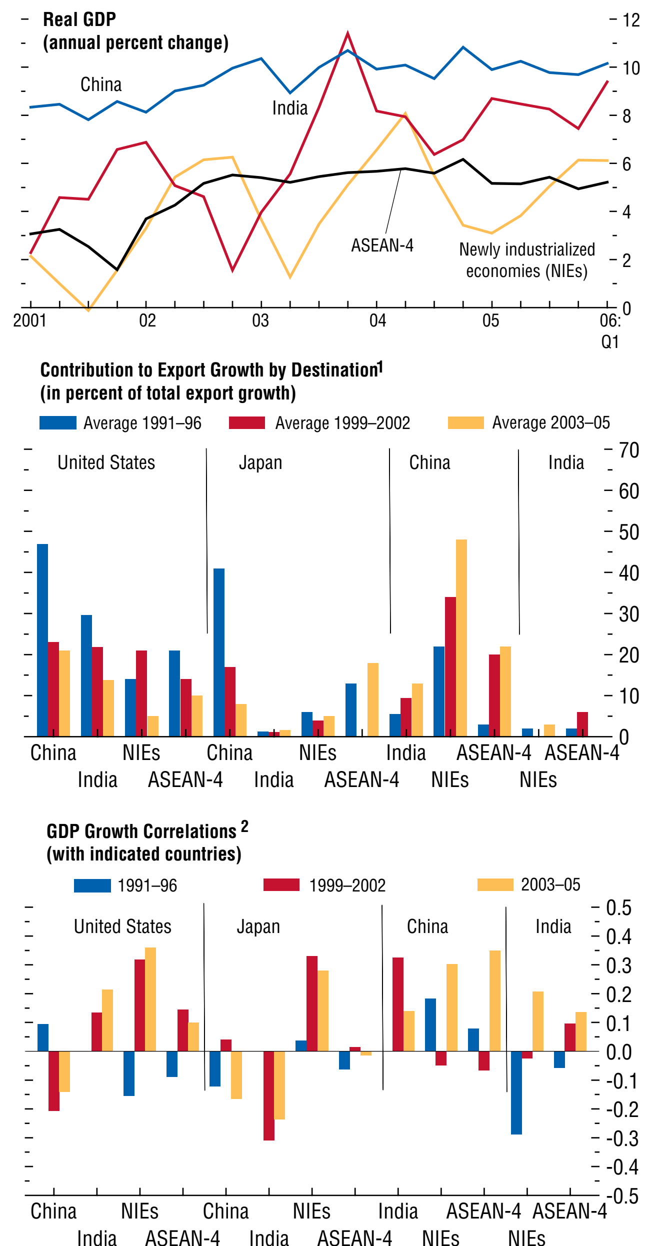
sistent current account surpluses and substantial reserve accumulation in recent years.

Headline inflation has increased with higher oil prices, but most countries have succeeded so far in restraining core inflation with quite small increases in nominal policy rates, helped by real currency appreciation that reflects strong external positions, although price controls and energy subsidies have also contributed in some countries. Together with declining currency risk premiums, this has provided for narrowing real interest differentials against the major currencies, and the generally low real interest rates throughout the region have supported domestic demand. However, to head off risks of rising inflation, policymakers in the region may need to respond to increasing interest rates in the major currencies areas—especially Japan—and to more testing international financial market conditions, with some likely adverse effects on growth. In India, inflation has picked up with rising oil prices and strong domestic demand. While the Reserve Bank of India has raised interest rates in recent months, further tightening may be needed to resist inflationary pressures.

With robust domestic demand growth in many countries and high oil prices, the regional current account surplus is expected to moderate by about ½ of a percentage point to around 4¼ percent of GDP in 2006–07. Within the region, current account performance varies considerably. In Korea and, more recently, Indonesia, current account surpluses have declined, while Thailand and India have experienced a turnaround to a deficit. In all of these countries, exchange rate flexibility has increased in the past two years, often in the context of inflation-targeting monetary policy frameworks, while domestic demand has begun to play a more prominent role in output growth. Nevertheless, private investment remains relatively weak in many countries, and reforms aimed at enhancing the business environment are particularly important at this juncture. Priorities include measures to deepen and integrate capital markets across the region and steps to lower regulatory burdens.

Figure 2.4. Emerging Asia: The Regional Impact of China's Rapid Growth

The strong growth momentum in emerging Asia owes much to vibrant growth in China, given its increasingly prominent role in intraregional trade, and India. Nevertheless, growth fluctuations in the advanced economies still have a considerable impact on fluctuations in the region, since markets in the advanced economies remain important destinations for the region's exports of final goods.



Source: IMF staff calculations.
[1]Excluding intragroup trade for the NIEs and ASEAN-4 group countries.
[2]In the case of the NIEs and ASEAN-4, the values represent the medians of the correlations coefficients of all countries in the group.

In contrast, China's current account surplus continued to rise in 2005 and the first half of 2006 and now accounts for some 70 percent of the regional surplus of about $260 billion (annual basis). Structural factors, including capacity expansion in sectors producing import substitutes, account for some of the rise in China's surplus, but continued exceptionally strong export growth has also contributed. While there has been some limited flexibility in the renminbi exchange rate in recent months, in current circumstances—with the large current account surplus continuing to rise and capital inflows remaining strong—more substantial appreciation of the currency would help to reduce the current account surplus and give the central bank greater control of domestic monetary conditions. The central bank's current focus on limiting renminbi fluctuations against the dollar makes effective liquidity control difficult, and direct measures of monetary control and limited interest rate increases have not been sufficient to restrain strong credit growth. The latter has contributed to concerns about the possibility of an investment boom-bust cycle, as the current exceptionally rapid investment growth could lead to overcapacity, falling profits, and balance sheet problems in the corporate and financial sectors. The move toward greater exchange rate flexibility would have to be supported by a continuation of the complementary financial sector reform currently under way, which would strengthen the economy's capacity to cope with greater interest rate and exchange rate movements. Exchange rate appreciation would also bolster households' purchasing power, which, together with reforms to the pension, health, and education systems and to the financial sector, would boost consumption.[6]

Policymakers across the region should take advantage of the broadly favorable growth outlook to implement structural reforms aimed at promoting fiscal sustainability and reducing vulnerabilities. In countries with high public debt and/or budget deficits (particularly India, Pakistan, and the Philippines), fiscal positions need to be put on a sustainable medium-term footing. In the Philippines and, to a lesser extent, Indonesia, the structure of public debt is associated with foreign currency risks, and continued fiscal consolidation and improvements in the composition of this debt would contribute to reducing the vulnerability to swings in global investor sentiment and enhance monetary policy credibility. In India, strong spending pressures have emerged, limiting fiscal adjustment in FY2006/07 after more substantial consolidation in recent years. With the general government deficit and debt still high, further consolidation is clearly warranted at both the central and state government levels, including through measures aimed at broadening the tax base and reducing subsidies.

Asia has benefited from impressive high growth over an extended period. Chapter 3, "Asia Rising: Patterns of Economic Development and Growth," analyzes this experience and looks at the policy implications. Drawing on the experience of fast-growing Asian countries at various stages of the catch-up process, it argues that policymakers need to meet a number of challenges to ensure that rapid growth in the region is sustained. First, steps to promote trade openness, widespread access to education, and financial sector development and to encourage entrepreneurship (such as reducing the costs of starting a business) will be important to facilitate the continued shift of resources out of agriculture to industry and services. Second, productivity growth in the services sector would be boosted by policies to strengthen market access and competition. Third, Asian countries that are the least advanced in the catch-up process can learn from the experience of other countries in the region, including the important role that institutional quality, financial development, business climate, and trade openness play in creating a favorable environment conducive to capital accumulation and productivity growth.

[6]See Chapter 5 of the IMF's September 2006 *Regional Outlook* for the Asia and Pacific region for evidence of lower-than-expected consumption in China against a benchmark estimate based on standard determinants.

Table 2.4. Selected Western Hemisphere Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless noted otherwise)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
Western Hemisphere	**5.7**	**4.3**	**4.8**	**4.2**	**6.5**	**6.3**	**5.6**	**5.2**	**0.9**	**1.4**	**1.2**	**1.0**
Mercosur[3]	**6.0**	**4.2**	**4.8**	**4.5**	**5.7**	**7.1**	**6.2**	**5.6**	**1.9**	**1.7**	**0.7**	**0.5**
Argentina	9.0	9.2	8.0	6.0	4.4	9.6	12.3	11.4	2.2	1.9	1.0	0.6
Brazil	4.9	2.3	3.6	4.0	6.6	6.9	4.5	4.1	1.9	1.8	0.6	0.4
Chile	6.2	6.3	5.2	5.5	1.1	3.1	3.5	3.1	1.7	0.6	1.8	0.9
Uruguay	11.8	6.6	4.6	4.2	9.2	4.7	5.9	4.3	0.3	–0.5	–4.3	–3.2
Andean region	**8.0**	**6.3**	**5.7**	**4.1**	**8.4**	**6.4**	**5.7**	**6.1**	**4.0**	**6.6**	**7.0**	**6.7**
Colombia	4.8	5.1	4.8	4.0	5.9	5.0	4.7	4.2	–1.0	–1.6	–1.2	–1.7
Ecuador	7.9	4.7	4.4	3.2	2.7	2.1	3.2	3.0	–0.9	–0.3	4.4	3.7
Peru	5.2	6.4	6.0	5.0	3.7	1.6	2.4	2.5	—	1.3	0.7	0.2
Venezuela	17.9	9.3	7.5	3.7	21.7	15.9	12.1	15.4	12.5	19.1	17.5	17.6
Mexico, Central America, and Caribbean	**4.0**	**3.5**	**4.3**	**3.8**	**7.0**	**4.9**	**4.5**	**4.0**	**–1.4**	**–1.0**	**–0.5**	**–0.8**
Mexico	4.2	3.0	4.0	3.5	4.7	4.0	3.5	3.3	–1.0	–0.6	–0.1	–0.2
Central America[3]	3.9	4.3	4.8	4.4	7.4	8.4	7.4	6.3	–6.3	–5.5	–5.2	–5.1
The Caribbean[3]	2.6	6.1	5.6	4.8	26.5	6.7	8.3	5.8	1.2	0.8	0.9	–1.8

[1]In accordance with standard practice in the *World Economic Outlook*, movements in consumer prices are indicated as annual averages rather than as December/December changes, as is the practice in some countries. The December/December changes in CPI for 2004, 2005, 2006, and 2007 are, respectively, for Brazil (7.6, 5.7, 3.8, and 4.5); Mexico (5.2, 3.3, 3.3, and 3.0); Peru (3.5, 1.5, 2.5, and 2.5) and Uruguay (7.6, 4.9, 5.5, and 4.9).
[2]Percent of GDP.
[3]The country composition of this regional group is set out in Table F in the Statistical Appendix.

Latin America: Continuing to Build Resilience

The economic expansion in Latin America gathered momentum in the first half of this year, with regional GDP on track to rise by 4¾ percent in 2006 as a whole and by 4¼ percent in 2007 (Table 2.4). Moreover, inflation largely remained subdued, anchored by credible monetary policy regimes in most of the larger countries. While external performance has continued to be supported by high prices for key commodity exports, domestic demand has become the main engine of growth. Convergence of inflation to targets has provided room to unwind previous monetary tightening in Brazil and Mexico, supporting a pickup in growth in both countries. In rapidly growing Argentina, the monetary policy stance has been gradually tightened in response to double-digit inflation but remains accommodative. At the same time, public spending has picked up across the region, on the back of continued revenue buoyancy, especially in Venezuela. There have also been signs of a resurgence of private investment, helped by increasing confidence, declining interest rates, and quite rapid increases in bank credit, although investment rates remain far lower than in emerging Asia. Political uncertainty remains a concern, however, reflecting in part questions about the ability of governments in a number of countries to resist populist measures.

Unsettled conditions in global financial markets in May–June 2006 initially dampened Latin American equity prices and exchange rates, particularly in the most liquid markets (e.g., Brazil) or in markets that had previously seen strong price run-ups (e.g., Colombian equities). However, markets have since recovered much of the lost ground, and Latin America's expansionary momentum seems to have been little affected. This resilience seems to reflect in part reduced vulnerabilities, including a shift to current account surpluses, more flexible exchange rate regimes, higher reserve cushions, and strengthened fiscal positions across the region. Nevertheless, recent market pressures have provided a timely reminder that the global context is likely over time to become less friendly to emerging

markets, with rising interest rates, less buoyant non-oil commodity prices, and reduced appetite for the riskier assets. This prospect poses the question of what further steps countries in Latin America could take to prepare for more testing conditions ahead.

Disciplined fiscal policy should be at the core of an effective policy framework for dealing with this challenge. Taking advantage of cyclically strong revenues to raise the primary surplus in good times helps to lower public sector debt and provide a more robust basis to weather periods of weakness. Fiscal restraint also provides greater room for monetary easing, thus reducing incentives for potentially destabilizing capital inflows and encouraging private investment. Chile has shown what can be achieved: its fiscal surplus is likely to rise to 6 percent of GDP in 2006 in line with its rule-based framework, reducing public debt to low levels and directing a significant proportion of copper-based revenues into an offshore stabilization fund. Moreover, the effective fiscal sterilization of the impact of rapid export growth has helped to contain appreciation of the Chilean peso, without recourse to foreign exchange market intervention in the context of rapid increases in copper-related revenues.

Looking across Latin America more broadly, primary surpluses have increased significantly during the present cyclical upswing, on the back of strong revenue growth, but there have been signs of an acceleration in government spending over the past two years, in contrast to the more restrained policies followed in 2003–04 (Figure 2.5 and Box 2.1). While greater spending on infrastructure and social priorities could bring long-term dividends, there is a concern that not all of the increased expenditure is well-targeted—in oil exporters and importers alike—and may prove difficult to unwind if and when global economic conditions become more testing. Moreover, public debt levels, while coming down, still remain high (over 50 percent of GDP in many of the Latin American countries shown in Figure 2.5), limiting scope for a counter-cyclical response to any future weakening of growth.

Faced with heavy foreign exchange inflows over the past two years, many Latin American countries have allowed exchange rates to strengthen, with some intervention to lean against upward pressures on the exchange rate, using the proceeds to build up international reserves and finance debt operations. Exchange rates have appreciated substantially from the lows of 2002 in a number of countries, but measures of real effective exchange rates are still broadly in line with long-term averages. Brazil and Colombia have been particularly active in retiring external debt and shifting the structure of public sector liabilities away from dollar-denominated debt, and in net terms Brazil has now eliminated dollar exposure from its public sector balance sheet. As a result, public sector balance sheet vulnerabilities have been substantially reduced across the region, although the transition toward long-term, fixed-rate, domestic-currency-denominated debt remains incomplete.

Looking ahead, recent more difficult market conditions have provided a reminder of the importance of allowing adequate exchange rate flexibility in both directions. In the context of more stable global financial market conditions, strong foreign exchange inflows may return. Sustained sterilized intervention would impose heavy quasi-fiscal costs—more so than in Asia where interest rates are generally lower. Moreover, excessively reducing exchange rate variations in the face of foreign exchange inflows may discourage appropriate risk management by market participants and could lead to easy monetary conditions—a concern in Argentina, for example, where the use of regulatory countermeasures will need to be supported by a further tightening of macroeconomic policies to contain inflation. Some further appreciation of the real exchange rate may be hard to avoid in such circumstances, although the impact on competitiveness may be mitigated by broader structural reforms to reduce domestic costs and improve the business climate. In the face of more turbulent conditions—as exemplified by the sell-off in May–June 2006—countries would need to allow rates to depreciate in line with market condi-

tions, generally limiting intervention to what may be helpful to stabilize disorderly market conditions, while tightening monetary policy if needed to safeguard inflation objectives.

The long-term challenge for Latin America remains to unlock the region's clear growth potential. Despite recently improved performance, Latin America has remained consistently the slowest-growing region among the emerging market and developing countries in recent years. These growth outcomes, and the slow progress in reducing poverty, have fueled popular frustrations. Continued progress toward strengthening macroeconomic policies and reducing balance sheet vulnerabilities should help to provide the basis for more sustained growth than in the past, but stepping up the pace of growth and more tangible progress toward social goals is likely to depend on extending market-based reforms, while also taking steps to ensure that benefits of growth are broadly shared.[7] Most Latin American countries made considerable progress in advancing reforms through the 1990s, but the pace of reforms slowed toward the end of the decade, against the background of financial crisis. More recently there have been renewed advances in some countries, but there have also been setbacks, including steps that partially unwind privatization and pension reforms in a number of countries. Looking forward, reform priorities include tackling budget rigidities to improve the targeting of public spending (including especially infrastructure and pro-poor social programs); reforms to encourage deepening financial intermediation; measures to raise economic openness (where Latin America still lags well behind other regions); labor market reforms to increase the flexibility of response to new opportunities and encourage job growth in the formal sector; and reforms to strengthen governance and the business environment.

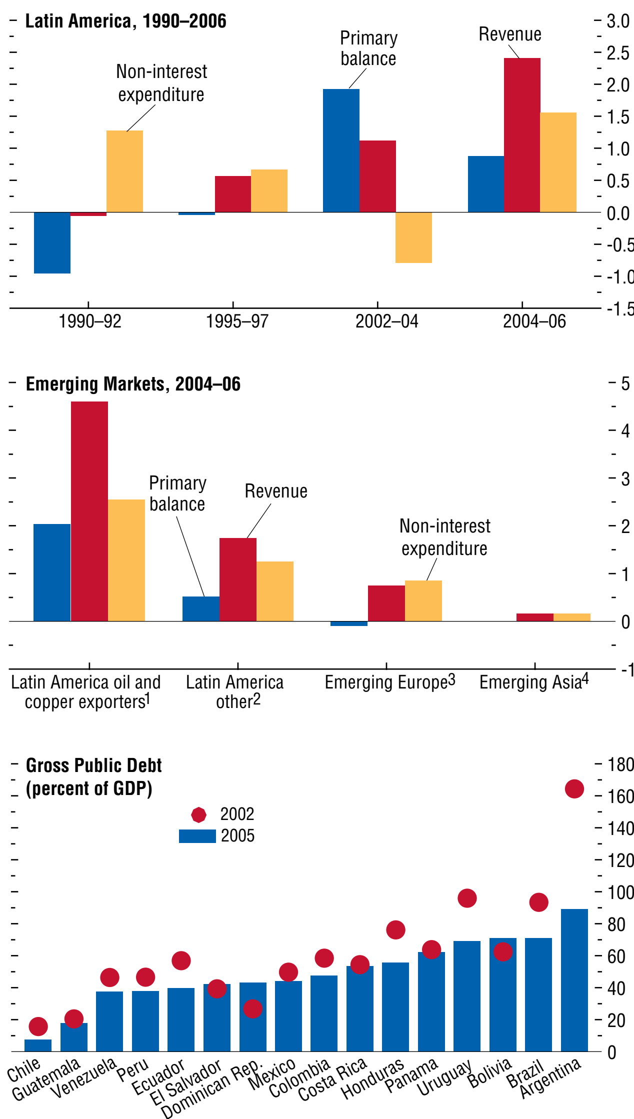
The policy framework for production of oil and gas is an important issue in the region. Latin America possesses the world's second larg-

[7]Zettelmeyer (forthcoming) provides a good recent overview of this issue.

Figure 2.5. Latin America: Progress Toward Fiscal Sustainability

(Unweighted averages; change in percent of GDP)

Latin American countries have significantly improved primary balances in recent years, helped by strong revenue growth. However, primary spending has risen sharply over the past two years, after a period of restraint. Public-debt-to-GDP ratios have declined, but remain high for a number of countries.



Source: IMF staff calculations.
[1]Chile, Ecuador, Mexico, and Venezuela.
[2]Argentina, Bolivia, Brazil, Colombia, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Panama, Paraguay, Peru, and Uruguay.
[3]Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Slovenia, and Turkey.
[4]China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Pakistan, the Philippines, Singapore, Taiwan Province of China, and Thailand.

Box 2.1. Improved Emerging Market Fiscal Performance: Cyclical or Structural?

Fiscal performance in many emerging market countries has improved substantially in recent years. The average overall fiscal balance of the largest 37 emerging market countries improved by nearly 3 percent of GDP from 2002 to 2005 (see first figure), and public debt dropped substantially, although it still remains above 50 percent of GDP in nearly half of those countries. These averages conceal an even better record for some regions and countries (although of course a less stellar performance in others). Nonetheless, this improvement potentially has significant economic and financial market implications, depending on whether it signifies a sustainable trend, or whether it is a transitory phenomenon that will be reversed when these economies encounter more difficult times. In other words, the key question is: to what extent has the improvement been driven by structural or by cyclical factors?

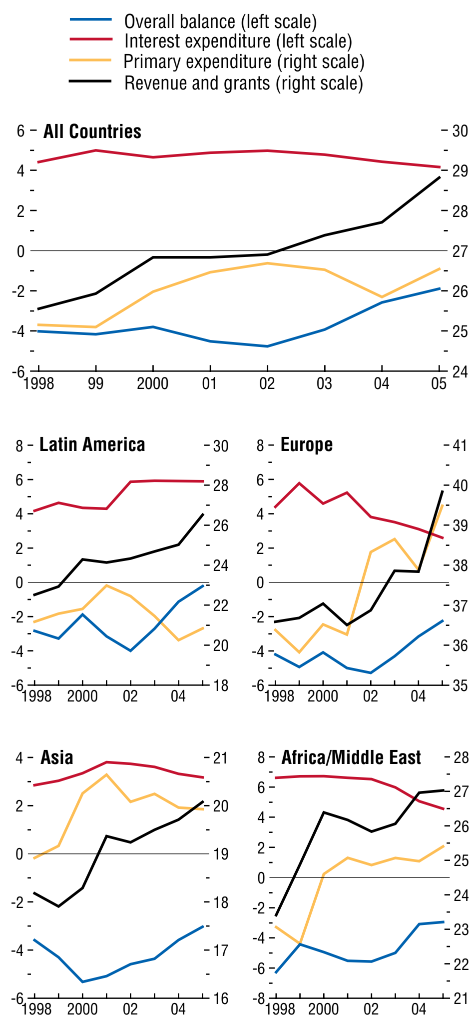
There is no doubt that there has been some underlying structural improvement in fiscal positions in emerging market economies. Helped by improvements in the underlying fiscal institutions, strengthened expenditure management, increased transparency, and sounder fiscal responsibility frameworks, many governments have been able to restrain expenditures in the face of buoyant revenues and easy access to capital markets—a departure from procyclical behavior in previous upturns. This is reflected in the drop in the average primary expenditure-to-GDP ratio in Latin America and Asia, although in emerging Europe revenues and primary spending rose in tandem.[1] For the average of emerging market countries, the primary expenditure ratio was no higher in 2005 than in 2002 before revenues started to boom (see first figure), although in some countries there has been a tendency to ease spending restraint in 2005 and 2006.

Note: The authors of this box are David Hauner and Manmohan S. Kumar.

[1]Government revenues in emerging Europe include grants from the European Union.

Emerging Market Fiscal Performance

(Percent of GDP; general government; unweighted average of 37 emerging market countries)



Sources: IMF, World Economic Outlook database; and IMF staff estimates.

Second, several emerging market countries have reduced their financing costs through debt restructuring and generally sound economic policies. Stronger policies have helped to accelerate integration in global financial markets, further

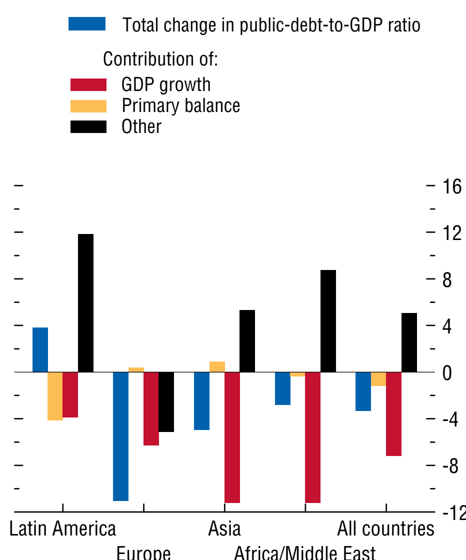
lowering borrowing costs. For instance, the fact that, with credit ratings improving, institutional investors in the major industrial countries—particularly pension funds—have begun to invest systematically in emerging market financial instruments has led to an expectation of more stable capital flows. This in turn has further reduced the risk premiums demanded on emerging market assets, and lowered interest costs.

Nevertheless, part of the improvement in emerging market countries' government finances appears to have reflected favorable cyclical factors. Buoyant GDP growth and soaring commodity prices have boosted government revenues in many countries (by an average of 2 percentage points of GDP from 2002 to 2005). Given a stable expenditure-to-GDP ratio, the improvement in the average primary balance is essentially due to rising revenues. Such revenue buoyancy, however, has an important cyclical component that, although not readily quantifiable, is likely to account for a significant part of the rapid increase in revenues. For example, revenues rose by a full 6 percent of GDP on average in the five of the 37 sample countries that are mainly exporting commodities.[2] The public debt ratio has also benefited from strong GDP growth. Growth subtracted on average about 7 percent of GDP from this ratio over the past four years, while primary balances subtracted only about 1 percent of GDP (second figure).

Benign global financial conditions in recent years have also helped fiscal performance. Global interest rates have been very low, and high liquidity and search for yield have contributed to declining yield spreads (see, for example, IMF, 2004). Moreover, many emerging market countries' currencies have strengthened substantially relative to the dollar and other currencies in which much of their debt is denominated, particularly in 2005. Both interest rate and exchange rate factors contributed to

[2]Excluding countries that are mainly exporting commodities does not materially change these results: the average primary balance would be about 0.7 percent of GDP worse for 2004 and 2005.

Change in Emerging Market Public Debt[1]
(Percent of GDP; change from end-2001 to end-2005)



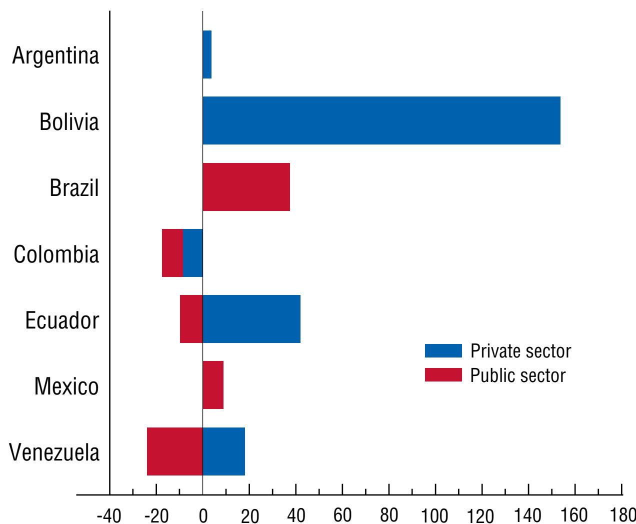
Sources: IMF, World Economic Outlook database; and IMF staff estimates.
[1]Public debt includes debt in domestic and foreign currency. The category "Other" includes exchange rate and interest rate effects, the stock-flow adjustment, as well as the statistical discrepancy.

the decline in interest expenditure over 2002–05 and to the improvement in the overall fiscal balance (Hauner and Kumar, 2005). This is particularly evident for the emerging European countries, which have benefited not only from the global environment, but also from interest rate convergence in the context of EU accession.

There is a risk that a reversal in cyclical conditions and the external financial environment could induce a deterioration in budgetary positions. And the most vulnerable countries could be hit hardest, because they tend to have benefited most from higher risk appetite. It is thus important for emerging market countries—especially those with larger underlying vulnerabilities—to maintain disciplined fiscal policies to take maximum advantage of continued favorable global conditions.

Figure 2.6. Latin America: Mixed Performance in the Hydrocarbons Sector
(Percent change in output over 2000–05 relative to total output in 2000)

Latin American countries have had mixed success in raising output of oil and gas in response to higher prices.



Source: IMF staff calculations.

est hydrocarbons reserves, but for the most part has not responded to the rise in international prices since 2004 with increased production and investment. On the positive side, long-term investment by partially state-owned Petrobras has allowed Brazil—the region's third largest producer—to achieve self-sufficiency in 2006. However, production has grown slowly or contracted elsewhere, including such major oil producers as Mexico and Venezuela, reflecting low rates of investment in the past and governance issues that are only now beginning to be addressed (Figure 2.6). In Mexico, investment has been boosted recently to counter the decline of the country's largest oil field. Bolivia was able to achieve a rapid increase in gas exports after opening up its hydrocarbons sector to private companies, but the recent decision to nationalize production and raise royalties has raised uncertainty and may have jeopardized prospects for new investment. Similarly in Ecuador, private oil production rose rapidly in 2005 after completion of a major pipeline, but public production has declined, and prospects now depend on the government's ability to improve the investment climate to attract new private investors and to strengthen public sector governance. The key issue here is less whether production and investment rights are allocated to the private or public sector, but whether the government is able to establish a stable and predictable set of production and investment incentives and governance structures to provide a firm basis for the huge financing and the long-term planning horizons required for major hydrocarbons projects.

Emerging Europe: Managing Risks from Heavy Reliance on Foreign Savings

The economic expansion has remained robust in emerging Europe, with regional growth running at about 5½ percent in 2005 (Table 2.5). Buoyant domestic demand generally has been the main driving force—fueled by increasing net capital inflows and credit growth. The growth momentum varies across the region, depending in part on the strength of the forces underpin-

Table 2.5. Emerging Europe: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless noted otherwise)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
Emerging Europe	**6.6**	**5.5**	**5.4**	**5.0**	**6.3**	**4.9**	**5.4**	**4.7**	**–5.7**	**–5.2**	**–5.7**	**–5.4**
Turkey	8.9	7.4	5.0	5.0	8.6	8.2	10.2	7.2	–5.2	–6.4	–6.7	–5.8
Excluding Turkey	5.7	4.6	5.5	5.0	5.3	3.6	3.4	3.7	–6.0	–4.6	–5.2	–5.2
Baltics	**7.6**	**8.8**	**8.6**	**7.6**	**3.0**	**4.2**	**4.7**	**4.3**	**–10.4**	**–9.5**	**–10.5**	**–10.4**
Estonia	7.8	9.8	9.5	8.0	3.0	4.1	4.6	3.8	–13.0	–11.0	–12.0	–11.7
Latvia	8.6	10.2	11.0	9.0	6.2	6.8	6.6	6.3	–12.9	–12.4	–14.0	–13.7
Lithuania	7.0	7.5	6.8	6.5	1.2	2.7	3.6	3.3	–7.7	–6.9	–7.5	–7.4
Central Europe	**5.0**	**4.3**	**5.2**	**4.6**	**4.3**	**2.4**	**2.2**	**3.2**	**–5.2**	**–3.1**	**–3.4**	**–3.1**
Czech Republic	4.2	6.1	6.0	4.7	2.8	1.8	2.9	3.3	–6.0	–2.1	–1.9	–1.6
Hungary	5.2	4.1	4.5	3.5	6.8	3.6	3.5	5.8	–8.6	–7.4	–9.1	–8.0
Poland	5.3	3.4	5.0	4.5	3.5	2.1	0.9	2.3	–4.2	–1.4	–1.7	–1.9
Slovak Republic	5.4	6.1	6.5	7.0	7.5	2.7	4.7	3.6	–3.6	–8.6	–7.7	–5.9
Slovenia	4.2	3.9	4.2	4.0	3.6	2.5	2.5	2.3	–2.1	–1.1	–2.0	–2.3
Southern and south-eastern Europe	**6.8**	**4.4**	**5.3**	**5.4**	**8.7**	**7.0**	**6.9**	**4.7**	**–7.3**	**–8.8**	**–10.3**	**–10.4**
Bulgaria	5.7	5.5	5.6	6.0	6.1	5.0	7.4	3.8	–5.8	–11.8	–12.4	–12.2
Croatia	3.8	4.3	4.6	4.7	2.1	3.3	3.5	2.8	–5.4	–6.3	–6.8	–6.8
Malta	–1.5	2.5	1.6	1.8	2.7	2.5	2.9	2.8	–9.6	–13.1	–12.5	–12.0
Romania	8.4	4.1	5.5	5.5	11.9	9.0	7.8	5.7	–8.5	–8.7	–10.9	–11.1

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

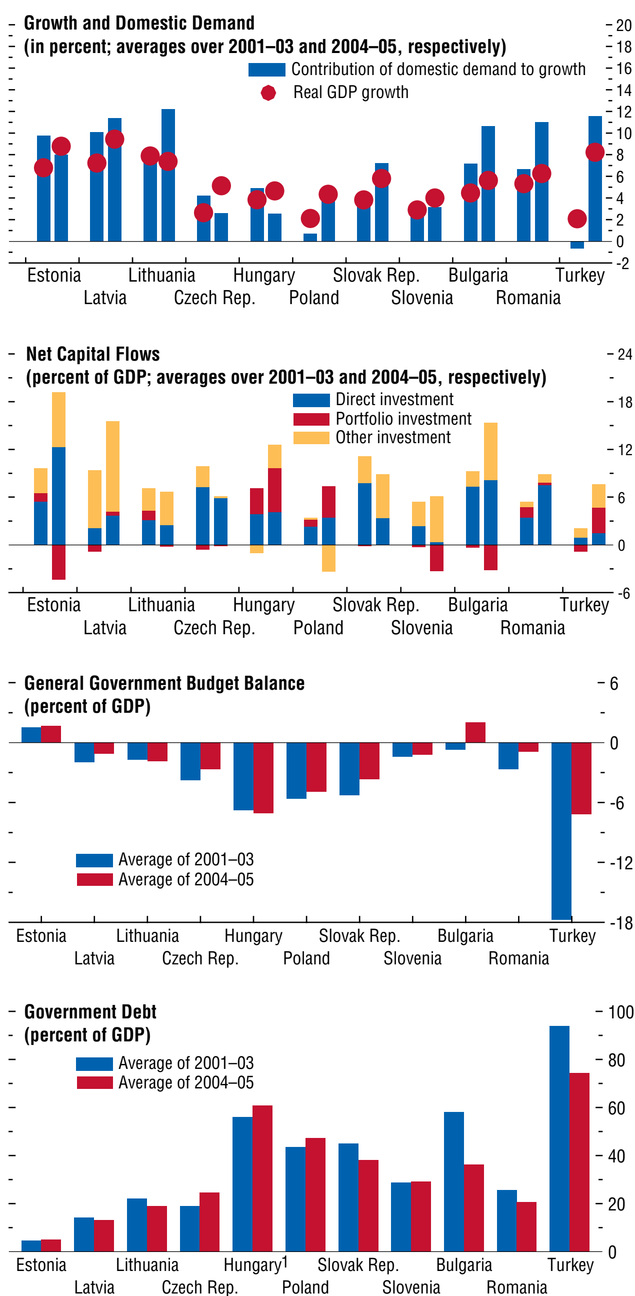
ning domestic demand, exchange rate developments, and progress in addressing structural rigidities. Growth has been particularly vibrant in the Baltic countries and Turkey, and it has accelerated in the Czech Republic and the Slovak Republic. The pace has been weaker in Hungary, Poland, and Slovenia, although more recently growth in Poland has picked up, supported by higher export market growth, improving investor sentiment, and firming labor market conditions.

The outlook is for continued solid regional growth in the range of 5–5½ percent in 2006–07, as robust domestic demand growth is expected to continue, and with the strengthening expansion in the euro area adding an external impetus. Compared to the last *World Economic Outlook*, however, growth is expected to slow more noticeably in Turkey—policy interest rates have been raised by 425 basis points since June to head off a weakening currency and intensifying inflation pressures—and in Hungary, in 2007, in view of the substantial fiscal consolidation that is targeted in that year. The adverse impact on regional growth is roughly offset by Poland's improved near-term growth prospects. The region's characteristic large current account deficits—only in the Czech Republic, Poland, and Slovenia are deficits relatively modest—are projected to widen in 2006, reaching 5.7 percent of GDP for the region as a whole, before declining slightly in 2007. The risks to the growth outlook are slanted to the downside, with the region's heavy reliance on foreign savings a particular vulnerability if international financial market conditions become even more testing.

When assessing such risks, one needs to consider that the region's generally large current account deficits have reflected in part favorable investment opportunities, given scarce capital and low labor costs, in the context of EU accession and integration. That said, to varying degrees within the region, these deficits have also been associated with rapid credit and consumption growth, asset price increases, and, in some cases, substantial real exchange rate appreciations—often in the context of limited

Figure 2.7. Emerging Europe: Rapid Growth and Its Risks

Strong domestic demand has buoyed growth in emerging Europe, underpinned by sizable and increasing net capital inflows and rapid credit growth. However, with its heavy reliance on foreign savings, the region is vulnerable to changes in international financial market conditions. Weak fiscal positions in some countries exacerbate the situation.



Source: IMF staff calculations.
[1]General government net debt.

nominal exchange rate flexibility—a constellation prone to create external vulnerabilities. In some countries, the inflows have been associated not just with private sector financial imbalances, but also with substantial fiscal imbalances, notably in Hungary but, to a lesser extent, also in Poland and the Slovak Republic. On the supply side, a key concern is that the large net capital inflows are increasingly in the form of more volatile portfolio and so-called "other flows," including short-term debt, rather than foreign direct investment (FDI). Indeed, as noted in Box 1.1, the region became the largest recipient of net non-FDI flows among all emerging market regions in 2005 (Figure 2.7). The important share of lending from advanced-economy banks to their subsidiaries in "other flows" may mitigate the risks to some extent, although any reduction in net financing would still require substantial external adjustment.

Against this background, policymakers must carefully balance the growth opportunities provided by foreign savings against the risks. While the extent of risks varies considerably across countries, given large differences in factors such as the size of short-term external debt and reserve coverage, reducing vulnerabilities is a policy priority, not the least in view of possible regional spillovers, given that the countries share similar vulnerabilities and common creditors. The policy mix to achieve this depends on country circumstances, but generally includes the following:

- *Fiscal consolidation.* In countries with fiscal sustainability problems, determined fiscal adjustment is needed to maintain investor confidence and avoid unfavorable public debt dynamics. This is most urgent in Hungary, where the deficit is likely to reach 10 percent of GDP this year. While the authorities plan to reduce the deficit by some 4 percentage points of GDP in 2007, the proposed measures may be challenging to implement, given legal and administrative complexities, and since they are mostly tax-based, the consolidation package may adversely affect potential growth, not just aggregate demand in the near term. In other

countries, some fiscal tightening may be helpful to moderate domestic demand pressures and their impact on external balances and inflation. This is particularly relevant when a fixed nominal exchange rate constrains monetary policy options, as in the Baltic countries, or when public debt ratios are still high, as is the case in Turkey.

- *Adequate prudential supervision and regulatory frameworks.* The often rapid credit growth in the region partly reflects normal financial deepening from a low base. However, as noted in previous issues of the *World Economic Outlook*, there has been a notable increase in riskier forms of credit, especially a substantial fraction of bank lending in foreign currency, and the share of credit financed by short-term borrowing from foreign banks has risen. Regulators need to ensure that financial systems are in a position to manage exchange and interest rate risks, including by tightening regulatory standards when appropriate.
- *Monetary policy tightening.* Higher interest rates need to be the first line of defense when inflation risks increase either because of strong domestic demand or acute downward pressures on the exchange rate. This policy challenge is well illustrated by the Turkish central bank's strong response to the sharp depreciation of the Turkish lira (19 percent in nominal effective terms between January and June this year). The bank will need to stand ready to tighten further if incoming data point to an unfavorable medium-term inflation outlook. Inflationary pressures have been more moderate in Central European countries, especially in the Czech Republic and Poland, but they have begun to pick up more recently, and some central banks raised policy rates in response (Czech Republic, Hungary, and Slovak Republic). Policymakers will need to stand ready to tighten further if continued rapid growth, depreciating exchange rates, or rising global inflationary pressures add to current pressures on prices.

In some of the new member states of the European Union that have already begun to keep fluctuations in the external value of their currencies within the required limits before euro adoption, strengthening external positions through domestic demand moderation would also reduce the vulnerabilities of exchange rates to swings in investor confidence and capital flow reversals.[8] The most relevant problem is that despite successful disinflation, inflation convergence—to less than 1.5 percentage points above the average level in the three European Union countries with the lowest rates—has been hampered by the combination of limited nominal exchange rate flexibility and pressures for real appreciation, which has tended to push inflation above the average in key trading partners. While some of the pressures for real appreciation are difficult to avoid as they result from so-called "Balassa-Samuelson" effects stemming from rapid productivity growth in the tradables sectors, they also reflect buoyant domestic demand and large capital inflows which, in the absence of monetary policy tools, should be offset primarily by fiscal tightening, although measures aimed at restraining credit growth may also be needed.

More broadly, with most countries in the region aiming for euro adoption in the medium term, policymakers need to ensure adequate preparation for the loss of monetary policy autonomy and the capacity to achieve external adjustment through nominal exchange rate changes in the face of country-specific events. Otherwise, if countries give up nominal exchange rate flexibility too early, such adjustment could require relative price changes

[8]The recently acceded members of the European Union in emerging Europe are committed to adopting the euro and, thereby, to the associated process of macroeconomic policy convergence. This process is most advanced in the five countries that have entered the so-called European Exchange Rate Mechanism (ERM II) and have begun to limit fluctuations in the external value of their currencies against the euro—Slovenia, Lithuania, Estonia, Latvia, and Slovak Republic. Slovenia was recently accepted into the euro area from January 2007, while Lithuania's entry was delayed because its 12-month average inflation rate over the period April 2005 to March 2006 was slightly above the relevant criterion and was expected to rise further during 2006.

Table 2.6. Commonwealth of Independent States: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless noted otherwise)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
Commonwealth of Independent States	**8.4**	**6.5**	**6.8**	**6.5**	**10.3**	**12.3**	**9.6**	**9.3**	**8.1**	**8.8**	**10.1**	**9.4**
Russia	7.2	6.4	6.5	6.5	10.9	12.6	9.7	8.5	9.9	10.9	12.3	10.7
Ukraine	12.1	2.6	5.0	2.8	9.0	13.5	9.3	13.5	10.6	3.1	–2.2	–3.8
Kazakhstan	9.6	9.4	8.3	7.7	6.9	7.6	8.5	7.9	1.1	–0.9	2.3	2.1
Belarus	11.4	9.3	7.0	4.5	18.1	10.3	7.9	9.0	–5.2	1.6	0.2	–1.1
Turkmenistan	14.7	9.6	9.0	9.0	5.9	10.7	9.0	8.0	0.6	5.1	7.6	8.0
Low-income CIS countries	**8.5**	**11.9**	**12.5**	**13.2**	**7.5**	**11.9**	**11.4**	**9.8**	**–7.0**	**1.7**	**10.2**	**21.1**
Armenia	10.1	13.9	7.5	6.0	7.0	0.6	3.0	3.0	–4.6	–3.3	–4.4	–4.6
Azerbaijan	10.2	24.3	25.6	26.4	6.7	9.7	8.7	10.5	–29.8	1.3	26.0	44.8
Georgia	5.9	9.3	7.5	6.5	5.7	8.3	9.6	6.0	–8.4	–5.4	–9.9	–11.5
Kyrgyz Republic	7.0	–0.6	5.0	5.5	4.1	4.3	5.7	4.5	–3.4	–8.1	–7.9	–7.7
Moldova	7.4	7.1	3.0	3.0	12.5	11.9	11.5	10.5	–2.0	–8.3	–10.5	–6.8
Tajikistan	10.6	6.7	8.0	6.0	7.1	7.1	7.8	5.0	–4.0	–3.4	–4.2	–4.8
Uzbekistan	7.7	7.0	7.2	7.0	8.8	21.0	19.3	14.5	10.0	13.1	12.0	11.9
Memorandum												
Net energy exporters[3]	7.6	7.1	7.2	7.3	10.4	12.4	9.8	8.6	8.7	10.0	11.8	11.0
Net energy importers[4]	11.5	4.3	5.5	3.4	10.2	12.0	8.8	11.8	4.8	1.5	–2.4	–3.7

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

through deflation, which is of particular concern in those countries with already large current account deficits that will eventually have to unwind. On the fiscal front, meeting the relevant Maastricht criteria will require sustained policy discipline in a number of countries, especially in Hungary, but also in Poland and the Slovak Republic. Structural reforms are also key to strengthen economic flexibility, as well as to boost prospects for the closing of the productivity gap with EU15 countries, both for new and prospective new members in the region (see Schadler and others, 2006). Policy priorities again vary across countries, given wide differences in structural regimes, but generally include:

- *Reducing labor market rigidities.* Employment rates in the region remain low compared to other emerging market countries. While partly reflecting transition-specific factors, such as an unusually rapid rate of job destruction that will gradually dissipate, low employment rates also owe to labor market rigidities, such as cumbersome restrictions on dismissals and temporary employment, fiscal disincentives to both labor supply and demand, and rigidities hampering regional mobility (e.g., in the housing market).
- *Institutional reform.* Reforms in this domain would aim at reducing costs of doing business, increasing product market competition, fostering further financial deepening, and increasing efficiency in government operations.

Commonwealth of Independent States: Managing Large Foreign Currency Inflows

Real GDP growth in the Commonwealth of Independent States (CIS) is on course to reach close to 7 percent in 2006, before easing to about 6½ percent in 2007 (Table 2.6). The region continues to benefit from high commodity prices and correspondingly strong export earnings (Figure 2.8). In several countries,

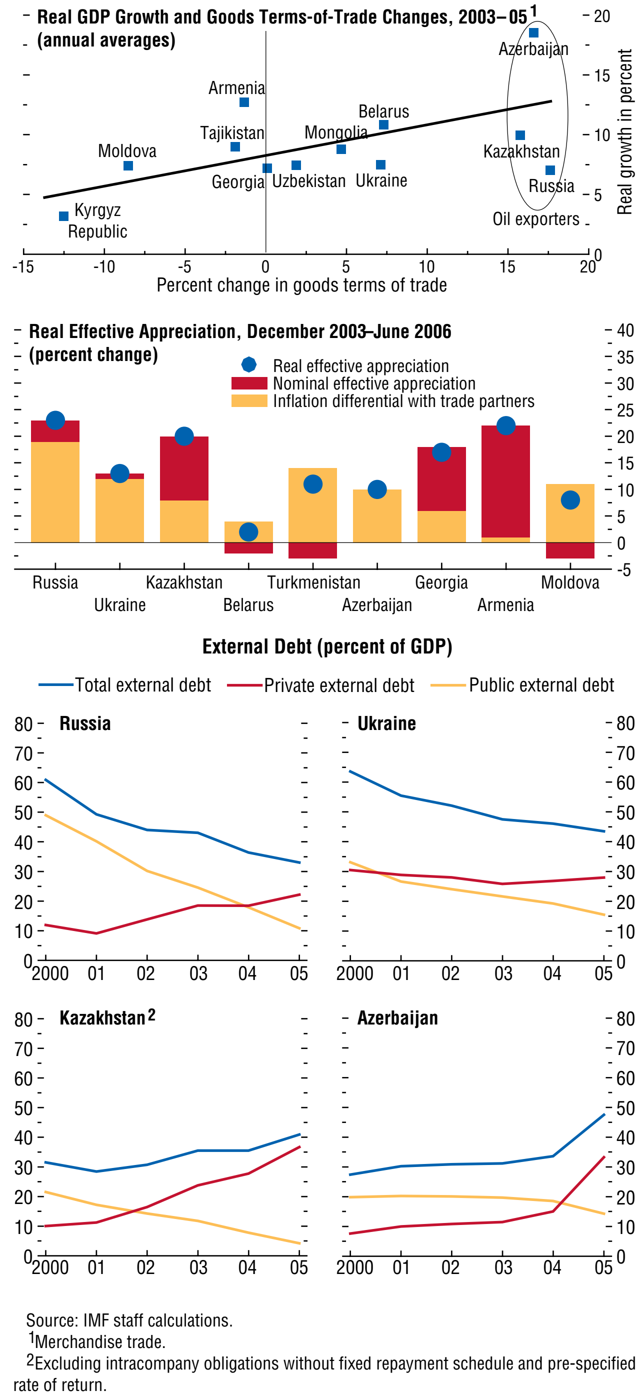
domestic demand has received an additional boost from substantial private capital inflows (Russia, Kazakhstan), official financing (Georgia), and/or remittances (Armenia, Georgia, Kyrgyz Republic, Moldova, Tajikistan). Investment is recovering, including in Russia, where the impact of factors responsible for the slowdown in 2004–05—including banking sector turbulences and a tax-induced decline in oil sector profitability—is waning. Short-term growth prospects are generally positive, although they remain heavily dependent on commodity price developments. In the Ukraine, growth picked up quite strongly in the first half of 2006, but the outlook remains clouded by a projected deterioration in the terms of trade—due to the repricing of gas imports from Russia and a possible reversal in the export price of steel—and lingering policy uncertainties.[9]

The favorable external environment has created important challenges for macroeconomic management, however, that need to be addressed with some urgency to boost longer-term growth prospects. High commodity prices have relaxed short-term fiscal policy constraints, both directly—by increasing export tax revenues and the profits of state-owned enterprises—and indirectly by boosting aggregate demand, and thereby receipts from consumption and income taxes. Often policymakers have used these extra funds prudently, including to pay down public debt and/or to build up foreign currency reserve cushions. More recently, however, some governments have granted large pension and wage increases (Azerbaijan, Belarus, Kyrgyz Republic, Tajikistan), which have further boosted consumption, undermined competitiveness, and would be hard to reverse should the commodity price cycle turn. Policymakers

[9]At present, the Russian energy company Gazprom charges between $47 (Belarus) and $160 (Moldova) for 1000 cubic meters of natural gas. This compares to a price of $230 per 1000 cubic meters for customers in western Europe. Gazprom increased export prices to some CIS customers earlier this year, and has announced its intention to bring prices even more closely in line with "market valuations."

Figure 2.8. Commonwealth of Independent States: Strong Foreign Currency Inflows Create Macroeconomic Challenges

Strong commodity export earnings and capital inflows have boosted growth, but they have also contributed to inflationary pressures. In some countries, private external debt is rising rapidly.



Source: IMF staff calculations.
[1]Merchandise trade.
[2]Excluding intracompany obligations without fixed repayment schedule and pre-specified rate of return.

should not assume that recent revenue gains will all be permanent (see Chapter 5). In countries where scope for fiscal easing exists—such as in Russia, where there is room for some increase in public spending without sacrificing sustainability, and in Kazakhstan—a more expansionary stance should be accompanied by a reinvigoration of stalled reforms to ensure that higher spending boosts investment and potential GDP growth.

Monetary policy also faces important challenges. While inflation has declined in recent months, it remains at or close to double-digit levels in many countries, especially oil exporters. Further progress is needed, but addressing disinflation is complicated by the focus of many central banks on stabilizing the nominal exchange rate against the U.S. dollar in the face of large current account surpluses and capital inflows. With the scope for sterilization of foreign exchange purchases limited by underdeveloped domestic debt markets, base money growth remains above levels consistent with low, single-digit inflation rates. The danger is that inflationary pressures may become entrenched, in which case costly measures may be required in the future to reverse the inflation buildup. While early repayment of external public debt or transfers into offshore oil funds (Azerbaijan, Kazakhstan) can help to reduce base money growth, the most effective way to lower inflation would be to allow for further nominal exchange rate appreciation, thus enhancing the scope for monetary control aimed at disinflation. In some energy-importing countries, inflationary pressures could also emerge from the prospective repricing of fuel and gas imports, in which case monetary policymakers will need to ensure that the necessary pass-through of higher costs does not feed into core inflation, wages, and inflation expectations.

The commodity price boom has also complicated efforts to diversify production and exports away from primary materials to goods with a higher value-added component. Attracted by high expected export earnings, recent investments—both domestic and foreign financed—have often focused on extractive industries (Azerbaijan, Turkmenistan) or on commodity transport infrastructure (oil and gas pipeline projects in Armenia, Azerbaijan, Georgia, Kazakhstan). Moreover, the overall level of investment in the region remains too low at 21 percent of GDP—the recent recovery notwithstanding—which casts doubt on the sustainability of current growth rates over the medium term. Structural reforms to improve the investment climate are crucial to avoid the emergence or aggravation of supply bottlenecks. In countries with large current account surpluses—notably Russia—higher investment would also contribute to reducing global macroeconomic imbalances.

External positions are strong in many countries in the region, especially fuel exporters. For the region as a whole, a current account surplus of over 10 percent of GDP is projected for 2006. Large surpluses have permitted a rapid reduction in the overall level of external debt in oil exporters, especially by the public sector. In several countries (including Azerbaijan, Kazakhstan, and Russia), however, the private sector has accumulated substantial foreign currency liabilities in recent years (Figure 2.8), often intermediated by the banking system. As a consequence, the private sector's vulnerability to a tightening in external financing conditions has increased. Financial system soundness indicators have remained broadly stable, but this is partly on account of the favorable macroeconomic environment. A strengthening of prudential regulations and risk-based supervision would help to reduce risks of financial instability in the face of a downturn, as would measures to restrict regulatory forbearance and—in some cases—policies to assure that the risks associated with the buildup of foreign currency liabilities remain contained.

Africa: Strong Growth Continues Despite High Oil Prices

Sub-Saharan Africa is currently enjoying its strongest period of sustained economic expansion since the early 1970s. Regional growth is

Table 2.7. Selected African Countries: Real GDP, Consumer Prices and Current Account Balance
(Annual percent change unless noted otherwise)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
Africa	**5.5**	**5.4**	**5.4**	**5.9**	**8.0**	**8.5**	**9.9**	**10.6**	**–0.1**	**2.3**	**3.6**	**4.2**
Maghreb	**5.1**	**4.0**	**5.8**	**4.7**	**2.9**	**1.5**	**4.1**	**3.8**	**7.1**	**12.2**	**14.5**	**11.1**
Algeria	5.2	5.3	4.9	5.0	3.6	1.6	5.0	5.5	13.1	21.3	24.8	19.1
Morocco	4.2	1.7	7.3	3.3	1.5	1.0	2.5	2.0	1.9	1.8	0.5	–0.1
Tunisia	6.0	4.2	5.8	6.0	3.6	2.0	3.9	2.0	–2.0	–1.3	–1.6	–1.4
Sub-Sahara	**5.6**	**5.8**	**5.2**	**6.3**	**9.6**	**10.7**	**11.7**	**12.6**	**–2.3**	**–0.6**	**0.4**	**2.3**
Horn of Africa[3]	**8.1**	**8.2**	**9.4**	**9.0**	**8.4**	**7.8**	**9.0**	**7.7**	**–5.8**	**–10.0**	**–7.0**	**–4.0**
Ethiopia	12.3	8.7	5.4	5.5	8.6	6.8	12.3	12.2	–5.1	–9.1	–10.1	–7.1
Sudan	5.2	7.9	12.1	11.3	8.4	8.5	7.0	5.0	–6.3	–10.6	–5.9	–2.8
Great Lakes[3]	**5.6**	**6.0**	**5.7**	**6.2**	**6.9**	**11.6**	**9.1**	**5.7**	**–3.3**	**–3.4**	**–5.6**	**–6.4**
Congo, Dem. Rep. of	6.6	6.5	6.5	7.2	4.0	21.4	10.0	8.9	–5.7	–4.9	–4.2	–0.2
Kenya	4.6	5.7	5.4	5.2	11.6	10.3	13.0	1.6	–2.7	–2.2	–3.8	–5.8
Tanzania	6.7	6.8	5.9	7.3	4.1	4.4	7.5	6.5	–3.9	–5.2	–8.3	–9.8
Uganda	5.7	6.0	5.5	6.0	5.0	8.0	6.7	7.0	–1.0	–1.6	–5.0	–7.1
Southern Africa[3]	**5.0**	**6.5**	**6.1**	**11.4**	**46.5**	**33.9**	**53.3**	**68.2**	**–0.6**	**3.8**	**4.8**	**6.9**
Angola	11.2	20.6	14.3	31.4	43.6	23.0	12.9	8.3	3.5	12.8	12.2	17.4
Zimbabwe	–3.8	–6.5	–5.1	–4.7	350.0	237.8	1,216.0	4,278.8	–8.3	–11.1	0.5	–0.5
West and Central Africa[3]	**6.5**	**5.6**	**4.6**	**5.7**	**8.0**	**11.6**	**7.1**	**5.6**	**–0.5**	**4.1**	**7.4**	**10.1**
Ghana	5.8	5.8	6.0	6.0	12.6	15.1	8.8	7.1	–2.7	–7.7	–7.6	–7.9
Nigeria	6.0	6.9	5.2	6.4	15.0	17.9	9.4	8.0	4.6	12.4	15.7	18.9
CFA franc zone[3]	**7.6**	**4.7**	**3.2**	**4.7**	**0.2**	**4.3**	**3.1**	**2.7**	**–3.6**	**–1.7**	**0.4**	**2.1**
Cameroon	3.7	2.6	4.2	4.3	0.3	2.0	2.9	3.0	–3.4	–1.5	—	0.3
Côte d'Ivoire	1.8	1.9	1.9	3.0	1.5	3.9	2.6	2.8	1.6	–0.1	1.8	3.1
South Africa	**4.5**	**4.9**	**4.2**	**4.0**	**1.4**	**3.4**	**4.6**	**5.7**	**–3.4**	**–4.2**	**–5.5**	**–4.7**
Memorandum												
Oil importers	4.8	4.5	4.8	4.5	7.3	8.3	11.1	12.5	–2.8	–3.3	–4.1	–3.8
Oil exporters[4]	7.3	7.4	6.7	9.1	9.7	9.0	7.2	6.2	5.8	12.2	15.4	15.8

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

expected at 5.2 percent this year—the third successive year it has exceeded 5 percent—before increasing to 6.3 percent in 2007 as oil output recovers in Nigeria and new oil fields in Angola and Equatorial Guinea come on stream (Table 2.7). Oil-exporting countries have contributed significantly to this strong performance. Increased oil production in a number of countries and the large terms-of-trade gains from the significant rise in oil prices have boosted domestic incomes and spending. Growth in oil-importing countries—although lagging that in oil exporters by a substantial margin—has also been surprisingly robust, despite higher oil prices and the removal of international textile trade quotas, which has adversely affected a number of countries, most particularly Lesotho and Swaziland. This resilience contrasts with earlier periods of high international oil prices, when growth in these countries was hit hard (the exception being 1972–74, when the regional terms of trade actually increased because of the concurrent boom in nonfuel commodity prices; see Figure 2.9; and Dudine and others, 2006).

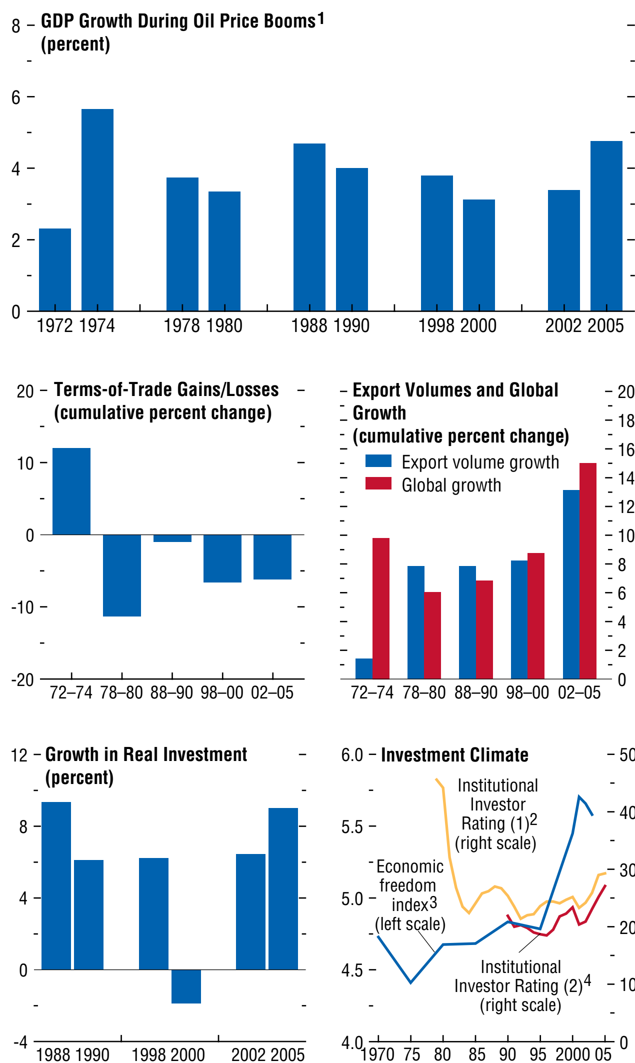
Why has growth in oil-importing countries held up so well in the face of high oil prices?

- The rise in nonfuel commodity prices has certainly helped to cushion the impact of higher oil prices in some countries, but this has not been universal (Box 2.2). For example, Mozambique, Zambia, and South Africa have benefited from higher metals prices, and

Figure 2.9. Sub-Saharan Africa: Oil-Importing Countries Record Strong Growth Despite High Oil Prices

(Sample medians)

Growth in oil-importing countries in sub-Saharan Africa has been resilient despite rising oil prices. Higher nonfuel commodity prices—which have cushioned the deterioration in the terms of trade—strong global growth, and better domestic policies have all helped.



Source: IMF staff calculations.

[1]Five oil price booms are identified as: 1972–74; 1978–80; 1988–90; 1998–2000; 2002–05. For this panel and the real investment growth panel, the first and last year of each boom are shown. For the terms of trade and export volume panels, the cumulative growth during the boom are shown.

[2]Comprises Côte d'Ivoire, Kenya, Mauritius, Senegal, South Africa, and Tanzania.

[3]Cato Institute.

[4]Comprises Benin, Botswana, Burkina Faso, Cameroon, Côte d'Ivoire, Ethiopia, Ghana, Kenya, Mali, Mauritius, Senegal, South Africa, Swaziland, Tanzania, and Togo.

Burundi, Ethiopia, Sierra Leone, Rwanda, and Uganda from stronger coffee prices. By contrast, exporters of cotton (Benin, Burkina Faso, Mali, and Togo) and cocoa (Côte d'Ivoire, Ghana, São Tomé and Príncipe) have seen a substantial deterioration in their terms of trade.

- The global economic environment has been supportive and regional export growth has generally been strong.
- Countries that have experienced a deterioration in their terms of trade in recent years have seen an increase in aid and stronger capital inflows that have helped cushion the income loss (see Box 2.2).
- Stronger domestic policy frameworks have helped support economic activity, particularly investment. Despite the impact of higher oil prices, inflation generally remains well contained and fiscal positions have deteriorated only modestly. Together with the institutional transitions that have taken place in a number of countries in recent years—see the September 2005 *World Economic Outlook*—this has created a better business climate, although the costs of doing business in Africa remain high.[10]

Nevertheless, while strong growth is expected to continue, there are a number of risks to the outlook. First, if oil prices remain elevated, they may have a more detrimental impact on growth going forward than they have done in the recent past, particularly if combined with a sharper-than-expected decline in non-oil commodity prices (see the analysis of the outlook for nonfuel commodity prices in Chapter 5). Second, export performance would suffer if global growth slowed or—against the background of large global imbalances—the euro appreciated

[10]An institutional transition is defined as a sustained improvement in the quality of economic institutions in a country. The quality of institutions is assessed using an overall index composed of indicators encompassing the legal structure and property rights, the freedom to trade internationally, and regulation of credit, labor, and business (see Chapter III of the September 2005 *World Economic Outlook* for details). The importance of sound institutions for growth was taken up in Chapter III of the April 2003 *World Economic Outlook*.

Box 2.2. Commodity Price Shocks, Growth, and Financing in Sub-Saharan Africa

The recent sharp increase in oil prices has been a burden on oil-importing countries around the world, especially low-income countries that can ill afford higher oil bills. However, unlike earlier episodes of oil price hikes (1979–80; 1998–2000), there have been simultaneous increases in prices of a number of other commodities, including metals and some agricultural products, that are exported by low-income countries, in the context of buoyant world demand. This box looks at the overall impact of commodity price changes on low-income countries in sub-Saharan Africa. In particular, it asks which countries have benefited from the commodity price changes; which have suffered, and by how much; and what has been the impact on growth?

Gainers and Losers

Oil prices increased by about 25 percent per year in real terms over the period 2002–05, but major price gains were also recorded by a number of other commodities, including uranium (38 percent per year), copper (30 percent), coffee (19 percent), gold (10 percent), and aluminum and diamonds (about 9 percent). Prices of other important commodity exports, such as tea, coffee, beef, and cotton, rose in the range of 3 to 5 percent a year.

In net terms, countries in sub-Saharan Africa have gained from these commodity price changes (column 1 of the table).[1] But this aggregate masks quite disparate developments at the country level. Out of the 33 countries for which disaggregated trade data are available through *World Integrated Trade Solution* (WITS), 13 countries experienced a terms-of-trade gain, averaging 4.3 percent of GDP per year, while 20 countries suffered terms-of-trade losses, averaging 1.7 percent of GDP per year. The net gainers were predominantly oil exporters (Cameroon, Gabon, Nigeria, and the Sudan), but also included exporters of diamonds (Botswana), uranium (Niger), copper (Zambia), aluminum (Mozambique) and tobacco (Zimbabwe). The largest losers were all net oil importers (Ghana, Madagascar, and Senegal).

Note: The authors of this box are Arvind Subramanian and Thierry Tressel.

[1]Disaggregated commodity trade data (available from the United Nations WITS Trade database) for countries in sub-Saharan Africa. In calculating the terms-of-trade impact, the counterfactual assumption is that prices would have otherwise remained at their 2002 levels; and to isolate the pure price effect, the changes were computed in terms of base period import and export volumes.

Commodity Terms-of-Trade Shocks and Financing
(Percent of GDP unless noted otherwise)

	Terms-of-Trade Shock (1)	Real GDP Growth (percent) (2)	Change in Net ODA (3)	Change in Net Private Capital Flows (4)	Total of: Terms of Trade Effect, Change in Net ODA and Private Capital Flows (5)
Average (33 countries)[1]	0.8	4.1	0.9	0.2	1.9
Average positive shock (13 countries)	4.3	3.2	0.2	–0.3	4.2
Average negative shock (20 countries)[1]	–1.7	4.2	1.7	0.6	0.6
Positive shocks (top third) (11 countries)	5.1	3.2	0.2	–0.9	4.4
Intermediate shocks (11 countries)[1]	–0.4	3.8	1.2	1.1	1.8
Negative shocks (bottom third) (11 countries)	–2.5	4.6	1.8	0.7	0.1

Source: OECD-DAC; and IMF, *World Economic Outlook*.
Note: Change in aid and net private capital flows are computed as changes between 2003–05 averages and 2002. Net private capital flows include net FDI, net private portfolio investments and net other private investment. Net ODA includes debt relief.
[1]Excluding Burundi and Mozambique.

Box 2.2 *(concluded)*

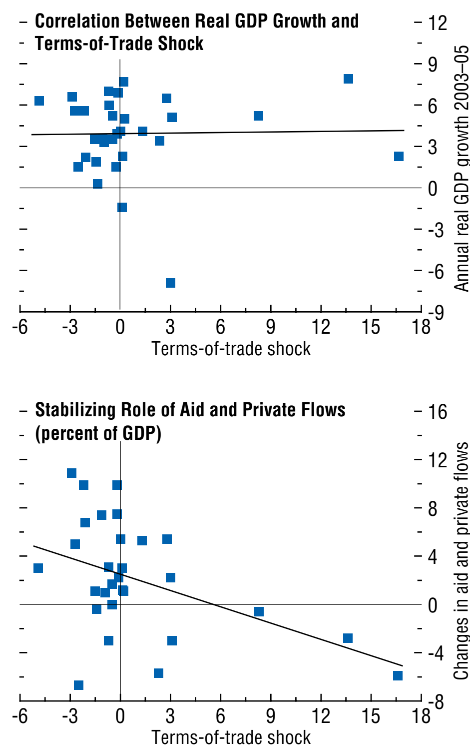
Impact on Growth

The remarkable feature of this commodity price cycle has been the fact that virtually all countries, even those that have suffered a terms-of-trade loss, have maintained robust growth.[2] Real GDP growth averaged 4.1 percent over 2003–05 in the 33 countries in the sample, with net terms-of-trade gainers and losers registering broadly similar growth (3.2 percent and 4.2 percent, respectively) (column 2).[3] This is surprising since, other things equal, countries that experience real income gains would usually be expected to experience higher aggregate demand growth, and hence higher overall growth. To look at this in more detail, the correlation between this income effect of terms-of-trade and growth across countries is depicted in the figure. The presumption is that this correlation would be positive, but in fact the figure shows a surprisingly weak correlation. The disaggregated picture is even more puzzling. The correlation is actually strongly negative for cases where there has been a positive terms-of-trade change and mildly negative for terms-of-trade losers.

One possible explanation for why growth in terms-of-trade losers has held up well is that world growth has remained robust, which has supported export volumes of all countries, especially in countries that suffered terms-of-trade losses. For the period 2003–05, the annual average growth in export volumes for the terms-of-trade losers was about 6.8 percent compared with about 2.5 percent for the gainers. In other words, volume effects have offset price effects, helping to maintain overall growth rates.[4]

Consumption and hence growth in the terms-of-trade losers could have been buttressed by aid and private capital flows, offsetting the dampening income effects of adverse

Commodity Prices, Aid, and Growth in Africa



Source: IMF staff calculations.

[2]Dudine and others (2006); and the IMF's September 2006 *Regional Outlook* for Sub-Saharan Africa.

[3]These growth figures differ from the data on sub-Saharan Africa aggregates shown in Table 1.10 because they include only the 33 countries for which the WITS data are available. Calculations based on WEO data for terms-of-trade (goods), rather than the disaggregated WITS data, yield a slightly different listing of terms-of-trade gainers and losers, especially since WITS does not include data on some major oil exporters, including Angola, Chad, and the Republic of Congo. Nonetheless, based on WEO data too, the growth performance of terms-of-trade losers is broadly similar to that of the gainers.

[4]Another possible channel shoring up demand would be movements in real exchange rates. But the data suggest that terms-of-trade losers also saw a real exchange rate appreciation (of about 6 percent on average), even though the magnitudes were lower on average for this group than for the terms-of-trade gainers.

terms-of-trade developments. For countries in sub-Saharan Africa, the predominant source of financing has been aid. Have aid flows helped countries facing terms-of-trade losses? In aggregate, aid flows to sub-Saharan Africa have increased since 2002, on average by about 1 percent of GDP per year (column 3 in the table). Moreover, the pattern of aid flows has helped to cushion countries facing net terms-of-trade losses: terms-of-trade gainers saw a small increase in aid flows while losers saw a much larger increase, averaging nearly 2 percentage points of GDP. Private capital flows have also contributed to consumption smoothing, rising by ½ percentage point of GDP per year for net terms-of-trade losers, contributing further to cushioning the impact of the shocks (column 4).[5]

Overall, adding up changes in aid flows, private capital flows and earnings from commodities, terms-of-trade gainers saw an increase in external flows of about 4.2 percent of GDP (column 5), but terms-of-trade losers also saw an increase of 0.6 percent of GDP on average.[6] The negative correlation between aid and private flows, on the one hand, and the terms-of-trade changes on the other, illustrates the stabilizing role performed by the former (lower panel of the figure). This may have been an important factor in explaining the resilience of growth even in countries that experienced terms-of-trade losses.

[5]Private capital flows includes foreign direct investment (FDI), portfolio investments and other private capital flows (including trade credit and bank borrowing), but not private transfers such as remittances.

[6]Nine countries, however, did experience a decline in their overall flows (Burkina-Faso, Cameroon, Côte d'Ivoire, Lesotho, Mauritius, Mozambique, Senegal, Togo, and Uganda).

There is also a possible supply side explanation for the observed pattern of growth: differences in governance. The average score for a measure of governance compiled by the World Bank that measures the rule of law is on average lower for terms-of-trade gainers than for losers, and this difference is statistically significant.[7] This is not surprising because, worldwide, commodity exporters typically tend to fare less well on measures of institutional quality. The most telling illustration is Zimbabwe, which experienced one of the largest terms-of-trade gains and yet registered the worst growth performance (–6.9 percent on average) over the period in question. The low correlation between the income effect from commodity price changes and growth is consistent with the view that the impact on overall growth depends to a great deal on the broader institutional context.

In conclusion, the welcome surprise of this commodity price cycle is that the net terms-of-trade losers in sub-Saharan Africa have maintained robust growth on average, cushioned in part by aid and private capital flows. However, the resilience of these economies could be tested if nonfuel commodity prices moderate (as suggested in Chapter 5), while oil prices stay high. Another open question is whether the large terms-of-trade gainers (mainly the oil exporters) will use their commodity earnings prudently to improve economic management and governance on a durable basis (for example, Nigeria and some other oil producers are saving a high and increasing proportion of their oil revenues) or whether they will once again be victims of the oil curse.

[7]Similar results are obtained using other measures of institutional quality.

substantially (undermining the competitiveness of the CFA franc-zone countries). Third, countries that have widening current account deficits and are more reliant on private capital flows—such as South Africa—would be hurt if global financial market conditions deteriorate. Fourth, an avian flu pandemic could have major implications for Africa given relatively undeveloped

health care systems. Lastly, political uncertainties and armed conflicts could adversely affect the outlook in a number of countries (e.g., ongoing unrest in the Niger delta presents a downside risk to growth in Nigeria).

The improved growth performance in sub-Saharan Africa in recent years is very welcome, but it still falls well short of the 7 percent annual growth needed to meet the Millennium Development Goal (MDG) of halving poverty by 2015 (and sub-Saharan Africa is not on target to meet the other MDGs either). It is important that governments in the region continue to press ahead with reforms to promote private sector investment—including foreign investment, which remains low and largely concentrated in Nigeria and South Africa—and employment. Such reforms will need to encompass further trade liberalization, reduced government involvement in the economy, improvements to the business environment through the streamlining of regulations and improved governance, the development of infrastructure, and the further strengthening of economic institutions. Efforts to strengthen domestic policies should continue to be supported by the international community, including through debt relief,[11] making good on recent commitments to further boost aid, and bold market opening initiatives by advanced and developing countries to improve access for regional exports.

In addition to these broad policy requirements, oil-exporting and -importing countries in the region face specific challenges. In oil exporters, policymakers will need to strike an appropriate balance between spending and saving the additional oil revenues. The higher revenues certainly provide scope for some additional government spending to foster growth, generate employment, and reduce poverty, but they should be managed in a way that is consistent with achieving overall macroeconomic policy objectives (notably containing inflation, which in many oil exporters is running above the regional average). In Nigeria, for example, a key challenge is to reduce inflation decisively to single-digit levels, which will require a tight fiscal stance in the near term. Improved transparency in the use of oil revenues is also important to ensure that the benefits of this sector are spread widely among the population. In this regard, implementation of the Extractive Industries Transparency Initiative (EITI) in oil-producing countries in the region should be a priority.

In oil-importing countries, the challenge is to continue to adjust to high oil prices, while pursuing reforms that strengthen medium-term growth prospects. Most countries have so far appropriately allowed the increase in international oil prices to pass through to domestic energy prices so that demand adjusts. This will need to continue, with countries with weaker fiscal and external positions having little scope to avoid passing through higher prices without delay. Exchange rates will have to adjust to the deterioration in the terms of trade (through nominal depreciation in countries with flexible exchange rates, or wage and price adjustment in countries with fixed exchange rate regimes), and if higher oil prices feed into wages and inflation, a tightening of monetary conditions would be called for. In South Africa, for example, the inflation outlook has deteriorated against the backdrop of rising oil prices, rapid credit growth, and the recent depreciation of the rand, and the central bank has appropriately tightened monetary policy to counter these pressures. Adjustment to high oil prices will need to go hand-in-hand with efforts to strengthen the social safety net to assist the poor who are disproportionately affected by higher energy prices. In countries where a social safety net does not exist, other pro-poor programs could be introduced or strengthened—for example, in Ghana, the government eliminated school fees and increased spending on health care and rural electrification at the same time that it increased fuel prices.

[11]Fifteen countries in sub-Saharan Africa have received $2.8 billion in debt relief from the IMF under the Multilateral Debt Relief Initiative (MDRI).

Table 2.8. Selected Middle Eastern Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless noted otherwise)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
Middle East	**5.5**	**5.7**	**5.8**	**5.4**	**7.6**	**7.7**	**7.1**	**7.9**	**11.9**	**18.5**	**23.2**	**22.5**
Oil exporters[3]	**5.8**	**6.0**	**6.0**	**5.3**	**7.3**	**7.0**	**7.9**	**8.4**	**13.8**	**21.3**	**26.6**	**25.8**
Iran, I.R. of	5.6	5.4	5.4	4.9	15.2	12.1	14.0	15.0	0.9	7.3	10.0	8.9
Saudi Arabia	5.3	6.6	5.8	6.5	0.4	0.7	1.0	1.0	20.7	29.3	32.9	31.9
Kuwait	6.2	8.5	6.2	4.7	1.3	3.9	3.5	3.0	31.1	43.3	52.5	51.9
Mashreq	**4.3**	**4.5**	**4.7**	**5.2**	**8.1**	**9.5**	**4.5**	**7.3**	**–0.4**	**–1.7**	**–2.5**	**–3.4**
Egypt	4.1	4.9	5.6	5.6	10.3	11.4	4.1	6.2	4.3	3.3	2.0	1.2
Syrian Arab Republic	3.1	2.9	3.2	3.7	4.4	7.2	5.6	14.4	—	–2.2	–1.8	–1.8
Jordan	8.4	7.2	6.0	5.0	3.4	3.5	6.3	5.7	–0.2	–18.2	–20.7	–19.7
Lebanon	6.0	1.0	–3.2	5.0	–1.3	0.3	4.5	3.0	–18.2	–11.9	–12.8	–16.2
Memorandum												
Israel	4.8	5.2	4.1	4.4	–0.4	1.3	2.8	2.0	2.6	2.9	1.2	1.0

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

Middle East: Living with Booming Oil Exports

Oil revenues in the Middle East region have risen further in the first half of 2006, because of both higher prices and some expansion in production (notably in Kuwait, Libya, Saudi Arabia and the United Arab Emirates). Reflecting the income gains, oil-exporting countries have continued to enjoy robust growth, particularly in the non-oil sectors, while external current account and fiscal balances have improved further. With non-oil sector growth running at 8 percent, inflation has begun to pick up, although it remains generally well contained (except in the Islamic Republic of Iran) by the combination of pegged exchange rates, open product and labor markets, and low global inflation. Equity markets in the region faced major corrections in early 2006—prices fell by some 25 to 35 percent from their peaks—but so far, financial stability has been preserved and the macroeconomic impact is likely to be contained.

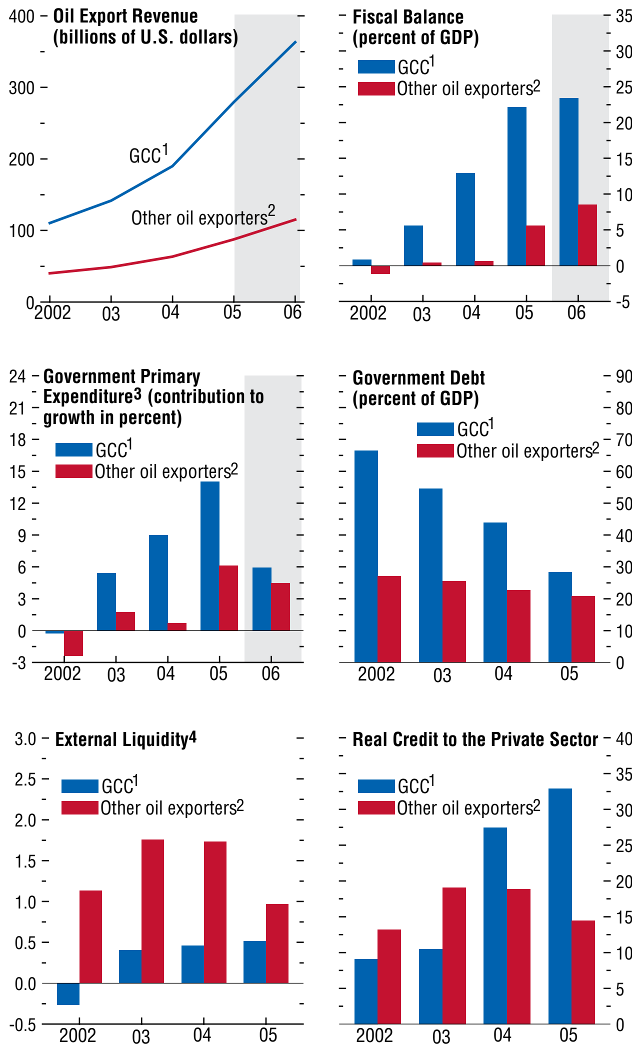
Despite large terms-of-trade losses, growth in oil-importing countries in the Mashreq (which account for about 20 percent of regional GDP) generally has held up well. This resilience reflects the supportive global economic environment and rapid credit growth as well as country-specific factors, such as delays in the pass-through of higher oil prices (Jordan) and higher Suez Canal receipts (Egypt).[12] In Lebanon, growth has been hampered by political uncertainty over the last year, and real GDP is expected to decline substantially in 2006 as a result of the recent conflict. Higher oil prices have also led to a pick up in headline inflation, and in weaker external positions (Jordan).

Looking forward, the outlook for the region generally remains favorable, given that oil prices are expected to remain high, and regional GDP growth is projected at close to 6 percent in 2006 (Table 2.8). With continued prudent financial policies and little growth in oil production, GDP growth is expected to moderate slightly to about 5½ percent in 2007. The regional current account surplus is projected to rise further to 23 percent of GDP in

[12]Egypt is not classified as an oil exporter in the *World Economic Outlook* even though the country is a net exporter of crude oil and, increasingly, natural gas because the share of fuel exports in total exports of goods and services is less than 50 percent. Accordingly, the country has directly benefited from higher oil prices, not just indirectly through position regional spillovers.

Figure 2.10. Middle East: Spending Booming Oil Revenue Wisely

Booming oil revenues provide an opportunity to address long-standing structural problems. However, rapid credit growth and asset price increases could signal risks of overheating, and further spending increases should depend on the extent of excess capacity and a country's absorptive capacity.



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

[1]The Cooperation Council of the Arab States of the Gulf (GCC) includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates.

[2]Consists of I.R. of Iran, Libya, Syrian Arab Republic, and the Republic of Yemen.

[3]Real growth in primary government expenditure weighted by the share of these expenditures in GDP in the previous period.

[4]Foreign reserve accumulation as a fraction of the current account balance.

2006—to around $280 billion—before starting to decline in 2007. Near-term prospects for oil exporters are generally more propitious than for non-oil exporters in the Mashreq, although the latter will continue to benefit from a supportive environment at both the regional and the global levels. Risks to growth are broadly balanced. On the upside, surging oil revenues could provide for higher government expenditure, while possible further corrections in some still richly valued asset prices are a downside risk. For the non-oil exporters, the external balance implications of the large terms-of-trade losses add an element of vulnerability to the outlook. Finally, geopolitical risks remain a serious concern.

The central policy challenge for the oil-exporting countries remains managing booming oil revenues. Most countries have appropriately begun to use the opportunity provided by higher revenues to increase spending to address long-standing structural problems, in particular the need to generate employment for the rapidly growing working-age population and to boost infrastructure and human capital development (Figure 2.10). In addition, national oil companies in the region have developed plans for ambitious capacity expansion and are ratcheting up investment. At the current juncture, there seems ample scope for this buildup of spending, given high unemployment in many countries and still low inflation, although with continued rapid credit growth, the risks of overheating need to be carefully monitored. It will however, be important for higher expenditure to be accompanied by determined efforts at capacity-enhancing reforms to ensure that the funds are well used and bring lasting supply-side benefits; otherwise, growth will remain dependent on continued high oil prices. Priorities in this regard are reforms that contribute to increasing private sector participation and investment in major sectors that would help to diversify oil-dependent economies.

With many oil exporters in the region pegging their currencies to the U.S. dollar, inflation will inevitably rise somewhat with higher

expenditure, as prices of locally produced goods and services will increase compared to those traded internationally. However, if expenditure increases are appropriately aligned with macroeconomic conditions and are accompanied by structural reforms, any pick-up in inflation should remain contained and temporary. In contrast to the generally low inflation in the region, inflation is running at about 12 percent (year-on-year basis) in the Islamic Republic of Iran, reflecting the combination of rising government expenditure and expansionary monetary policy. With monetary control hampered by multiple, internally inconsistent policy objectives and limited operational autonomy of the central bank, some fiscal policy tightening will be required to reduce inflation, with additional support from greater exchange rate flexibility.

In oil-importing countries, the key macroeconomic policy challenge is to facilitate the economic adjustment to the terms-of-trade loss, which is likely to include a substantial permanent component. Allowing for the full pass-through of the higher world oil prices to final users will be key to ensure budget sustainability and adjustment in energy consumption. Recent fuel price increases in Jordan were appropriate steps in this direction. In view of generally large current account deficits, fiscal consolidation is urgently needed to reduce external vulnerabilities related to public debt. In Egypt, the favorable outlook provides an excellent opportunity to reduce the large fiscal deficit and put public debt on a declining path. In some countries, real exchange rate depreciation may be helpful to support the external adjustment. Given limited exchange rate flexibility in the oil-importing countries, this adjustment may require some macroeconomic policy tightening to rein in domestic demand and reduce inflation below partner country levels. Concurrent structural reforms aimed at raising trade openness and productivity would provide important synergies.

Finally, policymakers throughout the region should be mindful of prudential risks in the financial sector. With oil export proceeds partly flowing into the domestic banking system and substantial net capital flows to non-oil exporters, broad money and, even more so, credit growth have accelerated sharply in many countries over the past three years and remain very high. At the same time, the favorable oil market outlook and buoyant investor confidence have underpinned large increases in equity and property prices relative to GDP in 2004–05, even though some of these gains were reversed in the first half of 2006. This combination has raised concerns about increased leverage in private sector balance sheets, including in the household sector, rising financial sector exposure to asset price corrections, and a possible deterioration in credit quality. Supervisors need to monitor such risks carefully and ensure adequate prudential standards. At the same time, reforms aimed at improving market liquidity and transparency will help to reduce asset price volatility that is not related to fundamentals. The recent lifting of restrictions in equity markets for foreign investors in Saudi Arabia was a welcome step in this regard.

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