CHAPTER 2 COUNTRY AND REGIONAL PERSPECTIVES

Against the background of the global outlook discussed in Chapter 1, this chapter analyzes prospects and policy issues in the major advanced economies and in the main regional groupings of emerging market and developing countries. A consistent theme is that while the short-term outlook is generally still positive, policymakers should increase efforts to advance fiscal and structural reforms to ensure that strong growth can be sustained.

United States and Canada: How Much Will the U.S. Economy Slow?

The U.S. economy has slowed noticeably over the past year. After a strong first quarter, real GDP grew by around 2¼– 2½ percent (seasonally adjusted annualized rate) in each of the last three quarters of 2006. While private consumption spending continued to increase robustly, the housing sector remained a substantial drag on growth, with residential investment declining by around 19 percent (annualized rate) in the second half of the year and business purchases of equipment and software softening toward year-end. The manufacturing sector has been weak, particularly in autos and sectors related to construction, as demand has slowed and inventories have risen.

The central question in assessing near-term prospects for the U.S. economy is whether this weakness in growth is a temporary slowdown—a "midcycle pause" as occurred in 1986 and 1995—or the early stages of a more protracted downturn. While uncertainties remain, and recent data on retail sales and durable goods orders have been weaker than anticipated, a growth pause still seems more likely at this stage than a recession. Consistent with past "midcycle pauses," the labor market remains robust, with job losses in manufacturing and construction being offset by strong gains in the services sector, and the unemployment rate is stable at 4½ percent (Figure 2.1). Further, corporate profitability and equity prices are at high levels, which should help support business investment, and real interest rates are still low by historical standards. And while the yield curve is inverted—which in the past has been a good leading indicator of recessions—it is less likely that this is portending a steep slowdown this time, as the inversion reflects low long-term rather than high short-term rates.[1] Lastly, the impact of the cooling housing sector on financial markets has been limited to date. While delinquency rates on subprime mortgages and spreads on associated securitized bonds have increased sharply, those on prime mortgages, other forms of consumer credit, and corporate borrowing still remain low (see the April 2007 *Global Financial Stability Report*). The financial sector is generally in good shape and credit remains readily available.

Consequently, while the growth forecast for 2007 has been lowered to 2.2 percent (0.7 percentage point lower than at the time of the September 2006 *World Economic Outlook*), the expansion is expected to gradually regain momentum, with quarterly growth rates rising during the course of 2007 and returning to around potential by mid-2008 (Table 2.1).[2] In particular, strong corporate balance sheets and high profitability should underpin a pickup in corporate investment after its recent softness, while the robust labor market should limit the negative wealth effect on consumption from weaker house prices. The downward revision to growth in 2007 largely reflects the weaker out-

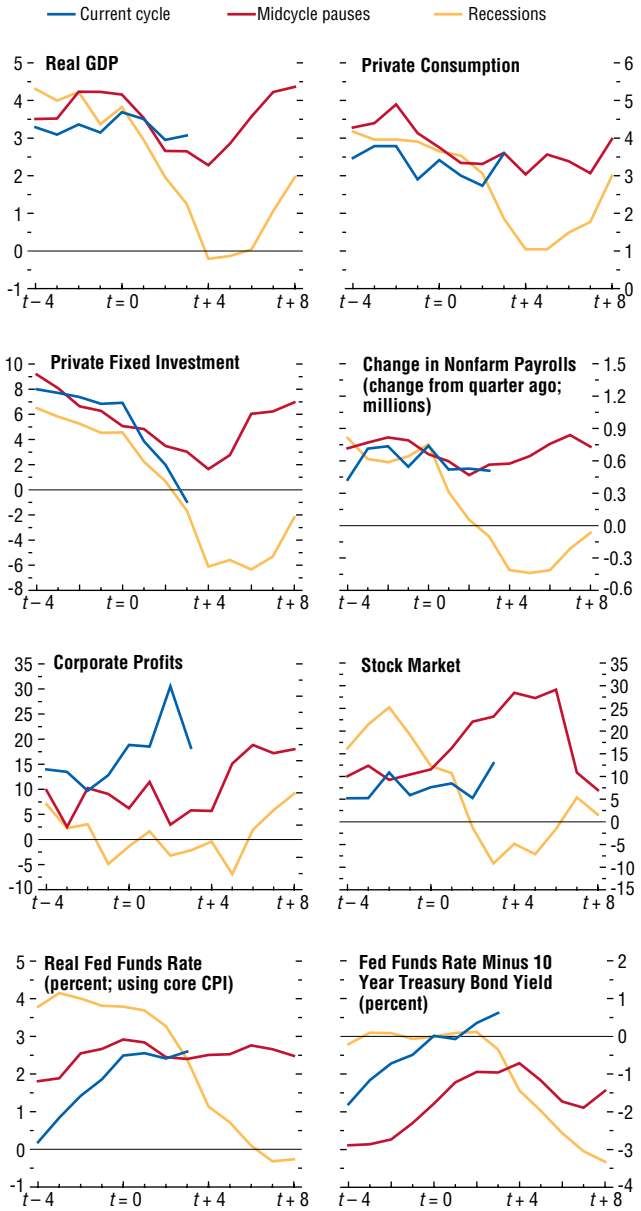
[1]Ongoing structural changes, including pension fund asset reallocation and foreign demand for U.S. securities, have boosted desired holdings of long-dated U.S. securities and pushed down their yield (see Wright, 2006).

[2]The March Consensus forecast is for growth of 2.4 percent in 2007 and 3 percent in 2008 with a range of 2.1–2.9 percent in 2007 and 2.5–3.6 percent in 2008.

Figure 2.1. United States: How Much Will the U.S. Economy Slow?

(Percent change from four quarters earlier, unless otherwise noted)[1]

With employment growth steady, corporate profitability strong, and real interest rates still relatively low, it still seems likely that the current slowdown will be shallow and short lived—a midcycle pause—rather than develop into a more significant downturn.



Sources: Haver Analytics; and IMF staff calculations.

[1] $t = 0$ is the peak of the GDP growth cycle. For recessions these peaks are in March 1990 and June 2000, and for midcycle pauses in March 1986 and December 1994. The peak of the current cycle is in March 2006.

look for residential investment. With the stock of new homes for sale rising to its highest level in over 15 years, home construction is falling more sharply than previously expected as homebuilders move to reduce their existing inventory. While there are some very tentative signs that housing demand may be stabilizing—mortgage applications for purchase and existing home sales have risen above their September–October lows—problems in the subprime mortgage market will likely prolong the residential investment cycle. The commercial real estate market may help to partly offset the downturn in the housing sector in the near term, both in terms of investment and employment (Figure 2.2). Nevertheless, it is not clear whether the current strength of the commercial sector will be sustained in the absence of a turnaround in residential investment, particularly against the backdrop of relatively high vacancy rates. The weakness in residential investment in the forecast is partly offset by the external sector, which is expected to make its first positive contribution to growth since 1995.

The balance of risks to this less buoyant outlook remains on the downside. A sharper-than-expected slowing in house prices would pose risks to both residential investment and, through the impact on wealth and employment, consumption (see also Box 2.1). Also, the deterioration in credit quality in the subprime mortgage market could spread to other market segments in a weaker housing environment, adversely affecting the financial sector and credit availability. There are also concerns that the curent softness of business investment could be extended. On the upside of the central forecast, the depreciation of the dollar could provide a stronger spur to exports than projected.

Inflation has eased somewhat in recent months, with 12-month core CPI (excluding food and energy) inflation declining to 2.7 percent in February from 2.9 percent in September. At the same time, however, a number of measures of wage costs have been moving higher against the background of the tight labor market and slowing productivity, although strong

Table 2.1. Advanced Economies: Real GDP, Consumer Prices, and Unemployment
(Annual percent change and percent of labor force)

	Real GDP				Consumer Prices				Unemployment			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Advanced economies	**2.5**	**3.1**	**2.5**	**2.7**	**2.3**	**2.3**	**1.8**	**2.1**	**6.0**	**5.5**	**5.4**	**5.4**
United States	3.2	3.3	2.2	2.8	3.4	3.2	1.9	2.5	5.1	4.6	4.8	5.0
Euro area[1]	1.4	2.6	2.3	2.3	2.2	2.2	2.0	2.0	8.6	7.7	7.3	7.1
Germany	0.9	2.7	1.8	1.9	1.9	1.8	2.0	1.6	9.1	8.1	7.8	7.6
France	1.2	2.0	2.0	2.4	1.9	1.9	1.7	1.8	9.7	9.0	8.3	7.8
Italy	0.1	1.9	1.8	1.7	2.2	2.2	2.1	2.0	7.7	6.8	6.8	6.8
Spain	3.5	3.9	3.6	3.4	3.4	3.6	2.6	2.7	9.2	8.5	7.8	7.7
Netherlands	1.5	2.9	2.9	2.7	1.5	1.7	1.8	2.1	4.7	3.9	3.2	3.1
Belgium	1.5	3.0	2.2	2.0	2.5	2.3	1.9	1.8	8.4	8.3	7.8	7.6
Austria	2.0	3.2	2.8	2.4	2.1	1.7	1.6	1.7	5.2	4.8	4.5	4.3
Finland	2.9	5.5	3.1	2.7	0.8	1.3	1.5	1.6	8.4	7.7	7.5	7.4
Greece	3.7	4.2	3.8	3.5	3.5	3.3	3.2	3.2	9.9	8.9	8.3	8.5
Portugal	0.5	1.3	1.8	2.1	2.1	3.1	2.5	2.4	7.6	7.7	7.4	7.3
Ireland	5.5	6.0	5.0	3.7	2.2	2.7	2.4	2.1	4.4	4.4	4.5	4.7
Luxembourg	4.0	5.8	4.6	4.1	2.5	2.7	2.1	2.1	4.2	4.4	4.6	4.8
Slovenia	4.0	5.2	4.5	4.0	2.5	2.7	2.7	2.4	6.5	6.4	6.4	6.4
Japan	1.9	2.2	2.3	1.9	–0.6	0.2	0.3	0.8	4.4	4.1	4.0	4.0
United Kingdom[1]	1.9	2.7	2.9	2.7	2.0	2.3	2.3	2.0	4.8	5.4	5.3	5.1
Canada	2.9	2.7	2.4	2.9	2.2	2.0	1.7	2.0	6.8	6.3	6.2	6.2
Korea	4.2	5.0	4.4	4.4	2.8	2.2	2.5	2.5	3.7	3.5	3.3	3.1
Australia	2.8	2.7	2.6	3.3	2.7	3.5	2.8	2.9	5.1	4.9	4.6	4.6
Taiwan Province of China	4.0	4.6	4.2	4.3	2.3	0.6	1.5	1.5	4.1	3.9	3.8	3.7
Sweden	2.9	4.4	3.3	2.5	0.8	1.5	1.8	2.0	5.8	4.8	5.5	5.0
Switzerland	1.9	2.7	2.0	1.8	1.2	1.0	0.6	1.0	3.4	3.4	2.9	2.8
Hong Kong SAR	7.5	6.8	5.5	5.0	0.9	2.0	2.1	2.3	5.7	4.8	4.4	4.2
Denmark	3.1	3.3	2.5	2.2	1.8	1.9	2.0	1.9	5.7	4.5	4.7	4.9
Norway	2.7	2.9	3.8	2.8	1.6	2.3	1.4	2.2	4.6	3.4	2.9	3.0
Israel	5.2	5.1	4.8	4.2	1.3	2.1	–0.1	2.0	9.0	8.4	7.5	7.2
Singapore	6.6	7.9	5.5	5.7	0.5	1.0	1.5	1.5	3.1	2.7	2.6	2.6
New Zealand[2]	2.1	1.5	2.5	2.6	3.0	3.4	2.3	2.6	3.7	3.8	4.2	4.4
Cyprus	3.9	3.8	3.9	4.0	2.6	2.5	2.1	2.1	5.3	4.9	4.8	4.7
Iceland	7.5	2.9	—	1.9	4.0	6.8	4.5	3.0	2.1	1.3	2.0	2.3
Memorandum												
Major advanced economies	2.3	2.8	2.2	2.5	2.3	2.3	1.7	2.0	6.0	5.6	5.5	5.5
Newly industrialized Asian economies	4.7	5.3	4.6	4.6	2.3	1.6	2.1	2.1	4.0	3.7	3.5	3.3

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

profitability gives corporates the scope to absorb these higher costs in their margins. Looking forward, with growth projected to remain below potential during the course of this year, inflation pressures are expected to moderate, but risks that inflation may be more persistent cannot be entirely discounted.

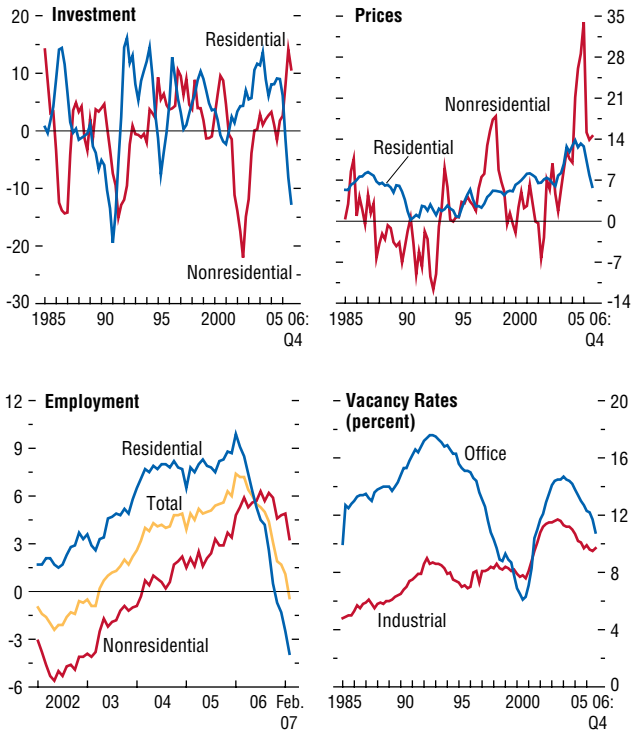
Against the background of weakening growth, the Federal Reserve called a halt to the monetary policy tightening cycle in August 2006, and has kept its target for the Federal funds rate unchanged at 5.25 percent. At present, after a string of weaker data, the Fed is expected by financial markets to ease rates by September. However, the Fed has appropriately kept its options open, stressing that the path of monetary policy will be determined by how the incoming data affect the perceived balance of risks between growth and inflation. If growth proves more resilient than expected, the labor market remains tight, and core inflation does not come down, expectations of monetary policy easing may not be realized.

The U.S. current account deficit is expected to narrow to close to 6 percent of GDP in 2007, about 1 percentage point of GDP less than at

Figure 2.2. United States: Developments in the Residential and Nonresidential Construction Sectors

(Percent change from a year ago, unless otherwise noted)

As the residential housing sector has slumped, investment in the nonresidential sector has boomed. Nevertheless, strong investment in nonresidential construction is unlikely to be sustained unless the housing market recovers.



Sources: CB Richard Ellis; CEIC Data Company Limited; Haver Analytics; MIT Center for Real Estate; and IMF staff calculations.

the time of the September 2006 *World Economic Outlook,* but little further decline is anticipated over the medium term (Table 2.2). The trade deficit is set to improve, with exports benefiting from robust partner country growth and the depreciation of the dollar, but the investment income account is expected to deteriorate. Boosting national saving in the United States is an important element of the multilateral strategy to reduce global imbalances. Against this background, it is encouraging that recent fiscal performance has exceeded expectations. The federal government deficit declined to 1.9 percent of GDP in FY2006, largely because of buoyant revenues, and data for early FY2007 suggest that the strong fiscal performance is continuing. Looking to the medium term, the president has indicated that the FY2008 budget will seek to balance the federal budget by FY2012. This commitment is welcome, although a more ambitious target of aiming to achieve balance excluding the Social Security surplus would be preferable, while allowing automatic stabilizers to operate through the cycle. Policy implementation will also be critical. In particular, it will be difficult to achieve the desired adjustment based solely on additional expenditure restraint given the unprecedented compression of discretionary nondefense spending already assumed in the budget projections. Revenue measures therefore cannot be ruled out. Fiscal consolidation needs to be supported by reforms to put the Social Security, Medicare, and Medicaid systems on a sustainable long-term footing. The administration's proposal to apply "means testing" to Medicare benefits could lead to significant cost reductions over time, although broader reforms to control growth of health care costs are also likely to be needed.

While public saving has risen as fiscal consolidation has progressed, private saving out of current income, particularly by households, has continued to decline. Some increase in household saving is likely given the slowing housing market, while recent changes to pension legislation to allow "opt out" defined contribution schemes may over time also boost saving. Never-

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

	2005	2006	2007	2008
Advanced economies	**–1.4**	**–1.6**	**–1.6**	**–1.6**
United States	–6.4	–6.5	–6.1	–6.0
Euro area[1]	0.1	–0.3	–0.3	–0.4
Germany	4.6	5.1	5.3	5.2
France	–1.6	–2.1	–2.2	–2.3
Italy	–1.6	–2.2	–2.2	–2.2
Spain	–7.4	–8.8	–9.4	–9.8
Netherlands	6.3	7.1	7.7	7.6
Belgium	2.5	2.5	2.4	2.5
Austria	1.2	1.8	1.9	1.6
Finland	4.9	5.3	5.1	5.2
Greece	–6.4	–9.6	–9.3	–8.7
Portugal	–9.7	–9.4	–9.1	–9.1
Ireland	–2.6	–4.1	–4.4	–3.0
Luxembourg	11.8	11.7	11.7	11.4
Slovenia	–2.0	–2.3	–2.6	–2.5
Japan	3.6	3.9	3.9	3.6
United Kingdom	–2.4	–2.9	–3.1	–3.1
Canada	2.3	1.7	0.7	0.6
Korea	1.9	0.7	0.3	—
Australia	–5.8	–5.4	–5.6	–5.5
Taiwan Province of China	4.6	7.1	7.1	7.1
Sweden	7.0	7.4	6.6	6.8
Switzerland	16.8	18.5	17.6	17.1
Hong Kong SAR	11.4	10.2	9.6	9.3
Denmark	3.6	2.0	1.7	1.9
Norway	15.5	16.7	14.9	15.9
Israel	2.9	5.2	3.6	4.3
Singapore	24.5	27.5	27.1	26.6
New Zealand	–9.0	–8.8	–8.4	–7.6
Cyprus	–5.6	–6.1	–5.2	–5.1
Iceland	–16.3	–26.3	–12.0	–11.5
Memorandum				
Major advanced economies	–2.2	–2.4	–2.3	–2.4
Euro area[2]	–0.1	–0.2	–0.3	–0.4
Newly industrialized Asian economies	5.6	5.6	5.3	5.1

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

theless, more can be done to further strengthen the incentives for households to save, including through a greater reliance on consumption rather than on income taxes and increased transparency about possible future shortfalls in the Social Security system.

The Canadian economy has slowed, and the growth projection for 2007 has been revised down to 2.4 percent (0.5 percentage point lower than in the September 2006 *World Economic Outlook*). Domestic demand growth is expected to weaken as a result of earlier interest rate increases, although the negative contribution to growth from the external sector should ease during the course of the year as the U.S. economy rebounds and the effect of past currency appreciation dissipates. Risks to the outlook stem largely from the external sector, most notably a weaker-than-expected U.S. economy, a sharp decline in commodity prices, or a renewed appreciation of the Canadian dollar. With core CPI inflation expected to remain close to the center of the 1–3 percent target range, the Bank of Canada has kept policy interest rates on hold since May. Nevertheless, if downside risks to growth materialize, there is ample scope to cut interest rates to support activity. The recent budget has reaffirmed the government's commitment to fiscal prudence, although steps to curb increases in public health spending are also necessary to ensure long-term fiscal sustainability.

Western Europe: Can Recent Vigor Be Sustained?

Activity in western Europe gathered momentum in 2006. GDP growth in the euro area reached 2.6 percent, almost double its pace in 2005 and the highest rate since 2000. Germany was the principal locomotive, fueled by robust export growth and strong investment generated by the major improvement in competitiveness and corporate health in recent years, as well as the consumption boost from the World Cup and some spending in anticipation of the value-added tax (VAT) increase in early 2007. Growth in France and Italy was somewhat slower and more dependent on consumption, supported by a pickup in employment growth. Improved labor market performance was observed broadly across the region, and the unemployment rate in the euro area fell to 7.6 percent by the end of 2006, its lowest level in 15 years. Meanwhile, the expansion gained pace in the United Kingdom, driven by an acceleration of domestic demand, especially consumption, while investment and export performance remained solid.

Box 2.1. Housing Market Slowdowns

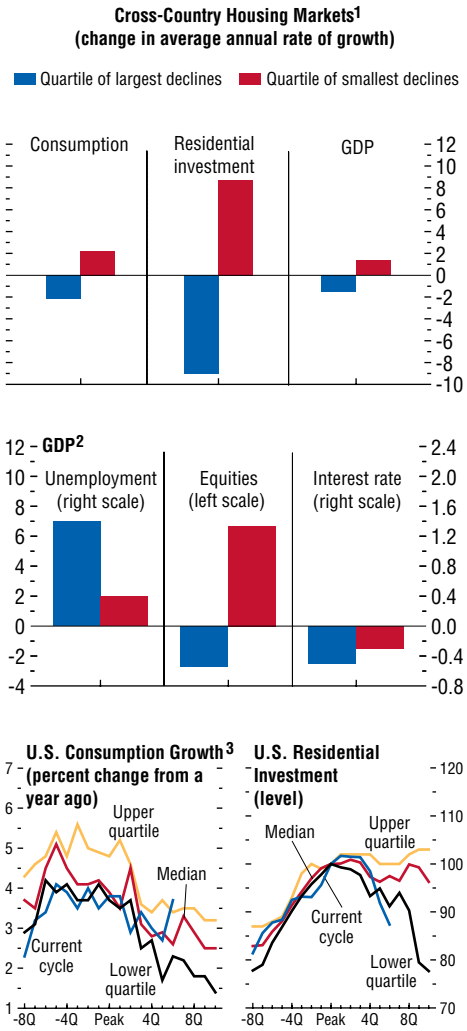
House price growth in the United States has slowed sharply since mid-2005. Yet, while residential investment has fallen, consumption has been little affected to date. This box seeks to understand these limited spillovers from the housing market in the context of international and U.S. experiences of previous housing market slowdowns.[1]

The two main components of expenditure linked directly with house prices are consumption and residential investment. The upper panel of the figure compares the largest and smallest declines in consumption, residential investment, and GDP across 48 episodes of real house price declines (for at least two consecutive quarters) in 13 OECD countries. It shows considerable variation across these episodes, with GDP growth on average declining by 1.5 percentage points in the lowest quartile, but actually increasing in the upper quartile. These variations can be examined by looking at what has happened to other aspects of these economies during the housing correction.

What other factors are likely to matter at a time when house prices are declining? The middle panel of the figure shows the change in the unemployment rate, the performance of equity markets, and an indicator of the stance of monetary policy, comparing occasions when relatively large and small changes in spending were experienced. The data suggest that the change in the unemployment rate is a key factor affecting the size of spillovers from a housing correction. This is because the labor market has a strong influence on household cash flows, income expectations, and thus vulnerability to distress arising from developments in the housing market.

Equity market performance, and financial wealth more generally, are also relevant factors. To the extent that households have a "buffer" of

Housing Market Downturns



Sources: Bank for International Settlements; Haver Analytics; and IMF staff calculations.

[1]The change in average annual rate of growth of consumption, residential investment, and GDP between the six quarters before and after the house price peak.

[2]Periods of falling house prices with the largest and smallest declines in GDP growth by quartile, for the six quarters before and after the peak. The average change in unemployment (percentage point), the average percent increase in real equity prices, and the change in short-term interest rate (percentage point) during the period of falling house prices.

[3]Median profile shows median response for a particular quarter across seven U.S. housing cycles (periods when real house prices fell) since 1969. Lower and upper quartile profiles are also shown.

Note: The main author of this box is Andrew Benito.

[1]See Chapter 2 of the April 2003 *World Economic Outlook* for an analysis of equity and housing market busts.

financial assets at their disposal, their spending may respond more moderately to easing house prices. The figure illustrates that where households benefited from gains in equity wealth, spending was less prone to being cut back in the context of falling house prices.

Significant effects from house price falls on spending and GDP are likely to prompt a response from policymakers. The figure shows that, on average, short-term interest rates were reduced by a larger amount on those occasions when house prices were associated with larger falls in spending and activity.

Recent U.S Experience

The lower panel of the figure shows the recent profiles for U.S. consumption and residential investment compared with previous U.S. housing market slowdowns. Consistent with international experience, the panel shows that there has been a wide range of experience across housing cycles in the United States. The recent housing market downturn has seen a particularly sharp reduction in residential investment, but the impact so far on consumption has been quite mild, although previous housing market adjustments generally witnessed a delay of several quarters before consumption declined.

Consistent with the international evidence, the effect of the present U.S. house price correction on consumer spending and activity to date has been contained by other developments in the economy. In particular, the U.S. labor market has remained robust with continued gains in employment, especially in services, despite some softness in the construction and manufacturing sectors, while unemployment has declined to cyclical lows.

Growth in the euro area is projected to moderate to 2.3 percent in 2007 and 2008, still somewhat above potential. The mild deceleration would reflect both the effect of some monetary and fiscal tightening, and a lower external contribution to growth. So far, activity in early 2007 is being well sustained, although, as expected, consumption in Germany has cooled in the wake of the VAT increase. The U.K. economy is expected to continue growing robustly in 2007. Risks to the outlook seem evenly balanced, with domestic risks on the upside, given bullish confidence, rising house prices, improving employment and productivity, and record corporate profitability, but external risks are on the downside.

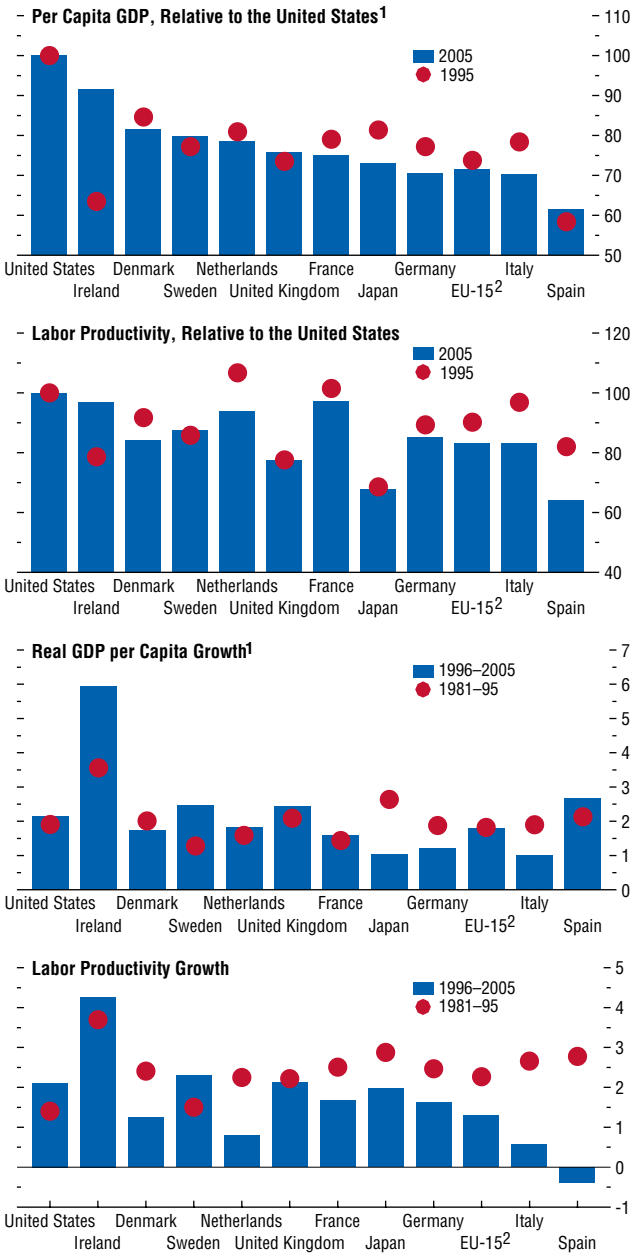
The drop in oil prices from August 2006 helped to bring headline CPI inflation in the euro area down to just below 2 percent by end-2006, while core inflation has risen recently, largely reflecting the VAT increase in Germany. Wage increases remain contained at low levels, despite labor market tightening. In the year ahead, inflation will be boosted by the German VAT increase, as well as continued tightening of spare capacity, but should remain close to 2 percent. With the area's growth projected to remain close to or above potential, and the possibility of some further upward pressure on factor utilization and prices, a further interest rate increase to 4 percent by the summer would seem warranted. Beyond this, additional policy action could still be required if growth momentum remains above trend and risks to wages and prices intensify. In the United Kingdom, buoyant demand and the ongoing pass-through of higher global energy prices to domestic utilities prices has pushed inflation to its highest level in five years. The combination of higher-than-targeted inflation and diminishing economic slack has prompted rate increases by the Bank of England, and inflation is expected to come down to the target by year-end. However, some further tightening may still be needed, particularly if wage pressures emerge.

The present expansion has provided a context for some progress toward needed fiscal consolidation, but concerns remain whether enough is being done. It is encouraging that the modi-

Figure 2.3. Western Europe: Productivity Is Failing to Catch Up

(Percent)

Growth in western European countries has fallen behind that of the United States over the past decade, as productivity performance has deteriorated.



Sources: OECD, *Economic Outlook;* and IMF staff calculations.
[1]Gross domestic product at 2000 constant PPP.
[2]Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

fied Stability and Growth Pact has functioned smoothly as countries under the Excessive Deficit Procedures have lived with requirements, and almost all countries in the euro area have now lowered deficits to below 3 percent of GDP.[3] However, overall adjustment in 2006 and 2007 would still be quite slow at around ½ percent of GDP per year, largely accounted for by Germany and Italy, and rooted for the most part in buoyant revenue growth rather than tighter expenditure control. Thus, the overall ambition appears rather limited given the pace of the cyclical upturn and the looming long-term pressures from aging, with some countries distant from meeting their medium-term objectives. Against this background, some strengthening of fiscal frameworks could be helpful—to bolster national fiscal governance mechanisms and to give the preventative arm of the Stability and Growth Pact more teeth to encourage progress toward meeting the medium-term goals. In the United Kingdom, the fiscal deficit fell to 2½ percent of GDP in 2006, and tight spending control will be needed to halt the rise in public debt.

Does western Europe's strong recent economic performance portend a sustained improvement? At this point, it is too early to assess definitively to what extent the present expansion may have reflected improving underlying conditions as well as a cyclical upswing. Taking a longer perspective, after steady convergence for much of the postwar period, Europe's per capita GDP levels have fallen steadily behind those of the United States since 1995, with only a few smaller countries doing better (Figure 2.3). This widening of the income gap reflects much weaker performance in labor productivity, as productivity in Europe continued to slow broadly in line with postwar trends, while productivity in the United States accelerated. Europe has made progress in strengthening labor utilization; in fact it has reduced the differential with the United States on this front as unemployment rates have been progressively

[3]Italy's deficit was kept above 3 percent of GDP in 2006 by one-off VAT refunds and assumption of railroad debts.

lowered—but the gap with the United States nevertheless remains substantial, particularly in continental Europe (Figure 2.4). Moreover, looking ahead, aging European populations may make it harder to sustain this improvement in labor utilization, as a rising share of the population will be in upper age brackets.

A major factor behind Europe's lackluster productivity performance vis-à-vis the United States relates to the slower take-up of new technologies, particularly rapid advances in information and communications technology (ICT).[4] Recent studies by the European Central Bank (ECB) and the IMF staff find that Europe generally has smaller ICT-producing sectors, has invested less in ICT equipment, and experienced lower total factor productivity growth in ICT-using services sectors such as retail, wholesale, and finance, relative to the United States.[5] These findings underline the importance of product and labor market reforms aimed at reducing barriers to competition and innovation, and encouraging greater R&D spending. While some progress has been made in these areas, it will thus be important to accelerate implementation of the Services Directive, enhance competition in network industries, and strengthen financial integration. Commitments made under the Lisbon agenda provide a useful framework to integrate national-level plans and apply effective areawide peer pressure.

While progress has been made in improving labor utilization in Europe, further policy reforms are still needed to close the performance gap with the United States, address social concerns related to persistently high rates of unemployment, and help to offset the negative impact of population aging on the size of the labor force. To some degree, lower labor

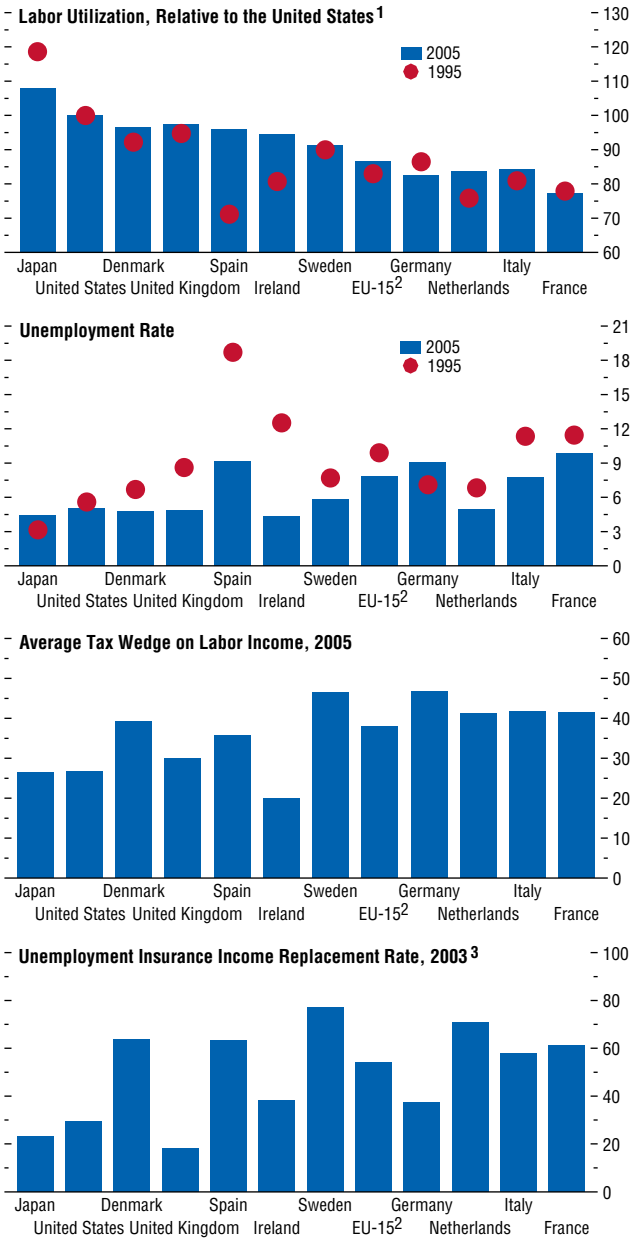
[4]See Gomez-Salvador and others (2006); and Estevão (2004).

[5]Another factor may have been the pickup in labor utilization in western Europe over the past 10 years—implying a reduced rate of capital deepening and possibly a lower rate of improvement of labor quality. But this factor cannot help explain why European productivity lags the United States in absolute terms.

Figure 2.4. Western Europe: Need to Do More to Raise Labor Utilization

(Percent)

Labor utilization has improved in western Europe, as unemployment rates have declined, but continues to lag the United States. Countries that have a low tax wedge on labor income and tighter unemployment insurance generally have higher labor utilization.



Sources: OECD, *Economic Outlook;* OECD, Taxing Wages Database and Benefit Entitlements and Gross Replacement Rates Database; and IMF staff calculations.

[1]Labor utilization is defined as hours worked divided by population.

[2]Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

[3]Defined as the average first-year gross income replacement rate over the three different family types and two different income levels.

utilization might reflect a greater preference for leisure, but the much higher incidence of unemployment in Europe, more extensive limits on working hours, and heavy taxes on labor income all suggest that the outcome only partly reflects voluntary choices. Recent cross-country analysis by the OECD suggests that key factors that have discouraged labor utilization in western Europe include high tax wedges between employment costs and take-home pay and generous unemployment compensation schemes (see Bassanini and Duval, 2006).

Successful reformers within western Europe have taken a variety of approaches aimed at improving labor utilization (see Box 2.2). Under the so-called Anglo-Saxon model, the emphasis is on applying a low tax wedge to labor income, relatively low replacement rates to unemployed workers, and low degrees of employment protection to encourage efficient labor markets. Nordic countries have also achieved success with somewhat different policy mixes. Denmark's "flexicurity" system combines a flexible labor market—low degree of employment protection—with generous short-term income protection, but tight eligibility for longer-term benefits and extensive active labor market policies (ALMPs) to facilitate job search, while Sweden has placed greater weight on wage moderation in the context of centralized wage bargaining and a broad social compact. Recent experience has also underlined the importance of complementary product market reforms (to foster job creation) and expenditure-based fiscal consolidation (in part to provide room for reductions in labor taxation and spending on ALMPs). Countries with still-high rates of unemployment can learn from such successful examples in developing strategies consistent with national, social, and political contexts.

Industrial Asia: Japan's Expansion Remains on Track

Japan's economic expansion hit a soft patch in the middle of 2006, mainly reflecting an unexpected decline in consumption, but growth rebounded strongly in the fourth quarter. The economy's underlying momentum remains robust, with private investment expanding—supported by strong profits, improved corporate balance sheets, and the resumption of bank lending—and rising export growth. Real GDP for 2006 as a whole expanded somewhat above potential at 2.2 percent.

Near-term prospects depend crucially on whether the rebound in consumer spending in the fourth quarter is sustained. In this context, underlying fundamentals appear to be favorable (Figure 2.5). While the rate of growth of regular monthly wages has been sluggish over the past year, the increase in employment—in particular, the hiring of more full-time workers—and bonuses has contributed to a steady growth in overall employee compensation that has yet to be fully reflected in aggregate consumption. As firms continue to expand capacity and add workers, unemployment has declined to nine-year lows and the ratio of job offers to applicants has risen to the highest level since 1992. In the context of the structural upturn in the business sector following years of restructuring and limited labor demand, this tightening of the labor market is likely to be increasingly reflected in rising real wages, providing further support for household spending.

Reflecting the above considerations, real GDP growth in Japan is expected to be broadly maintained at around 2¼ percent during 2007. A recovery in consumption is expected to largely offset some cooling of exports in view of the anticipated moderation in global growth. Risks to the outlook appear broadly balanced. On the upside, the strength of business sector indicators could translate into stronger-than-anticipated investment and hiring, and a further decrease in oil prices could boost consumption through its positive impact on disposable incomes. On the downside, the underlying strength of consumer spending remains uncertain, while a sharper-than-expected slowing in the United States could weaken net exports.

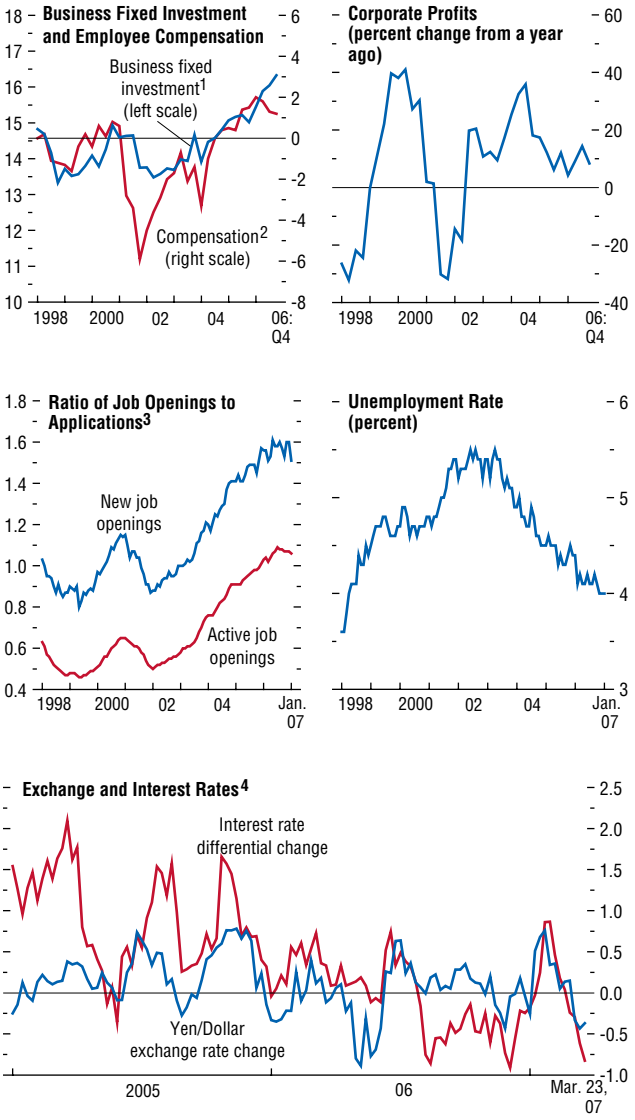
Supported by strong export growth and income from foreign assets, Japan's current

account surplus rose to close to 4 percent of GDP in 2006, yet the value of the yen has fallen to near 20-year lows in real effective terms. Against the background of structural shifts that support capital outflows (including a reduced "home bias" among domestic investors), an important factor underlying the weakening of the yen over the past year has been the widening interest rate differential between the yen and other key currencies and the exceptionally low volatility in foreign exchange markets. Taken together, these factors have further increased the yen's attractiveness as a funding currency for investments in other mature market currencies and within emerging Asia. While the scale of such outflows is difficult to measure, recent data suggest that the volume of such carry trades has grown. As a result, changes in the bilateral spread between yen and U.S. dollar interest rates in particular have become an increasingly important driver of the yen–U.S. dollar bilateral exchange rate. The outlook for interest rates among the major countries is therefore expected to continue to be an important determinant of exchange rate movements going forward.

The likely trajectory for interest rates in Japan is, in turn, closely tied to the outlook. With inflation still close to zero, the Bank of Japan has appropriately taken a cautious approach to raising interest rates since exiting its zero interest rate policy in July 2006, with its policy rate now standing at around ½ percent. Going forward, while interest rates will eventually have to be raised to more neutral levels, monetary accommodation should be removed only at a gradual pace and on the basis of information on the continuing strength of the expansion. The transition to a more neutral monetary stance could be supported by greater clarity regarding the Bank of Japan's medium-term inflationary goals, which would facilitate a smooth adjustment of private sector interest rate expectations. In turn, this would allow investors to unwind carry trades without sharp movements in bilateral exchange rates or abrupt shifts in the volume of

Figure 2.5. Japan: Understanding Developments in Domestic Demand

Employee compensation tends to rise during investment upturns. Rising corporate profits and tightening labor market conditions suggest that the recent softening of consumption may be temporary.



Sources: Bloomberg Financial Markets, LP; Haver Analytics; and IMF staff calculations.
[1]Measured as percent of GDP.
[2]Measured as percent change from a year earlier.
[3]Measured as ratio of new job openings to new applications and ratio of active job openings to active applications.
[4]Measured as change in eight-week moving average of yen/dollar exchange rate and change in interest rate differential of yen versus dollar one-year deposits.

Box 2.2. Lessons from Successful European Labor Market Reformers

From the early 1980s, unemployment rose precipitously in many European countries. In some cases, it remains high to this day. Other countries, however, have witnessed a remarkable turnaround, experiencing dramatic declines in unemployment rates, and corresponding steep increases in employment rates. A recent study by Annett (forthcoming) looks at the behavior of four countries—Denmark, Ireland, the Netherlands, and the United Kingdom—that stand out in terms of successful labor market performance over this period. In Europe today, these countries enjoy four of the five lowest unemployment rates, and they have also achieved the greatest reduction over two decades. Their employment gains have been equally impressive.

While the reform experiences differed across the countries, what they have in common is that they all adopted policy packages geared toward improving labor market performance in a manner that was both internally consistent and consistent over time. The outcome in all cases was *wage moderation*, in the sense of an increase in available labor supply at a given compensation rate. In a more technical sense, wage moderation corresponds to an outward shift in the labor supply (or wage) curve—more supply at a given wage, where the wage is defined as the productivity- and cyclically-adjusted real hourly compensation rate. Many factors can lead to outward shifts in the wage curve, including (1) changes in the attitudes of unions and workers, placing a greater emphasis on employment; (2) falling labor taxation, allowing workers to accept lower gross wages for the same net wage; (3) unemployment benefit reform that reduces the reservation wage (that is, the minimum at which a person would accept a new job rather than remaining unemployed and continuing a job search); and (4) reducing government employment or government wages, also reducing the reservation wage, given that government employment is an alternative to private employment. Looking across a two-decade horizon, Ireland, the Netherlands, and the United Kingdom are among the EU countries that have exhibited the biggest shifts in labor supply. Denmark's reform period came slightly later, in the mid-1990s.

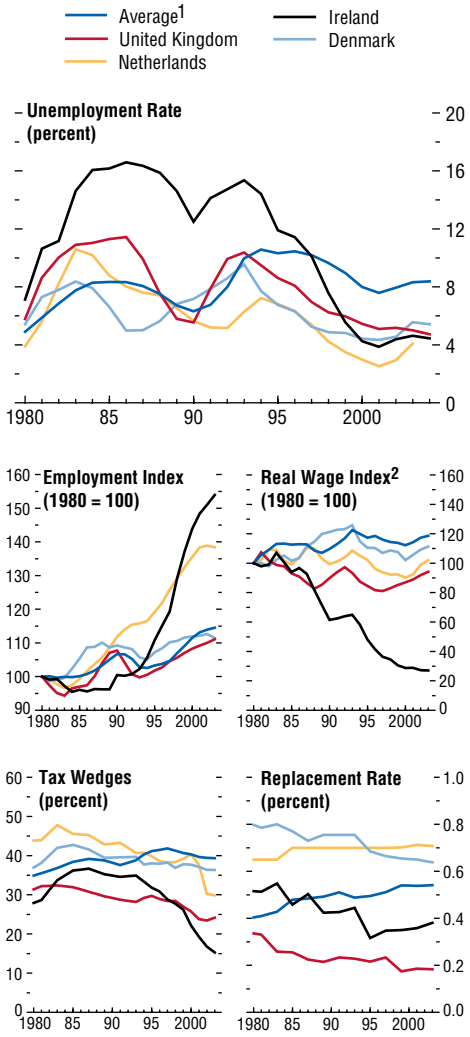
In Ireland and the Netherlands, wage moderation was abetted by coordinated agreements between social partners, under which unions agreed to curb their wage claims in return for labor tax cuts. This marked a distinct structural shift in unions' approach to wage bargaining. In contrast, the United Kingdom initially relied on a less consensual approach. Again, labor tax reductions were part of the strategy. Overall, the tax wedge on labor declined markedly in these countries over the course of two decades (see the figure).

The countries in question also engaged in some form of benefit reform, reducing the level of unemployment benefits or their duration, or strengthening eligibility requirements. Reforms led to less generous benefits in the United Kingdom and the Netherlands in particular (the latter focused on sickness and disability as well as unemployment), while in Ireland, benefits failed to keep pace with after-pay income. Denmark and the Netherlands also cut the maximum duration of unemployment benefits, while three of the four countries (excluding Ireland) tightened up eligibility requirements. Much as Ireland and the Netherlands traded moderation in wage growth for tax cuts, Denmark maintained high benefit levels while tightening duration and eligibility conditions—the unemployed were required to take part in Active Labor Market Programs, and requirements on this front became progressively tougher over time. By granting this kind of "buy in" to workers and other interests, policymakers maintained broad support for the reform agenda.

One common factor was that the successful cases generally pursued government expenditure reduction in tandem with labor tax cuts. Indeed, fiscal and structural adjustment were reinforcing, as periods of extensive fiscal consolidation coincided with labor supply shifts. The four countries in question undertook substantial

Note: The main author of this box is Anthony Annett.

Labor Market Indicators for Selected Industrial Countries



Source: IMF staff estimates.
[1]The unweighted average of the other 10 EU countries (excluding Luxembourg).
[2]Real cyclically- and productivity-adjusted wages. The unweighted average consists of the other 10 EU countries (excluding Luxembourg and Austria).

adjustment during various periods over the past two decades, and three of the four (excluding Denmark) reduced the size of government substantially. Reducing both government wages and transfers, as well as cutting labor taxes, encouraged unions to accept lower wages, which in turn led to higher profitability, employment, and growth.

Another common factor was that these countries placed a premium on flexible labor and product markets. Unlike many of their European counterparts, they did not attempt to shield workers with stringent employment protection legislation, and product markets were relatively deregulated. Denmark's much-touted "flexicurity" model insures workers against income loss, not job loss.

Annett (forthcoming) supports this analysis with an econometric study. Two simple equations are estimated: the first relates real wages to fiscal influences and the second relates nongovernment employment to wages and underlying product and labor market rigidity. A simple panel model is estimated in first differences for 14 countries between 1980–2003, incorporating country fixed effects and year dummies. The basic findings are that fiscal adjustment and labor supply improvements are intimately entwined, and wage behavior is affected by social expenditure, government wages, and tax wedges. Interestingly, the feedback from wage moderation to employment growth depends on the degree of product and labor market regulation, with flexibility prompting greater employment gains.

These results are consistent with other recent studies. Although the empirical literature on the institutional determinants on employment and unemployment is enormous, recent work—encapsulated in an OECD study by Bassanini and Duval (2006)—suggests that most of the change in structural unemployment over the past two decades can be explained by factors such as high and long-lasting unemployment benefits, high tax wedges, and stringent product market regulation. At the same time, they also note the importance of a package of complementary reforms rather than piecemeal initiatives.

Overall, these results show that a mixture of labor supply, product market, and fiscal reforms

Box 2.2 *(concluded)*

that complement and reinforce each other, and that are consistent over time, can be successful in encouraging wage moderation and improving employment outcomes. Also, workers can be cushioned from the impact of reforms by reducing labor taxes or by providing generous benefits subject to strict eligibility conditions and short duration.

This experience offers clear lessons for other countries. However, the reform path in each country will ultimately depend on its own underlying institutions and circumstances. Zhou (2006), for example, shows how the Danish model may not easily transfer to other countries, in part because of the significant fiscal expenditures involved.

capital flows into emerging Asia's local currency markets.

The cyclical recovery of revenues supported a further narrowing in the fiscal deficit (excluding social security) by about 0.8 percentage point of GDP to 4.3 percent of GDP in 2006. The government's budget envisages a reduction in the primary balance by about 1 percent of GDP in FY2007. While consolidation appears to be running ahead of the government's plan to achieve a primary surplus for the central and local government by FY2011, gross and net public debt ratios continue to rise from their already-high levels (185 and 96 percent of GDP, respectively). Consequently, additional fiscal efforts beyond those contained in the current medium-term plan will be required to put the debt-to-GDP ratio on a declining trajectory. With limited room for further cuts in expenditures, future fiscal reforms will therefore need to focus on revenue measures. Consideration should be given to raising the consumption tax rate and measures to broaden the income tax base. Japan also faces important challenges in the context of a rapidly aging population, underscoring the importance of supply-side structural reforms to raise the level of potential growth. Measures to boost flexibility and productivity in the nontradables sector are of particular importance.

In Australia and New Zealand, real GDP growth weakened slightly in 2006, reflecting slower domestic demand and the impact of a severe drought in Australia. Growth is expected to pick up during 2007–08. If inflation does not decline as expected, central banks may still need to tighten monetary policy further.

Emerging Asia: How Resilient Is the Region to a U.S. Slowdown?

Activity in emerging Asia continues to expand at a brisk pace, led by very strong growth in both China and India (Table 2.3). In China, real GDP expanded by 10.7 percent in 2006 on the strength of solid investment and export growth, although the pace of fixed asset investment cooled in the second half of the year in response to monetary policy tightening. Box 2.3 looks at the issue of whether very high levels of investment in China are efficiently allocated. In India, real GDP growth of 9.2 percent was supported by the strength of consumption, investment, and exports. The resilience of external demand, particularly in the electronics sector, has supported overall economic activity in the newly industrialized economies (NIEs), including Korea, where growth accelerated. Performance among the ASEAN-4 economies has varied. The pace of activity in Malaysia and Thailand has picked up. In Indonesia, domestic demand has begun to strengthen in response to interest rate cuts. In the Philippines, typhoon-related damage to agriculture led to temporarily weaker growth in the fourth quarter of 2006, but the economy's underlying momentum remains strong.

One question in assessing growth prospects for the region is how a sharper-than-expected

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]			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Emerging Asia[3]	**8.7**	**8.9**	**8.4**	**8.0**	**3.5**	**3.7**	**3.7**	**3.2**	**4.5**	**5.4**	**5.7**	**5.9**
China	10.4	10.7	10.0	9.5	1.8	1.5	2.2	2.3	7.2	9.1	10.0	10.5
South Asia[4]	**8.7**	**8.7**	**8.1**	**7.5**	**5.0**	**6.4**	**6.4**	**4.6**	**–0.9**	**–2.2**	**–2.5**	**–2.4**
India	9.2	9.2	8.4	7.8	4.2	6.1	6.2	4.3	–0.9	–2.2	–2.4	–2.3
Pakistan	8.0	6.2	6.5	6.5	9.3	7.9	6.5	6.0	–1.4	–3.9	–4.0	–3.6
Bangladesh	6.3	6.7	6.6	6.5	7.0	6.3	6.4	5.4	–0.3	0.9	0.7	—
ASEAN-4	**5.2**	**5.4**	**5.5**	**5.8**	**7.3**	**8.2**	**4.3**	**4.0**	**2.1**	**4.8**	**4.2**	**3.5**
Indonesia	5.7	5.5	6.0	6.3	10.5	13.1	6.3	5.3	0.1	2.7	1.8	1.3
Thailand	4.5	5.0	4.5	4.8	4.5	4.6	2.5	2.5	–4.5	1.6	1.5	0.9
Philippines	5.0	5.4	5.8	5.8	7.6	6.2	4.0	4.0	2.0	2.9	2.1	1.9
Malaysia	5.2	5.9	5.5	5.8	3.0	3.6	2.6	2.5	15.2	15.8	15.3	14.3
Newly industrialized Asian economies	**4.7**	**5.3**	**4.6**	**4.6**	**2.3**	**1.6**	**2.1**	**2.1**	**5.6**	**5.6**	**5.3**	**5.1**
Korea	4.2	5.0	4.4	4.4	2.8	2.2	2.5	2.5	1.9	0.7	0.3	—
Taiwan Province of China	4.0	4.6	4.2	4.3	2.3	0.6	1.5	1.5	4.6	7.1	7.1	7.1
Hong Kong SAR	7.5	6.8	5.5	5.0	0.9	2.0	2.1	2.3	11.4	10.2	9.6	9.3
Singapore	6.6	7.9	5.5	5.7	0.5	1.0	1.5	1.5	24.5	27.5	27.1	26.6

[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.

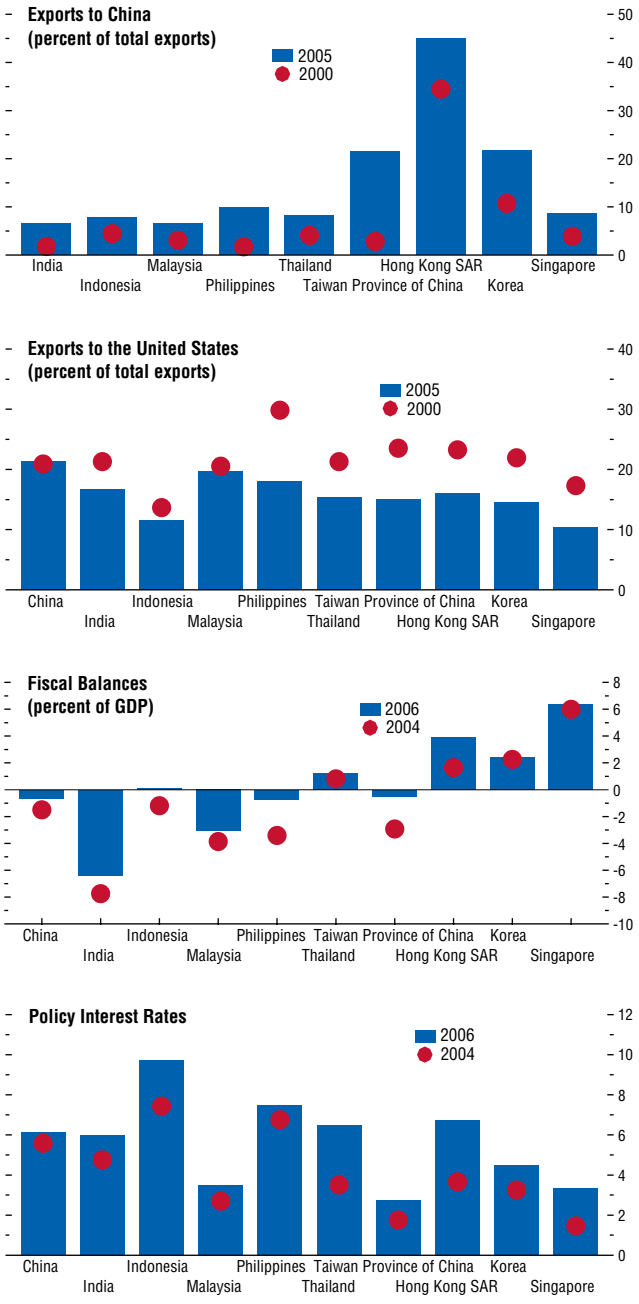
slowdown in the United States would affect the region. As Chapter 4 underscores, while demand for Asian exports would be affected, several factors suggest that the overall impact is likely to be relatively well contained:

- At this stage, the U.S. slowdown is being driven by the housing sector, with its effects on overall demand for exports from Asia likely to be muted. In contrast, the global demand for electronic goods, which is important for regional exports, particularly among the NIEs and the ASEAN-4 economies, has remained generally well supported despite some moderation toward late 2006.
- The importance of the United States as a destination for exports has been declining in most countries—with the important exception of China—and the role of intraregional trade has been rising (Figure 2.6).
- With the decline in inflationary pressures, there is room for countercyclical monetary policy in several countries. Fiscal policy could also play a role in cushioning a downturn in external demand in some countries, although in others, such as India, fiscal consolidation remains an important priority.

Against this background, the near-term outlook for growth in the region remains very positive. Real GDP growth is expected to ease this year and next, but remain at a high level. This reflects some moderation in growth in China and India in response to policy tightening and slower growth among the NIEs as global demand for exports softens. A pickup in activity, however, is expected in the ASEAN-4 economies as the effects of earlier monetary tightening fade. Risks on the upside include the possibility that the slowdown projected in China may not materialize if the effect of monetary tightening on investment proves temporary, while in India, the manufacturing sector and investment could gather added momentum in the near term. On the downside, a sharper-than-anticipated slowdown in the demand for Asian exports in general, and electronic goods in particular, could undercut growth. Financial markets in the region, especially those that appear richly valued, also remain vulnerable to

Figure 2.6. Emerging Asia: Assessing the Resilience to a Global Slowdown

Regional economies have less direct exposure to the United States than at the beginning of the decade, while their exposure to China has grown. Monetary and, in some cases, fiscal policy are also cyclically well positioned to respond to a slowdown in the demand for exports.



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

any unanticipated rise in global risk aversion. A related risk arises from the inflows into many regional markets stemming from the yen carry trade. These could unwind rapidly if investors were to revise their expectations of bilateral exchange rates and interest rate differentials, particularly in the context of rising volatility in foreign exchange markets. Encouragingly, the recent rise in market volatility in Thailand after the imposition of controls on capital inflows has not spread elsewhere. Avian flu also continues to pose a risk though its impact is more difficult to quantify.

Inflationary pressures across the region remain generally well contained, with monetary tightening—and currency appreciation in some countries—having limited the second round impact of the increase in oil prices last year, although rapid credit growth poses a challenge in a number of countries. In China, the People's Bank of China has responded to the rise in domestic liquidity and rapid investment growth by raising deposit and lending rates, strengthening liquidity management, and raising the reserve requirement ratio. Although investment has moderated in recent months, it remains high, and additional monetary tightening may well be needed. In India, upward inflationary pressures and rapid credit growth have prompted the Reserve Bank of India to raise policy rates and the cash reserve requirement for banks. With inflationary pressures still strong, some further tightening is likely to be needed.

The region's current account surplus rose almost a full percentage point (to 5.4 percent of GDP) in 2006, despite the rise in oil prices, underpinned by the strong growth of exports, particularly in China and among the ASEAN-4 countries. India's current account deficit widened in response to rising imports, reflecting the strength in domestic demand and the impact of higher oil prices. Looking ahead, the region's current account surplus is expected to continue to widen, but at a slower pace than has been evident in recent years, with China accounting for a substantial part of the rise. In this context, there have been some

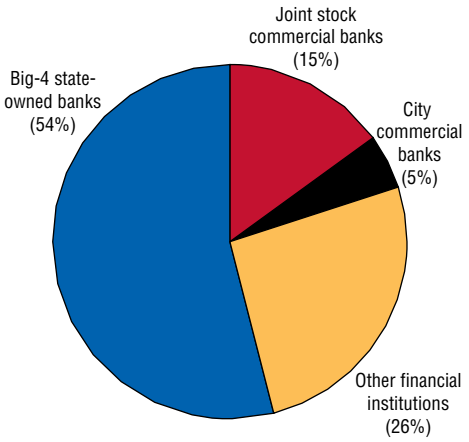
Box 2.3. Is China Investing Too Much?

The breakneck growth rate of the Chinese economy is in large part driven by capital accumulation (and exports). The country's investment-to-GDP ratio has been high and rising in recent years, exceeding 40 percent of GDP in 2005. One concern is that some of the investment, especially that by state-owned enterprises (SOEs), may not be efficient. In other words, the same output could be achieved with less capital, thus freeing resources for other uses. Improved efficiency would result in higher profitability for the corporate sector and safeguard the balance sheet of the banks that fund the firms.

There are various reasons why SOEs may be less efficient than domestic private firms. They may face more administrative interference in terms of restrictions on hiring and laying off workers and on switching product lines in response to changing market conditions. Further, they often do not have compensation schemes that encourage management to maximize economic efficiency and deter overinvestment and "empire building," notwithstanding some progress made with SOE reforms over the years that attempt to link executive pay with performance. In addition, some SOEs also have weak corporate governance that may provide opportunities for management to divert assets for their own benefit.

The Chinese financial system, which is dominated by majority or wholly state-owned banks, may favor SOEs despite steady effort by the authorities to increase the commercial orientation of these banks. While SOEs represent a declining share of output, down to about a third in 2005, their borrowing from domestic banks accounts for more than half of the total lending by these banks (first figure). Majority state-owned firms also take up the lion's share of all publicly traded companies in China's two stock exchanges. Some of the bias may be related to the tendency for private firms to be smaller in size and take on higher risk. But it is common to hear private firms complaining about the difficulty they face in securing funding for both short-term working capital and long-term investment needs even when they have comparable size and risk profiles as their state-owned peers.

Share in National Lending, 2004



Sources: *Almanac of China's Finance and Banking* (2005); and IMF staff calculations.

At present, approximately half of China's investment is financed out of the corporate sector's retained earnings. The reliance on bank lending by SOEs is correspondingly lower than would otherwise be the case. The high level of retained earnings in SOEs may reflect incentives for managers to increase firm size rather than to give the extra profit to the state in the form of dividends.

Research Questions

Against this background, a number of questions present themselves. Is there a significant gap in the returns to capital across firms of different ownership or firms in different locations? Has China succeeded in removing the bias in its financial sector in favor of SOEs after nearly three decades of economic reforms? What

Note: The main author of this box is Shang-Jin Wei. The box draws on a joint research paper with David Dollar.

Box 2.3 *(concluded)*

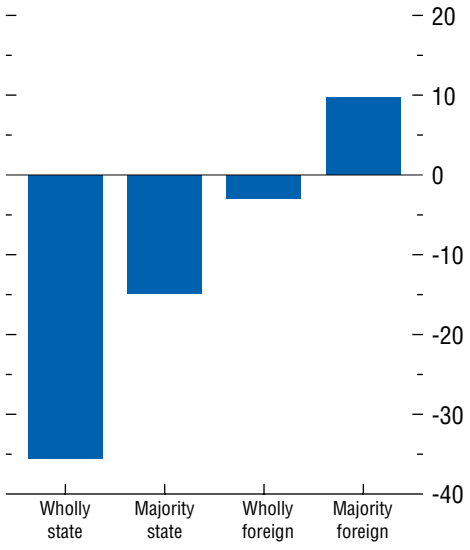
are the potential gains that could result from removing investment inefficiencies?

A new research paper by a pair of IMF and World Bank researchers investigates these questions using a data set derived from a survey carried out in 2005 covering 12,400 firms in 120 cities located all across China (Wei and Dollar, 2007).

For every firm in a given sector and location, the study computes the marginal revenue product of capital (MRPK) as value added minus payments to labor, divided by the stock of capital. Firm-level MRPK is then regressed on a set of indicator variables representing sector-time pairs and locations as well as a set of indicator variables representing firm ownership. The sector-year indicators capture the possibility that demand or supply shocks in a given sector/year could cause MRPKs in a particular sector-year to be different from others. The ownership indicators measure the MRPKs of various ownership groups relative to domestic private firms. These ownership groups are defined in a way that is mutually exclusive: wholly state-owned, majority state-owned, minority state-owned, wholly foreign-owned, majority foreign-owned (with no state shares), minority foreign-owned (with no state shares), and collectively owned.

Conceptually, managers would equate a firm's MRPK to the sum of the market interest rate, depreciation rate, and distortions in the capital market that the firm faces. If capital is efficiently allocated, then the MRPKs should be equalized across all firms, regardless of sector, location, or ownership. The difference in the MRPKs between two firms in the same sector reflects mostly the difference in the cost of capital. For example, if SOEs receive more favored treatment than domestic private firms in borrowing from banks or in obtaining government approvals to be listed in the domestic stock market, then the MRPKs for SOEs would tend to be lower than those of private firms on average. Using this framework, the study assesses three types of inefficiency, or biases, in capital allocation: at the level of ownership, location, and sector, respectively.

Marginal Revenue Product of Capital by Ownership Relative to Domestic Private Firms
(Percent)



Source: IMF staff estimates.

A number of interesting findings emerge. First, and most important, wholly and majority state-owned firms are found to have lower marginal returns to capital than private or foreign firms. The median MRPK for private firms is 63 percent. In contrast, the median values for wholly and majority state-owned firms are 37 percent and 52 percent, respectively. These numbers all appear large because they are computed before tax and depreciation, and reflect all other distortions to the cost of capital. The key point is that the returns to capital are not equalized across ownership types, and SOEs have substantially lower returns than private firms.

Differences in raw returns across ownership type could reflect that SOEs happen to be overrepresented in sectors or locations that have lower returns owing to temporary factors that are not related to ownership per se. To prevent this possibility from contaminating the interpre-

tation of the results, the research uses a statistical framework that compares firms of different ownership in the same sector and same region. With these corrections, the results still suggest that private firms make substantially higher returns—on the order of 11–54 percentage points, depending on the specifications—than their state-owned counterparts (see second figure).

Second, there is a significant locational bias in returns to capital. Western provinces, specifically the Yantze River Delta region (Shanghai, Jiangsu, and Zhejiang) and Bohai Circle (encompassing Beijing and Tianjin), have higher returns to capital than northwest and southwest regions. Third, there is also an allocative bias at the sector level, though not as economically and statistically significant as the other biases.

Policy Implications

To appreciate the aggregate cost of the inefficient financial allocation, the following thought experiment could be conducted. Consider a transfer of *X* percent of capital currently employed by the state sector to the private firms, but leave the allocation of labor (and other inputs) fixed. The amount of capital to be transferred is chosen in such a way that the MRPKs are equalized across ownership after the change. How much capital should be transferred? How much gain in aggregate value added could be achieved by the change? The answers depend on the estimated current gap in the MRPKs, the form of the production function, and some other parameters. In the benchmark case reported in Wei and Dollar (2007), under an efficient allocation, two-thirds of the capital currently employed by SOEs would be transferred to the private sector, which would raise GDP by 5 percent. Alternatively, with a more efficient use of capital, the country could reduce its very high investment rate substantially with no adverse effect on its growth rate. Such an improvement in investment efficiency could lead to a faster rise in household consumption and living standards.

There are a number of ways to improve the efficiency of capital usage. Besides curbing the amount of investment in the less efficient SOEs, efficiency could be raised through further reforms of the incentives for the managers of SOEs, including privatization, so that they will behave in a manner similar to their counterparts in profit-maximizing private firms. Moreover, financial sector reforms can also foster an improved allocation of capital.

concerns about differing degrees of exchange rate flexibility across the region. While a number of regional exchange rates have appreciated (notably the Korean won and Thai baht), in others there has been little change or even, as in China, a slight depreciation in real effective terms. A more decisive appreciation of the renminbi, in particular, would reduce competitiveness concerns from upward exchange rate movements in other countries, given increasing regional trade interdependence.

Strong private capital inflows in 2006 have complicated macroeconomic management in a few countries in the region, as net inflows remain close to historical levels. In Korea, for example, capital inflows have boosted liquidity and put upward pressure on the won. Countries have generally responded to these inflows through a combination of a buildup in reserves while allowing some appreciation of exchange rates, and in some cases a faster liberalization of capital outflows. In Thailand, the across-the-board imposition of unremunerated reserve requirements on inflows in December 2006 led to a sharp drop in investor confidence, and subsequently the measures were partly reversed. Going forward, faster liberalization of outflows, including removal of restrictions on foreign investments by domestic financial institutions, and modest cuts in interest rates could help to alleviate the pressure from inflows while reducing distortions in resource allocation.

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]			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Western Hemisphere	**4.6**	**5.5**	**4.9**	**4.2**	**6.3**	**5.4**	**5.2**	**5.7**	**1.4**	**1.7**	**0.5**	**–0.2**
South America and Mexico[3]	**4.5**	**5.4**	**4.8**	**4.2**	**6.2**	**5.2**	**5.2**	**5.7**	**1.7**	**1.9**	**0.6**	**—**
Argentina	9.2	8.5	7.5	5.5	9.6	10.9	10.3	12.7	1.9	2.4	1.2	0.4
Brazil	2.9	3.7	4.4	4.2	6.9	4.2	3.5	4.1	1.6	1.3	0.8	0.3
Chile	5.7	4.0	5.2	5.1	3.1	3.4	2.5	3.0	0.6	3.8	2.7	–0.2
Colombia	5.3	6.8	5.5	4.5	5.0	4.3	4.2	3.7	–1.6	–2.2	–2.3	–3.3
Ecuador	4.7	4.2	2.7	2.9	2.1	3.3	2.8	3.0	1.7	4.5	0.4	0.7
Mexico	2.8	4.8	3.4	3.5	4.0	3.6	3.9	3.5	–0.6	–0.2	–1.0	–1.4
Peru	6.4	8.0	6.0	5.5	1.6	2.0	1.0	2.0	1.3	2.6	0.7	0.4
Uruguay	6.6	7.0	5.0	3.5	4.7	6.4	6.0	5.0	—	–2.4	–3.3	–2.3
Venezuela	10.3	10.3	6.2	2.0	15.9	13.6	21.6	25.7	17.8	15.0	7.0	6.2
Central America[4]	**4.3**	**5.7**	**5.0**	**4.6**	**8.4**	**7.0**	**5.8**	**5.3**	**–4.8**	**–4.8**	**–5.0**	**–5.2**
The Caribbean[4]	**6.5**	**8.3**	**5.4**	**4.2**	**6.7**	**8.0**	**5.7**	**5.4**	**—**	**2.1**	**1.7**	**–0.3**

[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. The December/December changes in the CPI for 2005, 2006, 2007, and 2008 are, respectively, for Brazil (5.7, 3.1, 3.9, and 4.3); Mexico (3.3, 4.1, 3.7 and 3.3); Peru (1.5, 1.1, 2.0, and 2.0); and Uruguay (4.9, 6.4, 6.0, and 5.0).
[2]Percent of GDP.
[3]Includes Bolivia and Paraguay.
[4]The country composition of this regional group is set out in Table F in the Statistical Appendix.

Fiscal balances are expected to continue to strengthen in most countries in the region in 2007. Nevertheless, policy priorities differ across countries. Securing sustainable fiscal positions and reducing the vulnerabilities associated with high public debt and budget deficits remain key in India, Pakistan, and the Philippines (notwithstanding substantial progress in reducing debt over the last few years in the latter two). In India, rising revenues are expected to lead to a more than 1 percent of GDP decline in the deficit (to 6.3 percent of GDP) in FY2007, but with a public debt ratio of 80 percent of GDP, further consolidation remains a priority. Comprehensive spending and revenue reforms, including removal of exemptions to corporate income taxes and excise duties and the elimination of nonessential subsidies, could help achieve consolidation goals while creating space for priority spending. In other countries, fiscal policy has more flexibility to respond to external economic developments. In China, the planned increase in spending on social services, including health care, education, and pensions, would contribute to reducing the precautionary demand for savings and increase the dynamism of consumption.

Latin America: Boosting Productivity Is the Key to Sustaining Growth

Economic growth in Latin America is projected to ease to 4.9 percent this year from 5.5 percent in 2006 (Table 2.4). This slowdown is expected to be relatively broad-based—Brazil and Chile are exceptions—although growth in Argentina is still projected at 7.5 percent. The external environment is expected to become somewhat less favorable as global growth moderates and oil and metals prices decline from the record levels of 2006. Countries and regions that have particularly close trade links with the United States (such as Mexico, Central America, and the Caribbean) or are significant exporters of oil and metals (Chile, Ecuador, Peru, and Venezuela) will be most affected. On the other hand, lower oil prices will benefit countries that are not significant exporters of commodities (including many in Central America and the Caribbean). Further, the strength of grain prices

will help exporters of agricultural products such as Argentina and Brazil.

Differences in monetary policy across countries will also be an important driver of growth. In Chile, Colombia, and Peru, the central banks appropriately raised interest rates during 2006 to contain inflationary pressures (although the policy rate was cut by 25 basis points in Chile in January). Nevertheless, despite slower domestic demand, growth is still expected to rebound in Chile this year as exports recover from supply disruptions in the mining sector. However, monetary policy in Brazil has been eased substantially over the past 18 months, and with inflation well contained, there would appear scope for this easing cycle to continue. Together with recently announced initiatives to raise investment, lower interest rates should boost domestic demand, and recent data suggest that a pickup in activity is already under way. In Argentina, growth is expected to remain strong. Active sterilization by the central bank has allowed for a moderation in the growth of the targeted monetary aggregate, although short-term interest rates remain negative in real terms and fiscal policy is adding to demand pressures.

Risks to the outlook at this stage are slanted to the downside. As discussed in Chapter 4, a sharper-than-expected slowing in the United States would hit Latin America harder than other regions. A more pronounced decline in commodity prices or tighter financing conditions in international markets would also adversely affect growth prospects. Policy slippages that undermine investor confidence are another concern, particularly against the backdrop of pressures for populist fiscal measures in some countries. In Ecuador, concerns about a possible external debt restructuring saw spreads on external debt widen sharply earlier this year, although they have narrowed more recently.

Taking a longer-term perspective, 2004–06 was the strongest three-year period of growth in Latin America since the late 1970s, although growth still lagged that in other emerging market and developing country regions. The critical challenge for policymakers is to build on the reforms that have so far been implemented to accelerate growth further, entrench macroeconomic stability, and ensure that the benefits of growth are widely distributed. Efforts to boost growth, promote stability, and achieve better social outcomes are mutually reinforcing. Improving the distribution of income is not only essential from a social perspective but is also needed to ensure broad support for economic reforms and to help sustain growth momentum.[6] And reforms that boost potential output growth make it easier to reduce public debt and maintain low inflation, contributing to greater stability and investor confidence, which in turn will have a reinforcing impact on growth.

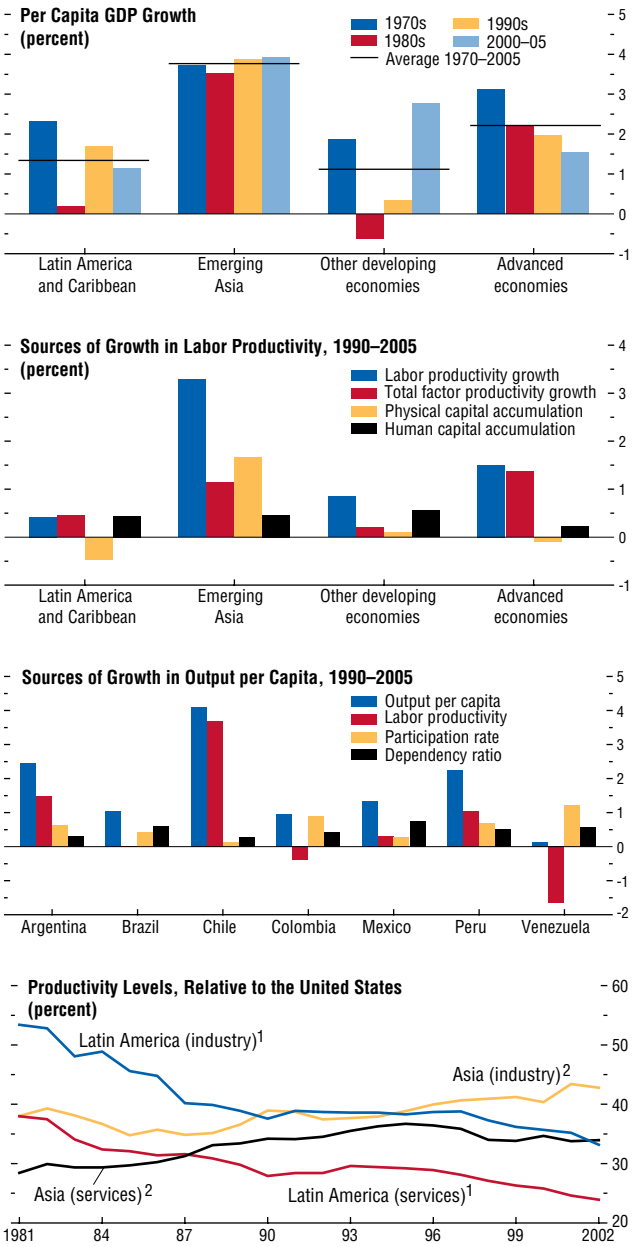
Considerable progress has been made in strengthening macroeconomic policy frameworks in many Latin American countries and this has helped reduce vulnerabilities. The inflation targeting frameworks introduced in a number of countries are proving useful monetary policy anchors and, outside of Venezuela, inflation outcomes have been generally favorable. In Argentina, inflation declined during 2006, but the authorities continue to rely on administrative measures to keep a lid on price pressures. Important progress has been made across the region in strengthening fiscal positions, reducing public debt, and improving the structure of this debt. And the regional current account has been in surplus for four years and comfortable reserve cushions have been established. Together with more flexible exchange rates, the region should be more resilient against adverse developments than it was in the past.

Yet, the period ahead will be challenging, and difficult policy decisions will need to be made. In particular, lower commodity prices will put pressure on current account and fiscal balances and make it more difficult to meet growing calls for increased social spending within a responsible overall budgetary envelope. In this environ-

[6]Berg, Ostry, and Zettelmeyer (2006) show that a more equal distribution of income is an important factor that increases the duration of periods of strong growth.

Figure 2.7. Latin America: Productivity Is Lagging

Despite the recent pickup, growth in Latin America still lags other regions. To improve growth prospects, the region's disappointing productivity performance needs to be reversed.



Source: IMF staff calculations.
[1]Sample includes Brazil, Chile, Costa Rica, El Salvador, Honduras, Jamaica, Panama, Trinidad and Tobago, and Venezuela for full period. For 1991–2002, Argentina, Dominican Republic, Ecuador, Guatemala, Mexico, Nicaragua, and Peru are also included.
[2]Sample includes China, India, Japan, Korea, Pakistan, the Philippines, Singapore, and Thailand.

ment, an even greater premium will need to be placed on fiscal reforms. In particular, for countries in which public sector revenues as a share of GDP are low and/or reliant on revenues from commodity exports (e.g., Mexico, Peru, and Venezuela), efforts are needed to broaden the tax base, reduce tax exemptions that benefit the better off, and improve tax administration. In others (including Brazil and Ecuador), budget rigidities in the form of revenue earmarking and mandatory expenditure requirements that are a constraint on the reallocation of resources toward priority areas need to be tackled. Such fiscal reforms would create room for increased spending on well-targeted social programs, building on the success of Oportunidades in Mexico, Bolsa Familia in Brazil, and Chile Solidario in Chile. These programs appear to be highly beneficial for the poor, but in terms of government spending, they are modest in size relative to other programs.[7] In Venezuela, efforts will be needed to rein in government spending that has grown exceptionally rapidly in recent years in response to the surge in revenues from the oil sector.

Reversing very disappointing productivity performance will be key to sustaining stronger rates of growth in Latin America (Figure 2.7; see also the IMF's April 2007 *Regional Economic Outlook: Western Hemisphere*). Labor productivity in the region has lagged considerably, falling relative to the United States and Asia in both industry and services. This relatively poor productivity performance is widespread, with Chile alone standing as an outlier. While priorities vary across countries, reforms to increase economic openness, improve the business climate, deepen the financial sector to ensure credit is available to finance investment projects at competitive interest rates, and limit the role of state-owned enterprises in the economy will all be important

[7]See "Latin America: Between Populism and Modernity," speech by IMF Managing Director Rodrigo de Rato at the International Foundation for Liberty Conference, Cato Institute, Washington, D.C., November 30, 2006.

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]			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Emerging Europe	**5.5**	**6.0**	**5.5**	**5.3**	**4.9**	**5.1**	**4.8**	**3.7**	**–5.3**	**–6.7**	**–6.6**	**–6.5**
Turkey	7.4	5.5	5.0	6.0	8.2	9.6	8.0	4.3	–6.3	–8.0	–7.3	–6.8
Excluding Turkey	4.7	6.2	5.7	4.9	3.5	3.2	3.5	3.4	–4.9	–6.2	–6.3	–6.4
Baltics	**9.0**	**9.7**	**8.7**	**7.0**	**4.2**	**4.8**	**4.9**	**4.8**	**–9.6**	**–15.3**	**–15.7**	**–14.9**
Estonia	10.5	11.4	9.9	7.9	4.1	4.4	4.8	5.3	–10.5	–13.8	–12.9	–12.2
Latvia	10.2	11.9	10.5	7.0	6.7	6.5	7.3	6.5	–12.7	–21.3	–23.0	–22.7
Lithuania	7.6	7.5	7.0	6.5	2.7	3.8	3.5	3.4	–7.1	–12.2	–12.3	–11.0
Central Europe	**4.4**	**5.7**	**5.2**	**4.7**	**2.4**	**2.1**	**3.1**	**3.0**	**–3.4**	**–3.9**	**–3.8**	**–4.0**
Czech Republic	6.1	6.1	4.8	4.3	1.8	2.5	2.9	3.0	–2.6	–4.2	–4.1	–4.2
Hungary	4.2	3.9	2.8	3.0	3.6	3.9	6.4	3.8	–6.7	–6.9	–5.7	–4.8
Poland	3.5	5.8	5.8	5.0	2.1	1.0	2.2	2.9	–1.7	–2.1	–2.7	–3.6
Slovak Republic	6.0	8.2	8.2	7.5	2.8	4.4	2.4	2.3	–8.6	–8.0	–5.7	–4.6
Southern and southeastern Europe	**4.4**	**6.7**	**6.0**	**4.9**	**7.0**	**6.0**	**4.3**	**4.3**	**–8.7**	**–10.7**	**–10.8**	**–10.2**
Bulgaria	5.5	6.2	6.0	6.0	5.0	7.3	5.3	3.6	–11.3	–15.9	–15.7	–14.7
Croatia	4.3	4.6	4.7	4.5	3.3	3.2	2.7	2.8	–6.4	–8.1	–8.3	–7.8
Malta	2.2	2.5	2.3	2.3	2.5	2.6	2.4	2.3	–10.5	–11.2	–11.5	–11.0
Romania	4.1	7.7	6.5	4.8	9.0	6.6	4.5	5.0	–8.7	–10.3	–10.3	–9.8
Memorandum												
Slovenia	4.0	5.2	4.5	4.0	2.5	2.7	2.7	2.4	–2.0	–2.3	–2.6	–2.5

[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.

to help strengthen productivity growth going forward.

Emerging Europe: Integrating with the European Union

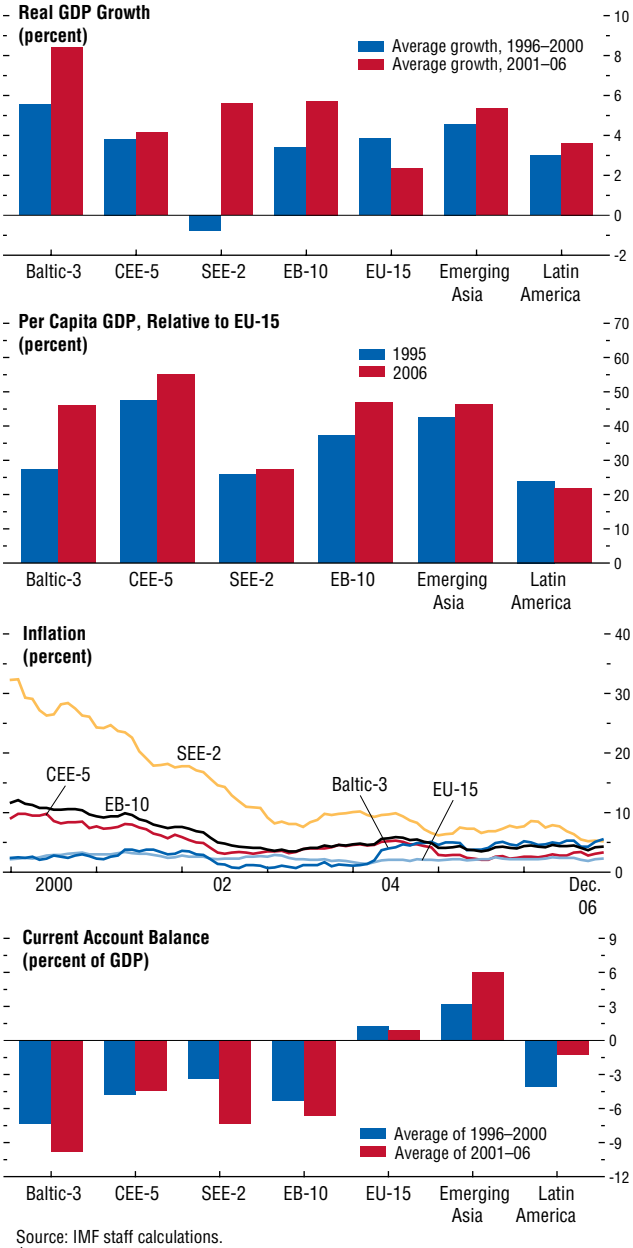
Growth in emerging Europe accelerated to 6 percent in 2006 (Table 2.5). Export performance remained strong, boosted by the increased momentum of growth in western Europe, particularly in the main trading partner Germany, and the opening of new auto plants. At the same time, domestic demand accelerated as investment continued to benefit from heavy foreign direct investment (FDI) inflows and consumption was boosted by rising employment and real wages and by lending related to continued strong capital inflows. Current account deficits widened further, but were amply financed in most countries, while CPI inflation was generally contained at quite low levels, as falling fuel prices and some upward movements in exchange rates helped to contain pressures from rising capacity use and tightening labor markets. However, there were two salient exceptions to this generally positive pattern. In Turkey, concerns about the widening current account deficit led to sharp downward pressure on the lira during the May–June emerging market correction, which required an abrupt tightening of monetary policy to rein in inflation, and growth subsequently decelerated. (Following the finalization of the World Economic Outlook database, the Turkish authorities released data showing that real GDP growth was 6 percent in 2006 rather than 5.5 percent as shown in Table 2.5.) In Hungary, the forint also came under pressure in May–June, with markets concerned about the sharply rising twin deficits—fiscal as well as current account—prompting the government to launch a strong multiyear fiscal consolidation effort.

Growth in emerging Europe is projected to slow moderately to 5.5 percent in 2007, largely reflecting the cooling of the expansion in western Europe and the policy tightening in Turkey

Figure 2.8. Emerging Europe: Convergence with the European Union[1]

(Unweighted averages)

Rapid GDP growth over the past 10 years has helped bring per capita incomes closer to average levels in the European Union. Inflation has also converged. Heavy reliance on foreign savings has contributed to support growth, but raises concerns if the convergence process is not sustained.



Source: IMF staff calculations.

[1]Baltic-3 includes Estonia, Latvia, and Lithuania; central and eastern Europe (CEE-5) includes Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia; south and eastern Europe (SEE-2) includes Bulgaria and Romania; eastern Europe and the Baltics (EB-10) includes Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia; EU-15 includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

and Hungary. Inflation would generally edge up (Turkey being the main exception), reflecting continued pressure on domestic resources, while the pattern of large current account deficits being financed through FDI and other private capital inflows should be sustained. The principal downside risks to this continued strong performance are external: emerging Europe would be vulnerable to both a marked deceleration in western Europe—the destination for two-thirds of its exports—and a deterioration in global financial conditions that reduced investors' willingness to continue financing its large current account deficits.

A key driver of emerging Europe's sustained success over the past 10 years has been the process of integration with the European Union. With the accession of Bulgaria and Romania in January 2007, 10 former Eastern bloc countries have now joined the European Union since May 2004, while other emerging Europe countries, including Turkey, continue along a path toward membership. This enlargement process has brought large economic benefits to the new member countries, both by opening up new trade and investment opportunities and by anchoring macroeconomic and institutional reforms. Over the past 10 years, GDP growth in these countries has averaged around 5 percent, supported by rapid increases in total factor productivity, raising per capita income levels closer to the EU average (Figure 2.8; see Schadler and others, 2006).

Convergence has been particularly impressive in the three Baltic states, helped not just by their low starting positions and more dynamic trading partners, but also their strong commitment to an attractive business environment (Lithuania and Estonia rank among the top 20 in the World Bank's *Doing Business in 2006*) and sound macroeconomic policies (including lower tax burdens and early commitment to fixing exchange rates against the euro). All 10 countries have benefited from high rates of inward FDI, averaging 5 percent of GDP, as companies have taken advantage of relatively low-cost, but highly skilled labor forces in a relatively secure

and familiar neighborhood, and from relatively low risk premia. These FDI flows together with heavy inflows of bank lending and EU transfers have financed substantial current account deficits, which should be sustainable provided that the convergence process continues to operate smoothly, although remaining a source of considerable vulnerability in the event of unexpected external disruptions or weakening of domestic policy frameworks.

All new member countries are committed to membership in the euro area, which would bring further benefits from trade integration and lower risk premia. However, notwithstanding generally favorable progress in bringing down inflation, so far only one country (Slovenia) has met the Maastricht criteria and joined the euro area (in January 2007). Four others (the three Baltics and the Slovak Republic) have entered the ERM II, a transitional period of at least two years during which the national currency must vary within "normal fluctuation margins" without severe tensions. These countries are well positioned to meet the fiscal criteria (maintaining a fiscal deficit of less than 3 percent of GDP and a general government debt of less than 60 percent of GDP) and the interest rate criterion (long-term interest rate on government bonds within 2 percentage points of the average in the three EU member countries with the lowest inflation rates), but satisfying the inflation criterion could be more challenging. This criterion requires that annual inflation not exceed the average of the three lowest inflation rates within the EU by more than 1½ percentage points—and is particularly demanding when it is recognized that Balassa-Samuelson effects could add 1½–2½ percentage points to inflation in an accession country as its productivity catches up to EU levels.[8] Other complicating factors include scheduled increases in administered prices, particularly for energy products, and the heavy weight of volatile food products in the CPI.

In other new member countries, timetables for joining the euro area have been extended. In part, delays have reflected difficulties in meeting the strict Maastricht criteria, but also questions about whether adequate progress is being made to ensure sufficient flexibility to live comfortably within a currency union—concerns that have been raised particularly in the larger economies (Czech Republic, Hungary, and Poland). While such misgivings are understandable—without sufficient economic flexibility, maintaining economic competitiveness under a fixed exchange rate may require costly demand adjustments—considerable dangers would also arise from trying to make do with a slow track of sluggish reforms and hesitant steps toward currency union. Most importantly, successful transitions into the euro area provide the best route to deal with the potential currency mismatches that have arisen in economies (such as Hungary and Poland) from the rapid increases in foreign currency lending in recent years.

The recent slowing pace of reform among the new members since they entered the EU thus raises concern. While performance over the past 10 years has been impressive, to a considerable degree growth rates reflect the rebound after the dislocation following the collapse of COMECON, as well as a benign global environment that has boosted growth in other emerging market countries too. Looking ahead, continuing structural improvements are critical to facilitate continuing smooth convergence within the European Union and ensure the broader competitiveness of these countries. One key issue is the need to boost labor market flexibility and reduce sizable tax wedges that have contributed to high unemployment rates, still in excess of 10 percent in Poland and the Slovak Republic. Another priority is to control government spending, including improved targeting of social transfers and addressing pressures on pension and health care costs from rapidly aging populations.

[8]The Balassa-Samuelson effect implies a rising real exchange rate for a country with relatively rapid growth in the tradables sector compared with the nontradables sector. See Buiter and Sibert (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]			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Commonwealth of Independent States	**6.6**	**7.7**	**7.0**	**6.4**	**12.4**	**9.6**	**9.0**	**8.3**	**8.8**	**7.7**	**5.0**	**4.4**
Russia	6.4	6.7	6.4	5.9	12.7	9.7	8.1	7.5	10.9	9.8	6.2	5.0
Ukraine	2.7	7.1	5.0	4.6	13.5	9.0	11.3	10.0	2.9	–1.7	–4.1	–5.5
Kazakhstan	9.7	10.6	9.0	8.1	7.6	8.6	8.8	6.8	–1.3	–1.4	–0.9	–0.4
Belarus	9.3	9.9	5.5	3.9	10.3	7.0	11.4	13.7	1.6	–4.1	–8.7	–6.4
Turkmenistan	9.0	9.0	10.0	10.0	10.7	8.2	6.5	9.0	5.1	15.3	11.7	11.7
Low-income CIS countries	**12.1**	**14.6**	**14.8**	**12.8**	**12.2**	**11.8**	**12.7**	**11.9**	**2.7**	**7.4**	**11.6**	**17.0**
Armenia	14.0	13.4	9.0	6.0	0.6	2.9	4.0	4.5	–3.9	–5.0	–5.5	–5.3
Azerbaijan	24.3	31.0	29.2	23.1	9.7	8.4	21.1	17.0	1.3	15.7	27.4	36.2
Georgia	9.6	9.0	7.5	6.5	8.3	9.2	6.3	5.5	–5.4	–9.5	–15.2	–12.7
Kyrgyz Republic	–0.2	2.7	6.5	6.6	4.3	5.6	5.0	4.0	–2.3	–16.8	–12.6	–10.8
Moldova	7.5	4.0	4.5	5.0	11.9	12.7	11.4	8.9	–8.1	–8.3	–6.2	–5.7
Tajikistan	6.7	7.0	7.5	8.0	7.3	10.1	11.4	9.2	–2.5	–2.5	–15.2	–15.3
Uzbekistan	7.0	7.2	7.7	7.5	21.0	19.5	10.4	12.2	14.3	19.4	19.7	18.6
Memorandum												
Net energy exporters[3]	7.1	7.7	7.4	6.8	12.5	9.8	8.6	7.9	9.9	9.3	6.5	5.8
Net energy importers[4]	4.5	7.7	5.4	4.7	12.0	8.5	10.8	10.1	1.6	–3.2	–6.0	–6.3

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

Commonwealth of Independent States: Strong Growth but More Economic Diversification Needed

Activity in the Commonwealth of Independent States (CIS) continues to expand briskly, reflecting the solid performance of energy exporters and a pickup in activity among energy importers, many of which have benefited from rising nonfuel commodity prices and strengthened domestic demand (Table 2.6). Looking forward, while real GDP growth is expected to moderate, its pace would be second only to emerging Asia among the major regions. In Russia, growth would remain strong, although output appears to be running close to capacity in the face of robust domestic demand. Oil production growth has slowed, however, reflecting limited past investment. In Ukraine, the rise in international steel prices and robust domestic demand are underpinning a strong growth rebound, but the pace of activity is expected to moderate in response to large increases in the price of imported natural gas and an associated overall deterioration in the terms of trade. Upside risks to the outlook for the region as a whole relate to a possible rebound in oil prices and stronger-than-anticipated demand for the region's principal non-oil commodity exports. On the downside, a sharp slowdown in global activity could adversely affect exports, although domestic demand should be resilient in most countries.

Current account positions have strengthened in energy exporters such as Turkmenistan and Azerbaijan. In other countries, current account balances have deteriorated due to a strong rise in import volumes as well as the rising costs of energy imports (Ukraine and Georgia) and the weakening demand for specific exports (Armenia). Looking ahead, the regional current account position is expected to remain strong, reflecting the continued underlying strength in demand for the region's principal exports.

Reflecting the strength of domestic demand and strong capital inflows, inflation among CIS countries remains among the highest in

the world, despite some moderation in several countries. In Russia, headline inflation came down by 2 percentage points during 2006, reflecting lower administered price increases and some nominal appreciation of the ruble, but at 9 percent still remained above the official target of 8½ percent for end-2006. Bringing inflation down to the 2007 target of 8 percent will depend on allowing greater nominal appreciation of the ruble and a more restrictive fiscal stance. In Ukraine, inflation has recently accelerated into double digits following the pass-through of higher energy import prices. Monetary policy needs to play a more active role to ensure that the recent spike in inflation does not feed into higher inflationary expectations. The authorities' preliminary steps toward an inflation targeting regime are welcome, but a gradual transition to greater exchange rate flexibility will be needed to support this framework.

Fiscal balances in several countries have deteriorated as large spending increases have outpaced the increase in revenues related to higher export earnings and stronger domestic economic activity. In some others, fiscal positions have strengthened. In Russia, the primary fiscal balance has improved as a large proportion of the higher oil revenues has been placed in the stabilization fund, although spending has also accelerated. In Ukraine, spending has been held below budgeted levels while revenue growth has been strong. More generally, in the context of already strong domestic demand, governments will need to be careful to avoid excessive public spending increases, particularly in areas that boost consumption—such as on pensions and wages—and exert upward pressure on inflation. In countries where there is scope to boost public spending over the medium term, governments should ensure that expenditures are geared toward generating high-quality growth that is not linked to the commodity price cycle and are allocated efficiently in the context of often weak institutional capacity.

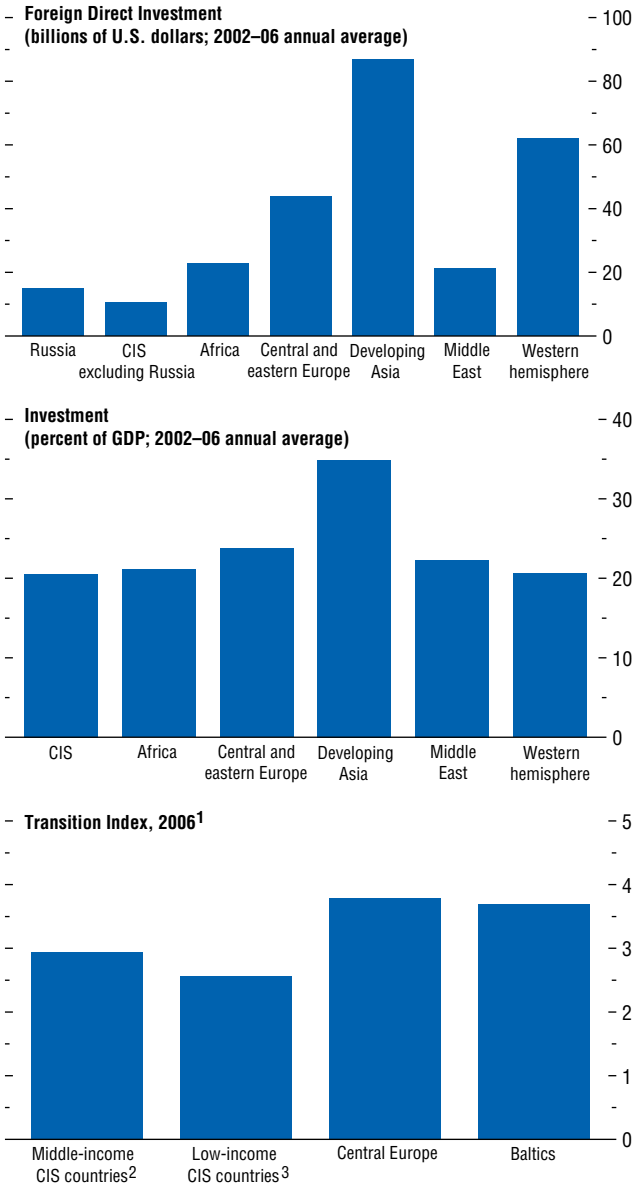
More generally, sustaining the recent strong growth momentum will require a diversification of the sources of growth away from exports of primary commodities. The strength of domestic demand in recent years has been driven to a large extent by consumption, fueled by capital inflows, rapid credit growth, and, in some countries, increased public sector spending in the form of wages and pensions. Despite sizable public investment in some countries, focused mainly in resource extraction industries and related transportation infrastructure, the overall ratio of investment to GDP among CIS countries remains relatively low (Figure 2.9). This underscores the need to attract greater private investment in noncommodity sectors. Foreign direct investment, in particular, is low in these sectors. Many countries in the region have a large unfinished structural reform agenda, as seen, for example, by the region's slower pace of reform relative to central Europe and the Baltics, and further progress is needed to improve the investment climate. The main priorities are broadening and deepening domestic financial markets, reforming civil services and the energy sector, making tax systems more growth- and investment-friendly, strengthening the protection of property rights, reducing corruption and state intervention, and strengthening legal and regulatory systems.

Africa: Sustaining Recent Growth Momentum

The short-term economic outlook for Africa remains very positive, against the backdrop of strong global growth, continued progress in cementing macroeconomic stability, the beneficial impact of debt relief, increased capital inflows, rising oil production in a number of countries, and strong demand for nonfuel commodities. Real GDP growth is expected to accelerate to 6.2 percent this year, from 5.5 percent in 2006, before slowing to 5.8 percent in 2008 (Table 2.7). Inflation (excluding Zimbabwe) is on a declining trend, while fiscal and current account balances are in surplus at the regional level (although this is due to large surpluses in oil-exporting countries).

Figure 2.9. Commonwealth of Independent States (CIS): Further Reform Needed to Raise Investment Levels

The CIS region attracts relatively low levels of foreign direct investment, while overall investment is still dominated by the natural resources sector and related transportation infrastructure. Further reform is needed to improve the investment climate.



Sources: EBRD, *Transition Report;* and IMF staff calculations.

[1]The transition Index is the unweighted average of large-scale privatization index, small-scale privatization index, enterprise restructuring index, price liberalization index, trade and forex system index, competition policy index, banking reform and interest rate liberalization index, securities markets and nonbank financial institutions index, and overall infrastructure reform index.

[2]Belarus, Kazakhstan, Russia, Turkmenistan, and Ukraine.

[3]Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan.

In sub-Saharan Africa, the projected acceleration in growth in 2007 is driven by oil-exporting countries. (see also the IMF's April 2007 *Regional Economic Outlook: Sub-Saharan Africa*). New production facilities will come on stream in Angola and Equatorial Guinea, while oil output in Nigeria, which has been disrupted by violence in the Niger Delta, is assumed to be fully restored by midyear. Strong oil revenues are also spurring domestic demand and growth in the non-oil sector. In Nigeria, for example, non-oil GDP has grown by an average of 8 percent over the past three years. After a strong expansion in 2006, growth in oil-importing countries is projected to ease this year, driven largely by developments in South Africa, where tighter monetary policy is expected to slow domestic demand. The decline in oil prices will underpin an improvement in the terms of trade in some countries, although for others the benefit will be offset by the drop in metals prices. In the Maghreb, growth in Morocco is expected to slow (following a bumper harvest in 2006), but activity in Algeria should rebound as hydrocarbon output recovers following maintenance work in 2006 and public sector investment increases.

Despite this positive outlook, risks are tilted somewhat to the downside. While the current rotation of growth away from the United States toward the euro area is unlikely to have a significant impact on sub-Saharan Africa (each accounts for around 25 percent of exports), a sharper-than-expected slowing in global growth would hurt the region, particularly through its impact on commodity prices. Exports of the CFA franc zone countries would also be affected by a further appreciation of the euro. There are also country-specific risks. In Nigeria, violence in the Niger Delta region may prevent the restoration of oil production as assumed in the baseline forecast. In South Africa, strong domestic demand growth has pushed the current account deficit to 6½ percent of GDP and inflation has moved toward the upper end of the 3–6 percent target band. The central bank has appropriately tightened monetary policy, but further interest

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]			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Africa	**5.6**	**5.5**	**6.2**	**5.8**	**8.4**	**9.5**	**10.7**	**10.4**	**1.8**	**2.2**	**0.1**	**—**
Maghreb	**4.0**	**4.5**	**4.4**	**5.0**	**1.5**	**3.1**	**4.0**	**4.1**	**11.9**	**14.4**	**8.6**	**8.1**
Algeria	5.3	2.7	4.5	4.1	1.6	2.5	5.5	5.7	20.7	24.4	15.3	15.2
Morocco	1.7	7.3	3.5	5.8	1.0	3.3	2.0	2.0	1.7	3.9	2.1	0.5
Tunisia	4.0	5.3	6.0	6.0	2.0	4.5	3.0	2.9	–1.0	–2.8	–2.2	–2.1
Sub-Sahara	**6.0**	**5.7**	**6.8**	**6.1**	**10.5**	**11.5**	**12.7**	**12.2**	**–1.1**	**–1.3**	**–2.2**	**–2.1**
Horn of Africa[3]	**9.3**	**11.5**	**9.1**	**8.7**	**7.7**	**9.3**	**12.4**	**8.8**	**–9.7**	**–13.6**	**–11.2**	**–7.0**
Ethiopia	10.3	10.6	6.5	6.6	6.8	12.3	17.0	12.9	–8.6	–11.6	–10.0	–6.6
Sudan	8.6	12.2	11.1	10.2	8.5	7.2	9.2	6.0	–10.5	–14.5	–11.5	–7.0
Great Lakes[3]	**6.2**	**5.5**	**6.4**	**6.5**	**11.5**	**9.7**	**8.2**	**5.4**	**–4.5**	**–5.8**	**–7.0**	**–7.2**
Congo, Dem. Rep. of	6.5	5.1	6.5	6.9	21.4	13.2	17.4	8.9	–10.0	–7.5	–10.3	–9.3
Kenya	5.8	6.0	6.2	5.8	10.3	14.1	4.1	3.5	–3.0	–3.3	–4.1	–3.9
Tanzania	6.8	5.9	7.3	7.6	4.4	5.8	5.5	5.0	–5.2	–9.3	–11.0	–11.2
Uganda	6.7	5.4	6.2	6.5	8.0	6.6	5.8	4.2	–2.1	–4.1	–4.4	–7.9
Southern Africa[3]	**7.0**	**6.6**	**12.6**	**7.6**	**31.1**	**47.7**	**55.5**	**60.2**	**3.4**	**5.0**	**2.0**	**0.9**
Angola	20.6	15.3	35.3	16.0	23.0	13.3	10.2	5.9	13.5	10.5	4.0	2.8
Zimbabwe	–5.3	–4.8	–5.7	–3.6	237.8	1,016.7	2,879.5	6,470.8	–11.2	–3.9	–0.8	0.2
West and Central Africa[3]	**5.6**	**4.4**	**5.8**	**6.0**	**11.5**	**7.4**	**6.8**	**6.7**	**2.5**	**5.1**	**3.5**	**2.4**
Ghana	5.9	6.2	6.3	6.9	15.1	10.9	9.4	8.8	–7.0	–8.2	–8.4	–7.9
Nigeria	7.2	5.3	8.2	6.7	17.8	8.3	7.9	9.1	9.2	12.2	9.7	7.6
CFA franc zone[3]	**4.5**	**3.0**	**4.2**	**5.3**	**4.4**	**3.5**	**2.8**	**2.7**	**–1.9**	**–0.4**	**–1.4**	**–1.9**
Cameroon	2.0	3.5	4.0	4.1	2.0	5.3	1.5	1.9	–3.4	–0.5	–2.1	–3.0
Côte d'Ivoire	1.5	1.4	1.7	3.3	3.9	1.6	2.0	3.0	–0.1	1.2	1.1	0.7
South Africa	**5.1**	**5.0**	**4.7**	**4.5**	**3.4**	**4.7**	**5.5**	**4.9**	**–3.8**	**–6.4**	**–6.4**	**–6.0**
Memorandum												
Oil importers	4.8	5.3	4.8	5.2	8.2	11.1	12.3	12.1	–3.4	–4.2	–4.4	–4.2
Oil exporters[4]	7.6	5.9	9.5	7.3	8.9	5.9	7.1	6.5	11.1	12.6	7.6	6.8

[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.

rate increases may still be needed to counter inflationary pressures, which could result in a sharper growth slowdown. Given the importance of South Africa, particularly for the rest of southern Africa, any such slowing could negatively affect other countries.[9]

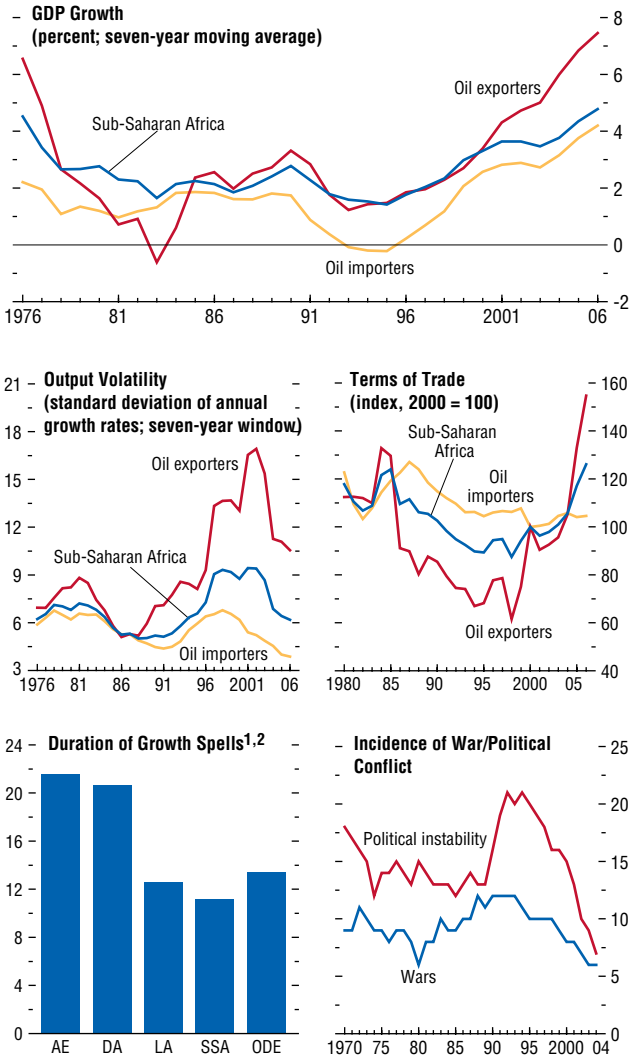
Since the beginning of this decade, real GDP growth in sub-Saharan Africa has averaged a little over 4½ percent a year, the strongest seven-year period since the beginning of the 1970s, while output variability has declined (Figure 2.10). These developments have raised hopes that Africa has entered a period of strong and sustained growth that will begin to make deeper inroads into the extremely high poverty rates that still plague the continent.[10] Yet, the strong growth of the early 1970s was followed by two decades of stagnation as the region struggled to cope with a deteriorating terms of trade, high inflation, and bouts of conflict and political instability. Indeed, Africa

[9]Arora and Vamvakidis (2005) estimate that a 1 percentage point slowing in South African growth is associated with a ½–¾ percentage point slowing in the rest of sub-Saharan Africa.

[10]Despite the improved growth performance, only a few African countries will reach the target set by the Millennium Development Goals (MDGs) of halving extreme poverty by 2015 on current trends (see the *Global Monitoring Report 2006*).

Figure 2.10. Sub-Saharan Africa: Can Recent Growth Momentum Be Sustained?

Sub-Saharan Africa is currently witnessing a period of strong growth. While this is partly due to positive terms-of-trade developments, oil importers are also growing robustly. The key now is to sustain the recent growth momentum, something the region has been unable to do in the past. A more stable political climate should help sustain high growth rates.



Sources: Berg, Ostry, and Zettelmeyer (2006); and IMF staff calculations.

[1]AE: advanced economies; DA: developing Asia; LA: Latin America; SSA: sub-Saharan Africa; ODE: other developing economies.

[2]From Berg, Ostry, and Zettelmeyer (2006). A growth spell is defined as a statistically significant upbreak in growth followed by a period during which per capita growth averages at least 2 percent.

has been replete with examples of countries where growth has accelerated for short periods of time. Empirical evidence suggests that growth episodes in sub-Saharan Africa start with broadly the same frequency as other regions, but the duration of these episodes is considerably shorter, and they tend to end in painful output collapses (Berg, Ostry, and Zettelmeyer, 2006).[11]

Against this background, the question is how current growth momentum in sub-Saharan Africa can be sustained, and indeed accelerated, going forward. While armed conflicts and political instability continue to undermine prospects in a number of countries, the frequency of such events in the region as a whole has declined over the past decade. This suggests that economic policies, rather than sociopolitical developments, will be the main determinant of whether strong growth continues or not. To this end, sustaining the recent improvement in macroeconomic stability will be crucial, but challenging, particularly in oil-exporting countries where the increase in oil revenues has created strong pressures for government spending.[12] An increasing focus will also need to be placed on implementing the structural reforms that will help foster vibrant market-based economies.

Further trade liberalization is key to these efforts, because of both its direct effect on competition in the domestic economy and its impact on improving institutional quality (see the September 2005 *World Economic Outlook*). Trade reforms have increased the openness of sub-Saharan African economies since the mid-1990s, but trade regimes in the region generally remain more restrictive than in the dynamic economies of Asia.[13] Steps are

[11]Becker and Mauro (2006) find that large output losses in developing countries are most frequently triggered by large declines in the terms of trade.

[12]See Chapter 3 of the April 2007 *Regional Economic Outlook: Sub-Saharan Africa* for a discussion of the macroeconomic challenges facing African oil exporters.

[13]For example, Johnson, Ostry, and Subramanian (2007) show that the bureaucratic costs in terms of the number of documents and days it takes to undertake import and export activity are particularly high in sub-Saharan Africa.

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]			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Middle East	**5.4**	**5.7**	**5.5**	**5.5**	**7.1**	**7.9**	**10.6**	**8.7**	**18.8**	**18.1**	**12.1**	**10.7**
Oil exporters[3]	**5.7**	**5.5**	**5.3**	**5.2**	**6.8**	**8.9**	**10.4**	**8.5**	**21.7**	**20.9**	**14.4**	**12.9**
Iran, I.R. of	4.4	5.3	5.0	5.0	12.1	14.6	17.8	15.8	7.4	6.7	6.0	4.7
Saudi Arabia	6.6	4.6	4.8	4.0	0.7	2.3	2.8	2.0	29.3	27.4	19.7	17.1
Kuwait	10.0	5.0	3.5	4.8	4.1	3.0	2.8	2.6	40.5	43.1	34.4	32.3
Mashreq	**4.2**	**5.9**	**5.9**	**6.1**	**7.8**	**5.3**	**10.7**	**9.0**	**–1.1**	**–1.9**	**–2.5**	**–3.8**
Egypt	4.5	6.8	6.7	6.6	8.8	4.2	12.3	10.7	3.2	0.8	0.7	–1.5
Syrian Arab Republic	2.9	3.0	3.3	4.7	7.2	10.0	8.0	5.0	0.8	–1.2	–3.4	–3.0
Jordan	7.2	6.0	6.0	6.0	3.5	6.3	5.7	3.5	–17.8	–16.0	–14.6	–15.0
Lebanon	1.0	—	1.0	3.5	–0.7	5.6	3.5	2.5	–11.7	–6.8	–11.0	–10.0
Memorandum												
Israel	5.2	5.1	4.8	4.2	1.3	2.1	–0.1	2.0	2.9	5.2	3.6	4.3

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

also needed by the international community to improve market access for regional exports. Delivery on aid commitments by the advanced economies would also help sustain growth momentum and support progress toward achieving the MDGs.

Strengthening institutions and improving the business climate would help to spur private sector activity and diversify economies away from excessive reliance on commodities (see also Box 2.5 in the April 2007 *Regional Economic Outlook: Sub-Saharan Africa*). At present, sub-Saharan African countries generally rank toward the bottom in the World Bank's Doing Business surveys, although reforms are under way in some countries.[14] Development of the non-commodity-producing sectors would not only generate much-needed employment, but would also reduce the region's vulnerability to terms-of-trade movements. Increased spending to address infrastructure bottlenecks and improve education and health care is also necessary, with the increase in oil wealth and recent debt relief making such options possible. Nevertheless, spending needs to be consistent with absorptive capacity and macroeconomic objectives, and to be accompanied by improved financial management to avoid wasteful spending.

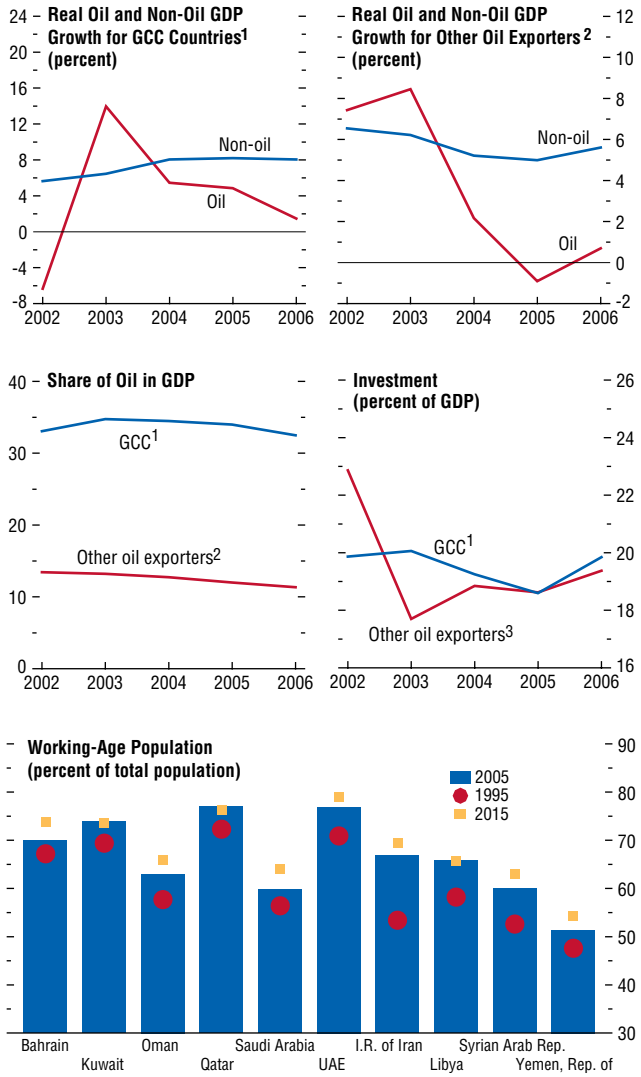
[14]In the 2007 survey, Ghana and Tanzania were ranked among the top 10 reformers in the world, while it was noted that 11 other countries have also started to simplify business regulations and this would be reflected in the Doing Business indicators next year.

Middle East: Expanding the Benefits of the Oil Boom

Middle Eastern oil exporters enjoyed another year of solid growth in 2006, accompanied by strong current account and fiscal balances (Table 2.8). Oil revenues continued to grow rapidly although the pace was tempered by the decline in oil prices since August and some cuts in output late last year among Organization of the Petroleum Exporting Countries (OPEC) members. The strong overall momentum of the non-oil sector has been maintained, with little discernible impact from the sharp correction in regional equity markets in early 2006. Inflationary pressures among oil exporters continue to remain generally well contained, although expansionary fiscal policies have contributed

Figure 2.11. Middle East: Investment in Non-Oil Sectors Key to Employment Growth

With rapidly rising working-age populations, meeting the challenge of the employment generation will require an expansion of investment in the non-oil sector.



Sources: United Nations Common Database; 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 (UAE).
[2]Consists of I.R. of Iran, Libya, Syrian Arab Republic, and the Republic of Yemen.
[3]Excludes I.R. of Iran.

to a further increase in inflation in the Islamic Republic of Iran.

In the non-oil-exporting countries of the Mashreq region, growth accelerated in 2006 in the context of an upturn in foreign direct investment and an overall favorable external environment. In Egypt, growth and exports in the non-oil sector have picked up strongly, although underlying demand pressures have contributed to rising inflation over the course of the year. In Lebanon, the mid-2006 conflict and monthlong blockade led to an economic slowdown accompanied by a further deterioration in the fiscal deficit and rising public debt and inflation.

The outlook for the region as a whole remains favorable, with some moderation of growth among oil exporters. The region's current account surplus is expected to decline from its 2006 level of 18 percent of regional GDP to around 10¾ percent of GDP over the next two years as a result of the decline in oil prices and stronger import growth. Risks to the outlook appear broadly balanced at this juncture. On the upside, oil prices could rebound after their recent decline. Beyond geopolitical uncertainties, downside risks stem from a further decline in oil prices, although the prudent management of oil revenues during the current upturn leaves oil exporters in the region in a much stronger position than in previous cycles to smooth public spending, given significantly reduced external and public debt vulnerabilities.

Following Oman's announcement of its decision not to join the Cooperation Council of the Arab States of the Gulf (GCC) monetary union at the scheduled date of 2010, it is reported that the six GCC monetary authorities are considering possible alternatives, including closer monetary policy coordination, during the transition to a full monetary union. While efforts to enhance policy coordination would be beneficial to the GCC countries, important preconditions remain to be fulfilled, including the need to better define monetary policy objectives, the use of more uniform monetary instruments, the establishment of the institutional framework required to improve the coordination of mon-

etary policies, and formation of the planned customs union.

Despite the recent high growth and rise in real per capita incomes in the region, Middle Eastern oil exporters remain heavily dependent on the hydrocarbon sector. At the same time, rapid population growth has contributed to some of the highest levels of unemployment in the world and relatively low employment-to-population ratios (Figure 2.11).[15] While increased public sector employment has helped cushion the impact of rising labor supply in a number of GCC countries in the past, the demand for jobs is outpacing economy-wide supply by increasing margins. The current favorable conjuncture provides a unique opportunity for the region's oil exporters to implement policies that can address the twin challenges of diversifying oil-dependent economies and providing employment to a rapidly expanding labor force. In this context, the ambitious investment plans of the members of the GCC (totaling over $700 billion during 2006–10) should make a major contribution.

For the region's oil exporters more generally, a greater role for private investment in the non-oil sector will be key to balancing growth and providing increased employment opportunities. While a stable macroeconomic environment remains an important precondition, a number of other reforms could play an important role in increasing private investment in the region. The main priorities are improvements in the business environment, including the reduction of complex regulations and barriers to entry and exit, better access to finance for small and medium enterprises, improved trade facilitation (including increased efficiency in customs and ports, and document processing) to complement trade liberalization measures already undertaken, and better overall institutional frameworks. In addition, measures to improve the quality of education in schools and vocational training programs could help align the skills mix of the labor force with the needs of the private sector.

[15]Although data on unemployment are updated infrequently in most countries of the region, estimates of underlying trends are discussed in International Labor Organization (2007) and de Boer and Turner (2007).

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