World Economic Outlook

Global Expansion Likely To Continue

The news from the October 1996 *World Economic Outlook* is encouraging—for both the short term and the medium term. The IMF's biannual survey of global economic prospects and policies envisages satisfactory growth or recovery for most countries—industrial, developing, and transition—all over the globe. At the same time, many countries will need to address persistent or potential weaknesses and imbalances to share fully in the current expansion.

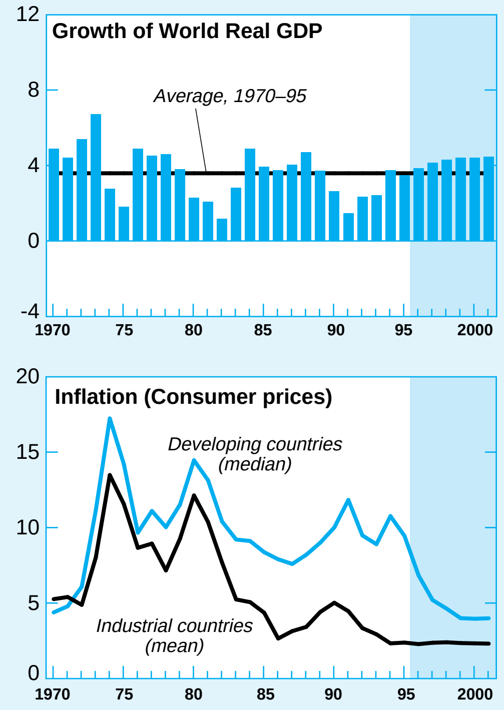
World output growth slowed slightly to 3 1/2 percent in 1995 from 3 3/4 percent in 1994 (see chart). The slight faltering of growth in 1995 reflected a significant weakening in many industrial countries in western Europe as well as in the developing countries of the Western Hemisphere. Elsewhere in the developing world, growth was generally well maintained, notably in Africa. In Asia, growth, though remaining rapid, has moderated somewhat since 1994, allaying concerns about overheating. Among many countries in transition to market-based systems, output declines abated further, while others, having successfully turned the corner, grew vigorously.

Short and Medium-Term Prospects

Notwithstanding the disappointing performance in western Europe in 1995, the *World Economic Outlook* sees the global economic expansion continuing at a satisfactory pace in 1996–97 and over the medium term. The near-term outlook is for a slight pickup to 3 3/4 percent in 1996 and a further strengthening to about 4 percent in 1997. These projections are based on expectations that the United States will grow at or near potential and that activity in much of Europe will strengthen in the second half of 1996 and in 1997. Among the Western Hemisphere developing countries, the recovery from the Mexican financial crisis of late 1994 is projected to gain momentum. Economic conditions in other developing countries, in Africa, the Middle East, and Europe are also expected to improve—although growth will remain uneven across countries. Growth in the Asian developing countries is expected to moderate but remain high. For the countries in transition, aggregate output is projected to stabilize in 1996 and grow significantly in 1997 for the first time since the process of transition began.

Scanning the medium-term horizon, the *World Economic Outlook* predicts reasonably encouraging prospects for the world economy. Assuming that established policies of national authorities remain unchanged, IMF staff projections call for a strengthening of world growth to an average annual rate of 4 1/2 percent during 1998–2001, fueled mainly by the expected resumption of growth in the transition economies. This projection compares with the long-term trend growth rate of 3 1/2 to 4 percent observed over the past quarter century.

World Indicators[1]



[1]Shaded areas indicate IMF staff projections.

Data: IMF, *World Economic Outlook*, October 1996

Industrial Countries Need Fiscal Consolidation, Labor Reform

The industrial countries have met with continuing success in containing inflation, but growth and labor market performance remain uneven. Economic growth slowed in most industrial countries in 1995, with the notable exceptions of Japan, Italy, and some of the smaller European countries. In 1996, growth is expected to strengthen slightly to 2 1/4 percent, with expansions in the United States and Japan offset by continuing sluggishness in most of continental Europe, including France and Germany.

Many countries in the European Union (EU) have yet to share fully in the current expansion. These countries need to address deep-seated structural and macroeconomic weaknesses, including, in some cases, difficulties in their banking systems. In much of continental Europe, the policy mix has shifted toward tighter budgetary policies and easier monetary conditions—in response to the faltering of growth in the second half of 1995 and in view of the approaching deadline for bringing budget deficits to 3 percent of GDP (1997 is the test year for deciding which EU member countries meet the criteria for participation in the third and final stage of economic and monetary union, which begins in 1999).

Of immediate and continuing concern is the need to make further progress toward reducing fiscal imbalances over the medium term. Not only does the maintenance of an adequate pace of consolidation offer the best prospect for a sustained improvement in economic performance over the medium term, according to the *World Economic Outlook*, but the short-term costs may also be smaller than those arising from a failure to address persistently large deficits.

For many countries in Europe, fiscal balances are related to problems in the functioning of labor markets. These shortcomings have contributed to a substantial upswing in the EU's unemployment rate over the past 25 years—to 11 percent, of which as much as 8 to 9 percent is structural (that is, not likely to be absorbed through cyclical recovery). Together with discouraged job seekers and a high rate of early retirement, these unemployment figures represent considerable underutilization of labor resources. This, in turn, has reduced potential output and exacerbated budgetary pressures through revenue losses and outlays for income support.

There is a real risk in Europe, according to the *World Economic Outlook*, that in the absence of comprehensive labor market reforms, unemployment rates could rise further. So far, however, European countries have demonstrated excessive timidity in implementing labor market policies, and reforms have been mostly piecemeal and ineffective.

The essential aim of labor market reforms, according to the *World Economic Outlook*, must be to allow market forces a greater role in helping to clear the labor market at much lower levels of unemployment. Policymakers need to mobilize public support for reform while overcoming fears that a deregulated labor market would seriously jeopardize Europe's social fabric. Several measures could be taken to foster reductions in unemployment while still maintaining some level of protection:

- substantial scaling back of passive support measures, including lower benefit levels for the unemployed;
- shorter durations and tighter eligibility criteria and job-search requirements for unemployment benefits;
- replacement of passive income-support measures, with a negative income tax conditional on employment or job search;
- reductions in payroll taxes and minimum wages; and
- substantial scaling back of job security legislation.

Developing Countries Need Sound Financial Systems

Continuing the solid expansion under way since the beginning of the decade, developing countries grew by nearly 6 percent in 1995, despite a marked slowdown in Latin America in the wake of the Mexican financial crisis. Sunny prospects also characterize the *World Economic Outlook*'s projections for 1996 and 1997: aggregate growth will likely remain at about 6 percent as Mexico and Argentina recover, growth in Africa strengthens, and the expansion in several Asian countries moderates. Inflation, which slowed substantially to 20 percent in 1995, is expected to ease further in most countries. Further progress is also expected in reducing fiscal imbalances throughout most of the developing world.

Despite the sustained overall improvement in economic performance of the developing world, individual countries have shown marked divergences. Some have made only limited progress and continue to fall behind in relative income positions. Among the strong performers, fiscal imbalances have been generally contained, and the role of the public sector has been geared mainly toward promoting private sector development. Macroeconomic stability and market-oriented structural reforms, including more open trade and payments regimes, have laid the basis for substantial increases in their shares of world trade and income and for their greater access to international capital markets.

Less successful countries, in contrast, are often characterized by persistent fiscal imbalances aggravated by support for loss-making public enterprises; extensive government intervention in the economy through regulations and restrictions on the private sector and foreign trade; poor control of inflation; and financial repression, including policies that hold interest rates at artificially low levels and maintain overvalued exchange rates, which discourage saving and distort resource allocation.

Activity in emerging market countries is generally expected to remain buoyant on the basis of strong domestic fundamentals and continued large capital inflows, especially of foreign direct investment. But a pressing issue in many emerging market countries has been how to deal with the risk of overheating, which can result in unsustainable macroeconomic imbalances, rising inflation, and strains in financial markets—and ultimately affect the confidence of domestic and foreign investors. The importance of addressing such problems at an early stage, according to the *World Economic Outlook*, is underscored by concerns about the vulnerability of banking systems to foreign exchange and financial market crises and domestic policy reversals. In the past several years, a number of emerging market countries have experienced disruptive and costly banking crises, and the fragility of banking systems in many other countries suggests that similar difficulties may occur in the future. To reduce such risks, the emerging market countries need to enhance the soundness of their financial sectors through strong prudential standards and supervision.

Weaknesses in banking systems have also held back economic growth in countries that have not received private capital flows. These countries share with the strong performers the need to strengthen domestic financial systems, both to promote the mobilization and efficient allocation of domestic saving and investment and as a prerequisite for the successful liberalization of restrictions on cross-border financial flows. In many poor countries, external debt burdens have reached unsustainable levels. This situation will need to be resolved quickly with concerted assistance from the international community, so that the debt burdens do not detour these countries from continuing on the path of sustained structural reforms and macroeconomic adjustment.

Transition Economies Face Demographic Challenges

Overall activity in the transition economies is projected to stabilize in 1996, after five years of decline, and several countries are expected to grow by 5 percent or more. Further gains in reducing inflation are also projected, with four countries registering annual inflation in the single digits. Although strong domestic demand has been the main engine for growth in some cases, rapid expansion of exports has continued to play an important role. In addition, many of the advanced transition economies are receiving substantial inflows of foreign direct investment.

The countries more advanced in the transition process—such as Poland, the Czech Republic, the Baltic countries, and Croatia—can expect sustained growth and further progress toward financial stabilization. Among the countries less advanced in transition, delays in reforms, lack of macroeconomic discipline, and policy slippages have in some cases led to financial market instability and further output declines.

Many other late bloomers, however, have made encouraging progress. Russia has made great strides in reducing inflation, and growth is expected to begin to pick up in the second half of 1996. Weaknesses in government finances, however, continue to be a concern. Armenia, Georgia, and Ukraine have made considerable progress toward moderate inflation; the Armenian and Georgian economies are both expected to grow by about 7 percent in 1996.

Some important lessons can be drawn from the experience of the transition economies over the last five years, according to the *World Economic Outlook*:

- Reduction of inflation from high levels is critical for halting and reversing the sharp contractions in output that are an unavoidable feature of the first phase of the transformation process.
- Growth is unlikely to resume without substantial progress with structural reform in a broad range of areas, including in banking systems that are plagued by mismanagement and massive bad loan problems.
- Restructuring the enterprise sector may result in temporarily high unemployment. Governments need to support the process, not by allowing enterprises to maintain soft budget constraints, but by fostering labor mobility and wage flexibility, setting up retraining schemes, and establishing affordable, well-targeted safety nets to lessen the hardships associated with unemployment.

Emerging market countries must strengthen their financial sectors with prudential standards and supervision.

The longer-term growth prospects for the transition economies, according to the *World Economic Outlook*, may not be as favorable as in many of the dynamic emerging market countries. Despite high levels and quality of education, which suggests an advantage in terms of human capital, most transition economies have rapidly aging—and slowly growing—populations. These unfavorable demographic trends translate into rising dependency ratios, which imply little improvement in an already weak saving performance. Moreover, weak banking systems in many countries may impair the mobilization of domestic saving and hamper the efficiency of resource allocation through the financial system. Much will depend, notes the *World Economic Outlook*, on governments' ability to cope with three main policy challenges:

- striking an appropriate balance of fiscal consolidation and provision of social safety nets;

• ensuring prudent use of foreign capital to augment domestic savings; and

• putting the banking system on a sound footing in order to mobilize and effectively allocate domestic saving.

Global Strategy: The Path to Success

Countries differ according to category of development, as well as within categories; and each has its peculiar and characteristic problems. But, as the *World Economic Outlook* notes, the achievements of recent years underscore the validity of the cooperative strategy to strengthen the global expansion set out by the IMF's Interim Committee in 1993 and reaffirmed in its October 1994 Madrid Declaration.

At the same time, the IMF study concludes, continuing problems in many countries suggest a need to broaden the strategy and strengthen its implementation. Recent experience has confirmed that economic success requires sustained efforts at both structural reform and macroeconomic stabilization. Failure to tackle serious weaknesses in some areas may increase the short-term costs—and delay the positive effects—of those policies that go in the right direction. More comprehensive and better balanced policy approaches are necessary if a greater number of countries are to realize their full growth potential.