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Assumptions and Conventions

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates will remain constant at their average levels during July 25–August 21, 1996 except for the bilateral rates among the European exchange rate mechanism (ERM) currencies, which are assumed to remain constant in nominal terms; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary policies in industrial countries, see Box 1); that the average price of oil will be $19.42 a barrel in 1996 and $17.94 a barrel in 1997, and remain unchanged in real terms over the medium term; and that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 5.6 percent in 1996 and 6.0 percent in 1997. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The estimates and projections are based on statistical information available on September 10, 1996.

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

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

— to indicate that the figure is zero or negligible;

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

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

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

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

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

* * *

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

Preface

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

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

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

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

Primary contributors to the current issue are Francesco Caramazza, Robert F. Wescott, Staffan Gorne, Paula De Masi, James Haley, Mahmood Pradhan, Jahangir Aziz, John McDermott, Phillip Swagel, and Cathy Wright. Other contributors include Guy Debell, Anne-Marie Gulde, Douglas Laxton, Ceyla Pazarbaşioğlu, Robert Price, and Anthony G. Turner. The authors of the annexes are indicated on the first page of each. The Fiscal Analysis Division of the Fiscal Affairs Department computed the structural budget and fiscal impulse measures. Sungcha Hong Cha, Toh Kuan, and Michelle Marquardt provided research assistance. Shamim Kassam, Allen Cobler, Nicholas Dopuch, Isabella Dymarskaia, Gretchen Gallik, Mandy Hemmati, and Yasoma Liyanarachchi processed the data and managed the computer systems. Susan Duff, Caroline Bagworth, and Margaret Dapaah were responsible for word processing. Juanita Roushdy of the External Relations Department edited the manuscript and coordinated production of the publication.

The analysis has benefited from comments and suggestions by staff from other IMF departments, as well as by Executive Directors following their discussion of the *World Economic Outlook* on September 4 and 6, 1996. However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities.

Partnership for Sustainable Global Growth

The following "Declaration on Partnership for Sustainable Global Growth" was adopted at the conclusion of the forty-seventh meeting of the Interim Committee of the Board of Governors of the IMF, September 29, 1996.

The Interim Committee has reviewed the "Declaration on Cooperation to Strengthen the Global Expansion," which it adopted two years ago in Madrid.[1] It notes that the strategy set out in the Declaration, which emphasized sound domestic policies, international cooperation, and global integration, remains valid. It reiterates the objective of promoting full participation of all economies, including the low-income countries, in the global economy. Favorable developments in, and prospects for, many industrial, developing, and transition economies owe much to the implementation of sound policies consistent with the common medium-term strategy.

The Interim Committee sees a need to update and broaden the Declaration, in light of the new challenges of a changing global environment, and to strengthen its implementation, in a renewed spirit of partnership. It attaches particular importance to the following:

- Stressing that sound monetary, fiscal, and structural policies are complementary and mutually reinforcing: steady application of consistent policies over the medium term is required to establish the conditions for sustained noninflationary growth and job creation, which are essential for social cohesion.
- Implementing sound macroeconomic policies and avoiding large imbalances are essential to promote financial and exchange rate stability and avoid significant misalignments among currencies.
- Creating a favorable environment for private savings.
- Consolidating the success in bringing inflation down and building on the hard-won credibility of monetary policy.
- Maintaining the impetus of trade liberalization, resisting protectionist pressures, and upholding the multilateral trading system.
- Encouraging current account convertibility and careful progress toward increased freedom of capital movements through efforts to promote stability and financial soundness.
- Achieving budget balance and strengthened fiscal discipline in a multiyear framework. Continued fiscal imbalances and excessive public indebtedness, and the upward pressures they put on global real interest rates, are threats to financial stability and durable growth. It is essential to enhance the transparency of fiscal policy by persevering with efforts to reduce off-budget transactions and quasi-fiscal deficits.
- Improving the quality and composition of fiscal adjustment, by reducing unproductive spending while ensuring adequate basic investment in infrastructure. Because the sustainability of economic growth depends on development of human resources, it is essential to improve education and training; to reform public pension and health systems to ensure their long-term viability and enable the provision of effective health care: and to alleviate poverty and provide well-targeted and affordable social safety nets.
- Tackling structural reforms more boldly, including through labor and product market reforms, with a view to increasing employment and reducing other distortions that impede the efficient allocation of resources, so as to make our economies more dynamic and resilient to adverse developments.
- Promoting good governance in all its aspects, including by ensuring the rule of law, improving the efficiency and accountability of the public sector, and tackling corruption, as essential elements of a framework within which economies can prosper.
- Ensuring the soundness of banking systems through strong prudential regulation and supervision, improved coordination, better assessment of credit risk, stringent capital requirements, timely disclosure of banks' financial conditions, action to prevent money laundering, and improved management of banks.

The Committee encourages the Fund to continue to cooperate with other international organizations in all relevant areas. It welcomes the recent strengthening of Fund surveillance of member countries' policies, which is an integral part of the strategy. It reaffirmed its commitment to strengthen the Fund's capacity to fulfill its mandate. It will keep members' efforts at achieving the common objectives of this strategy under review.

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[1]See the October 1994 *World Economic Outlook,* page x.

I

Global Economic Prospects and Policies

World economic and financial conditions remain generally encouraging, notwithstanding a disappointing performance recently in continental western Europe, and the global economic expansion is expected to continue at a satisfactory pace in 1996–97 and over the medium term (Table 1 and Chart 1). The strength of economic activity is particularly impressive in the emerging market countries of the developing world, with an increasing number of them reaping the benefits of structural reforms and strong macroeconomic fundamentals. In a number of such countries in Asia, concerns about overheating have been alleviated to some extent by a moderation of growth. And in most of the transition countries, the private sector is increasingly responding to the progress that has been made toward macroeconomic stability, the growing reliance on market forces, and these countries' integration into the world economy.

Among the industrial countries, there has generally been continuing success in containing inflation, but growth and labor market performance have remained uneven. A number of countries—most notably the United States—are experiencing robust growth of output and employment; these economies tend to be characterized by relatively flexible and dynamic labor and product markets and significant progress toward fiscal consolidation. In Japan, supportive monetary and fiscal policies and a correction of the earlier overvaluation of the yen have finally put the economy on the path of recovery after a protracted economic slowdown. But financial sector problems remain a downside risk and the authorities will soon have to confront the task of restoring balance in the public finances.

Many industrial countries, however, are yet to share fully in the current expansion, and continue to face the important policy challenges of addressing the deep-seated structural and macroeconomic weaknesses in their economies. Some countries are also experiencing difficulties in their banking systems with attendant downside risks to confidence and economic activity. In much of continental Europe, in response to the faltering of growth in the second half of 1995 and in view of the approaching deadline for Economic and Monetary Union (EMU), the policy mix has shifted toward tighter budgetary policies and easier monetary conditions. Together with a correction of earlier exchange rate misalignments this has improved prospects for a resumption of stronger growth in the latter part of 1996. The projected strengthening of growth will facilitate fiscal consolidation and lessen uncertainties about the EMU timetable and the associated risk of tensions in financial markets. In addition to stronger efforts to reduce the growth of public expenditures and contain fiscal imbalances, fundamental labor market reforms and deregulation of product markets remain essential if Europe is to achieve greater economic dynamism and be able to meet future challenges.

In the developing world, despite the growing number of success stories, many countries continue to struggle with macroeconomic imbalances and structural impediments that keep their living standards well below what they are potentially capable of achieving. The role of market forces is generally increasing, but high degrees of government intervention in the economy and large claims on financial resources by the public sector and quasi-public entities continue to hamper the development of the private sector in many countries. These problems also often limit countries' ability to take advantage of their improving access to foreign markets. Reforming the public sector, removing price distortions, liberalizing foreign trade and payments, opening up to foreign direct investment, and strengthening the capacity of the financial system to mobilize domestic saving and allocate financial resources to productive uses are all essential elements of a comprehensive growth strategy. Such reforms need to be supported by prudent macroeconomic policies aimed at containing fiscal deficits, controlling inflation, and maintaining external viability.

In the transition countries, where there have been considerable improvements in inflation performance, there is still a need to continue the reform process and to achieve and safeguard greater macroeconomic stability. In many countries, including some that are relatively advanced in the transition process, fiscal deficits remain excessive and contribute to continued price pressures. Transformation of the enterprise sector is often being impeded by acquiescence to tax and wage arrears and by growing portfolios of nonperforming bank loans, which undermine the ability of price mechanisms and of the financial system to allocate resources more efficiently. The inadequacy of social safety nets also hampers the needed restructuring of loss-making enterprises. Without adequate progress in these areas the economic and social costs of the tran-

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

(Annual percent change unless otherwise noted)

	1994	1995	Current Projections 1996	Current Projections 1997	Differences from May 1996 Projections 1996	Differences from May 1996 Projections 1997
World output	**3.7**	**3.5**	**3.8**	**4.1**	**—**	**–0.1**
Industrial countries	2.8	2.1	2.3	2.5	0.3	–0.1
Major industrial countries	2.8	2.0	2.2	2.5	0.3	–0.1
United States	3.5	2.0	2.4	2.3	0.6	0.2
Japan	0.5	0.9	3.5	2.7	0.8	–0.3
Germany	2.9	1.9	1.3	2.4	0.3	–0.6
France	2.8	2.2	1.3	2.4	—	–0.3
Italy	2.2	3.0	1.1	2.2	–1.3	–0.5
United Kingdom	3.9	2.5	2.2	3.0	—	0.3
Canada	4.1	2.3	1.4	3.2	–0.5	0.3
Other industrial countries	3.0	2.8	2.3	2.6	–0.1	—
Memorandum						
European Union	2.8	2.5	1.6	2.5	–0.2	–0.2
Developing countries	6.6	5.9	6.3	6.2	–0.1	–0.3
Africa	2.9	3.0	5.0	5.0	–0.3	0.5
Asia	9.1	8.6	8.0	7.5	–0.2	–0.2
Middle East and Europe	0.5	3.6	3.9	3.3	0.9	–0.5
Western Hemisphere	4.7	0.9	3.0	4.0	–0.2	–0.7
Countries in transition	–8.8	–1.3	0.4	4.0	–2.1	0.2
Central and eastern Europe	–2.9	1.2	1.6	4.2	–1.4	—
Excluding Belarus and Ukraine	3.4	4.9	4.2	4.7	–0.3	0.2
Russia, Transcaucasus, and central Asia	–14.8	–4.1	–0.9	3.8	–2.9	0.5
World trade volume (goods and services)	**8.8**	**8.9**	**6.7**	**7.2**	**0.3**	**0.1**
Imports						
Industrial countries	9.3	7.8	5.3	5.5	0.4	0.5
Developing countries	8.1	11.6	11.3	10.1	1.2	–1.5
Countries in transition	3.5	13.3	12.3	8.5	0.7	–1.6
Exports						
Industrial countries	8.3	7.3	4.3	6.0	–0.5	0.6
Developing countries	11.1	11.5	10.3	10.7	0.2	–0.5
Countries in transition	4.6	12.2	10.7	6.2	1.8	–1.1
Commodity prices						
Oil[1]						
In SDRs	–7.8	1.9	17.8	–7.6	13.0	–0.4
In U.S. dollars	–5.5	8.0	13.2	–7.6	11.8	–0.3
Nonfuel[2]						
In SDRs	10.8	2.1	4.8	–2.4	2.9	–0.9
In U.S. dollars	13.6	8.2	0.7	–2.5	2.1	–0.8
Consumer prices						
Industrial countries	2.3	2.4	2.3	2.4	—	–0.1
Developing countries	46.8	19.8	13.3	10.8	0.7	1.0
Countries in transition	264.8	128.0	41.3	16.8	3.2	3.2
Six-month LIBOR (in percent)[3]						
On U.S. dollar deposits	5.1	6.1	5.6	6.0	0.2	0.4
On Japanese yen deposits	2.4	1.3	1.0	2.4	—	—
On deutsche mark deposits	5.3	4.6	3.3	3.8	—	–0.7

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during July 25–August 21, 1996, except for the bilateral rates among ERM currencies, which are assumed to remain constant in nominal terms.

[1] Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil.

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

[3] London interbank offered rate.

sition will be considerably higher, the benefits will be smaller and slower to materialize, and the risks of reversal of the economic and political reform process will remain.

The achievements of recent years underscore the validity of the cooperative strategy to strengthen the global expansion set out by the Interim Committee in 1993 and reaffirmed in its October 1994 Madrid Declaration. At the same time, the continuing problems affecting many countries suggests a need to broaden the strategy in several areas and to strengthen its implementation. Experience in recent years has confirmed that economic success requires sustained efforts at both structural reform and macroeconomic stabilization and that efforts over a broad range of policies are mutually reinforcing. It has become particularly apparent that a 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.

Industrial Countries

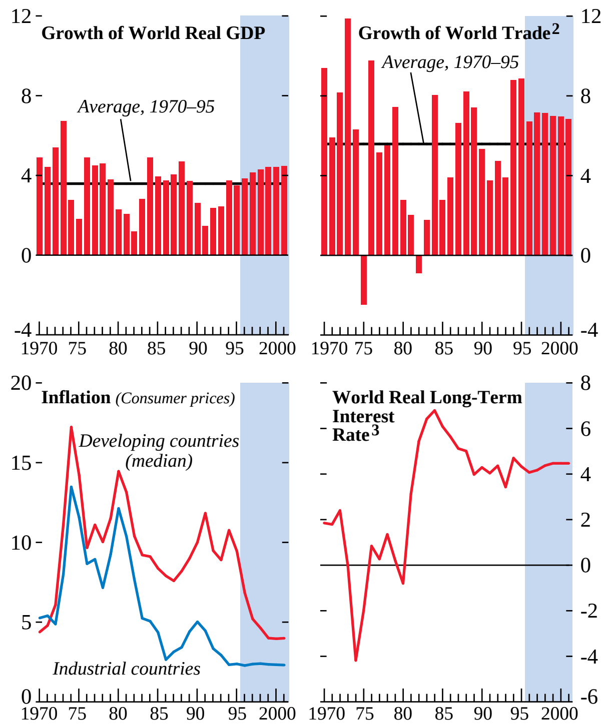
In the industrial countries, there are promising signs that economic activity will turn out to be stronger in 1997 than during the past year, when growth slowed sharply in many countries.[1] At the same time, inflation is likely to remain subdued while external imbalances are expected to diminish further in a number of cases. For the United States, the slowdown in 1995 was needed to reduce the risk of overheating after the strong performance of 1994, which brought the economy to a high rate of resource utilization. More recently, activity has again picked up, partly in response to the easing of monetary conditions that began in mid-1995. In Europe—with the main exception of the United Kingdom, where growth had also been above trend—the slowdown in growth was decidedly unwelcome as recoveries from the trough of the 1992–93 recession were incomplete and unemployment had remained high. Since the beginning of 1996, however, conditions for a renewed strengthening of activity have improved as monetary conditions have generally eased, as long-term interest rates remain well below their levels in late 1994 and the first half of 1995, and as overstocking appears to have been corrected somewhat. Moreover, with greater convergence of eco-

[1]The average annual growth rate for the industrial countries shown in Table 1 of about 2 percent in 1995 masks the extent of last year's slowdown. On a fourth-quarter-to-fourth-quarter basis, growth in the major seven countries slowed to only 1.5 percent in 1995 (from 3.1 percent in 1994) but is projected to pick up to 2.5 percent in 1996.

Chart 1. World Indicators[1]

(In percent)

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



[1]Shaded areas indicate IMF staff projections.
[2]Goods and services, volume.
[3]GDP-weighted average of ten-year (or nearest maturity) government bond yields less inflation rates for the United States, Japan, Germany, France, Italy, United Kingdom, and Canada. Excluding Italy prior to 1972.

Box 1. Policy Assumptions Underlying the Projections

Fiscal policy assumptions for the short term are based on official budgets adjusted for any deviations in outturn as estimated by IMF staff and also for differences in economic assumptions between IMF staff and national authorities. The assumptions for the medium term take into account announced future policy measures that are judged likely to be implemented. In cases where future budget intentions have not been announced with sufficient specificity to permit a judgment about the feasibility of their implementation, an unchanged structural primary balance is assumed. For selected industrial countries, the specific assumptions adopted are as follows.

United States: For the period through FY1999, fiscal revenues and outlays at the federal level are based on the administration's March 1996 budget proposal (as updated in the July 1996 Mid-Session Review of the 1997 Budget), after adjusting for differences between the IMF staff's macroeconomic assumptions and those of the administration. From FY 2000 onward, the federal government primary balance as a proportion of GDP is assumed to remain unchanged from its projected FY 1999 level.

Japan: Measures that have already been announced are assumed to be implemented over the medium term. These measures include an increase in the consumption tax rate from 3 percent to 5 percent in 1997 and a simultaneous end to the temporary income tax cut, implementation of the 1994 pension reform plan, and the medium-term public investment plan.

Germany: The 1996 projection for the general government is based on the 1996 federal budget and recent official estimates for the other levels of government, adjusted for differences in macroeconomic projections. The 1997 projections are based on official tax estimates and envisage implementation of most of the government's proposed fiscal package. Elements of the package that have gained the requisite agreement (e.g., from the unions and the Bundestag) have been incorporated, while measures that still need Bundesrat approval or lack specificity at the Länder level have not been fully taken into account. Projections for 1998 and beyond are predicated on an unchanged structural primary balance.

France: The projections for both 1996 and 1997 take into account policy measures that have already been implemented. In addition, it is assumed that the government's plans for the 1997 budget of the state (a freeze in nominal expenditure yielding an adjustment of about ½ of 1 percent of GDP) will be fully achieved, given the strong commitment to meeting the criteria for European Economic and Monetary Unit (EMU). As regards social security spending in 1997, the projections assume that Parliament (using the new powers conferred by the constitutional amendment adopted earlier this year) will set a ceiling consistent with the government's overall objectives.

Italy: The projections take into account policy measures that have already been implemented, including the June 1996 supplementary package. In addition, it is assumed that the measures announced in the 1997–99 plan are fully implemented and yield the officially estimated amounts. Projections beyond 1999 assume an unchanged structural balance.

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

Canada: Federal government outlays for departmental spending and business subsidies conform to the medium-term commitments announced in the March 1996 budget. Other outlays and revenues are assumed to evolve in line with projected macroeconomic developments. The unemployment insurance premium, however, is assumed to fall in 1998/99 to a level that is consistent with an unchanged surplus in the unemployment insurance account. The fis-

nomic and policy fundamentals within Europe, exchange rates have returned to levels more consistent with balanced growth following the misalignments that arose in the spring of 1995 when the deutsche mark (together with the yen) appreciated sharply against the U.S. dollar and several other currencies. In Japan, in contrast to the moderation of growth elsewhere in 1995, the recovery has gained momentum, with confidence gradually recovering as the yen depreciated from the excessively high values reached in the early part of last year.

Inflation in the industrial world has been generally well contained in recent years and is no immediate threat to sustained growth in most countries. But as discussed further below, monetary authorities will, of course, need to remain vigilant to incipient price pressures as growth continues or strengthens. (The monetary and fiscal policy assumptions underlying the projections are summarized in Box 1.) Of continuing concern, however, is the need shared by most industrial countries to make further progress toward substantially reducing their fiscal imbalances over the medium term. Structural (i.e., cyclically adjusted) deficits have only been brought down from 3½ percent of GDP in 1992 to 2½ percent of GDP in 1995 for the industrial countries as a group, and the financing of fiscal deficits remains a source of pressure on world real interest rates, keeping the level of private investment and potential future growth below what otherwise could be achieved. A growing number of councal situation of the provinces is assumed to be consistent with their stated medium-term deficit targets.

Spain: Projections for 1996–97 incorporate the multiyear expenditure control agreements in the areas of public sector wages and employment, health care, and regional and local governments; additional cuts announced in May; and the economic liberalization, tax measures, and wage freeze announced in June and July. For 1997, the income tax schedule and excise taxes are assumed to be adjusted in line with inflation. The projections do not take into account the implications for 1996–97 of the recently discovered large public expenditure overruns in 1995.

Netherlands: Projections assume continued adherence to the government's medium-term expenditure path for the central government and social security. While the authorities have not specified a general government deficit target for 1997, their 1997 expenditure ceilings for central government and social security that were decided in the spring of 1996 provide scope for a deficit well under 3 percent of GDP.

Belgium: Projections for 1996 are based on the budget and the spring budget control exercise. For 1997, IMF staff estimates reflect the general government deficit ceiling of 3 percent of GDP included in the framework law passed by Parliament in July 1996 that gives the government broad powers to achieve participation in EMU (recent pronouncements by the authorities have signaled a desire for a deficit of 2.8 percent of GDP).

Sweden: The medium-term projections are based on the government's multiyear consolidation program approved by Parliament in 1995 and additional measures taken in April 1996.

Greece: Projections for 1996 reflect the IMF staff's assessment of the outcome of the official budget. Measures to meet the targets of the convergence plan are still being defined in the 1997 budget under preparation, and the projections at this stage are based on IMF staff estimates of current services.

Portugal: Projections for 1996 are based on implementation to date of the official budget. Preparation of the 1997 budget (which will aim at a deficit of not more than 3 percent of GDP) is currently under way, and the projections for 1997 and beyond are at this stage based on an unchanged structural primary balance.

Switzerland: Projections for 1996–99 are based on official estimates for current services. Thereafter, the general government structural primary balance is assumed to remain constant.

Australia: Projections for the Commonwealth government are based on the 1996/97 budget, adjusted for any differences between the economic projections of the staff and the authorities. Unchanged policies are assumed for the state and local government sector from 1996.

* * *

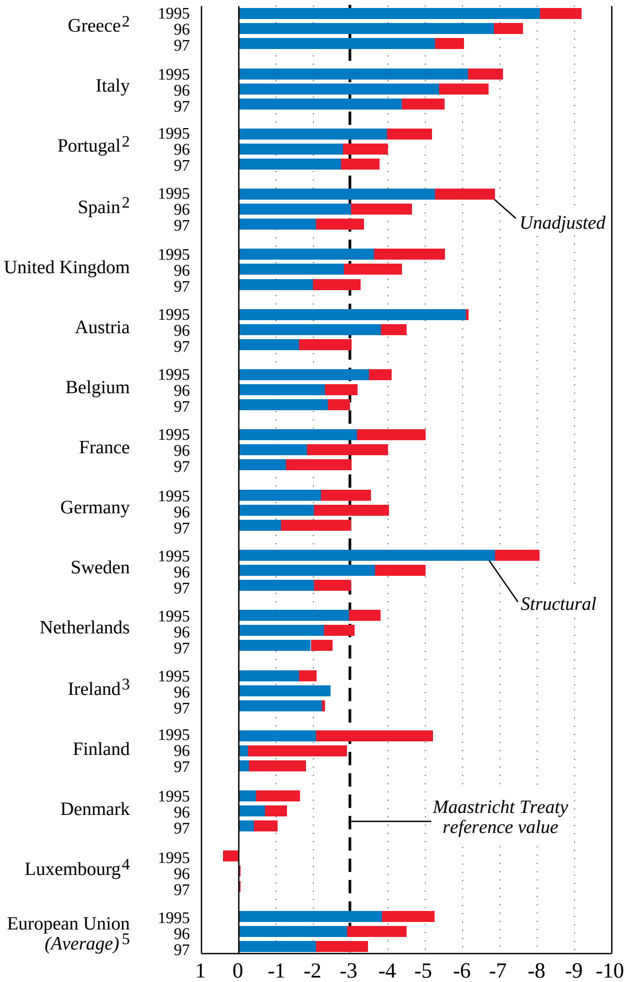
Monetary policy assumptions are based on the established framework for monetary policy in each country, which in most cases implies a nonaccommodative stance over the business cycle. Hence, it is generally assumed that official interest rates will firm when economic indicators, including monetary aggregates, suggest that inflation will rise above its acceptable rate or range and ease when the indicators suggest that prospective inflation does not exceed the acceptable rate or range and that prospective output growth is below its potential rate. For the exchange rate mechanism (ERM) countries, which use monetary policy to adhere to exchange rate anchors, official interest rates are assumed to move in line with those in Germany, except that progress on fiscal consolidation may influence interest differentials relative to Germany. On this basis, it is assumed that the London interbank offered rate (LIBOR) on six-month U.S. dollar deposits will average 5.6 percent in 1996 and 6 percent in 1997; that the six-month LIBOR rate in Japan will average 1 percent in 1996 and 2.4 percent in 1997; and that the three-month interbank deposit rate in Germany will average 3.3 percent in 1996 and 3.8 percent in 1997.

tries, however, are setting targets for substantially eliminating their fiscal shortfalls over the medium term. These consolidation efforts appropriately are focused on the need to contain the level and growth of public expenditure, which may ultimately permit reductions in tax burdens. There is also increased awareness of the need to address early on the problem of unfunded pension liabilities, which threaten to exacerbate pressures on public finances as populations age in coming decades (see Chapter III of the May 1996 *World Economic Outlook*). In many countries, however, the debate about pension reform and the search for solutions has only just begun.

Most of the largest fiscal imbalances are suffered by members of the European Union (EU), including some of those countries that have experienced the highest unemployment rates and the weakest growth performance in recent years. It is generally recognized that progressive elimination of fiscal imbalances is necessary for an improvement in growth performance over the medium term. The priority that has now been given to fiscal consolidation has already begun to yield benefits in reducing risk premiums in long-term interest rates, in improving confidence, and in strengthening medium-term growth prospects, particularly in those countries where financial markets previously indicated some lack of confidence in government policies. The attention being given to fiscal consolidation also reflects the desire to meet the objective of keeping fiscal deficits within the Maastricht Treaty reference value of

Chart 2. European Union: General Government Budget Positions[1]
(In percent of GDP)

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



[1]IMF staff estimates and projections. The ordering of countries is based on the projected unadjusted budget positions in 1997, except that where the differences between projections are not significant the ordering is alphabetical.

[2]The estimates differ from those of national authorities (shown in Table 3) at least in part because sufficient information on the measures to be proposed in the 1997 budgets is not yet available. See Box 1 for details regarding the IMF staff's fiscal assumptions.

[3]The unadjusted budget position for Ireland in 1996 is not shown separately because it is about equal to the structural balance, reflecting the fact that output is close to potential.

[4]Structural budget positions are unavailable and unadjusted budget positions are expected to be in approximate balance in 1996–97.

[5]Excludes Luxembourg.

3 percent of GDP by 1997, the test year for deciding which member countries meet the criteria for participation in the third and final stage of EMU beginning in 1999.

While the weakness of activity in early 1996 would appear to militate against the pursuit of specific fiscal targets defined in actual rather than cyclically adjusted or structural terms, the legacy of excessive fiscal imbalances in many European countries suggests that any significant backsliding from announced consolidation efforts could have severe implications for interest rates and financial market confidence, especially since it might derail the EMU process. 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, but also the short-term costs may be smaller than those arising from failure to address adequately the persistently large deficits. At the same time, it is important to avoid aggravating a difficult situation through unduly procyclical fiscal policies. If recent economic weakness were to be prolonged, it would be necessary to allow fiscal policy to provide automatic stabilizers for activity, but only in those countries that are making convincing and adequate progress in reducing structural imbalances (Chart 2). To foster greater fiscal discipline in Stage 3 of EMU, it is encouraging that the EU is considering an agreement whereby countries would aim for a budgetary position close to balance over the medium term. This should provide a basis for allowing automatic stabilizers to operate without budget deficits exceeding 3 percent of GDP during a normal business cycle.

For many countries, particularly in Europe, fiscal imbalances are related to shortcomings in the functioning of labor markets, which have resulted in a dramatic upward trend in unemployment over the past twenty-five years. As much as 8 to 9 percentage points of the EU's current unemployment rate of over 11 percent is widely considered to be structural in the sense that it is unlikely that it could be absorbed through cyclical recovery alone, without significant inflationary risks. Together with discouraged job seekers and heavy resort to early retirement, these high rates of unemployment represent a considerable underutilization of labor resources, which has reduced potential output and exacerbated budgetary pressures through revenue losses and outlays for income support. Clearly, a substantial reduction in this underutilization through appropriate labor market reforms would go a long way toward addressing Europe's fiscal shortfalls.

Many economists and policymakers agree on the root causes of rising structural unemployment and on the types of reform that are needed to reverse it. Much remains to be done to tackle the problem, however, and it has proved extremely difficult to mobilize public support for the necessary reforms. In many countries, there is great reluctance to modify labor market regulations, benefits, and privileges that are widely perceived to be social achievements, but which contribute to persistently high unemployment and social exclusion by keeping labor costs above warranted levels for low-productivity workers and by reducing incentives to work and to create jobs. New Zealand and the United Kingdom are the most prominent examples of countries that have begun to reduce their structural unemployment rates. Most other countries have introduced some reforms aimed at reducing overly generous levels of unemployment compensation, tightening eligibility criteria, reducing taxes on employment, restraining increases in minimum wages, or facilitating restructurings and layoffs—and thereby hirings. The reforms in many countries, however, have been mostly piecemeal, and the beneficial effects of progress in one area have often been hampered by new or deeply ingrained distortions in other areas.

The essential aim of labor market reforms must be to allow market forces a greater role in helping to clear the labor market at much lower levels of unemployment. Since this may well result in lower real wages for some skill categories, governments, in Europe and Canada, in particular, are faced with the challenge of also reforming tax and transfer systems so that they may better meet equity objectives and safeguard a reasonable level of social protection without the negative implications for incentives and employment that are associated with present arrangements. Enhanced training and education are also needed in all countries to alleviate poverty and social exclusion. In Europe, as emphasized in earlier issues of the *World Economic Outlook*, labor market reforms are not only needed to address the problems of unemployment and fiscal imbalances, but are also essential for the success of the planned monetary union: increased labor market flexibility will be needed to substitute for the loss of the exchange rate instrument when countries are faced with exceptional adjustment needs.

In contrast to the continued difficulties in the fiscal area and in labor markets, monetary authorities in the industrial countries have been highly successful in achieving reasonable price stability, the primary objective for monetary policy. The industrial countries are now enjoying the lowest inflation rates in thirty years with price increases well within official target ranges and generally at very low levels in most cases. It is through the achievement and maintenance of a high degree of price stability that monetary policy can make its most important contribution to both supporting the highest sustainable growth paths for output and employment and minimizing cyclical fluctuations around these growth paths. When monetary policy fails to contain inflationary pressure, thereby necessitating stronger tightening at a later date, the eventual effects on the stability of output and employment and on the sustainable growth rate are likely to be negative.

Success on the inflation front has enhanced the credibility of the anti-inflationary commitment of monetary authorities and thereby reduced inflation premiums in interest rates in many countries, as indicated by the trend declines in nominal and real long-term interest rates since the early 1980s. Credibility has also provided some room for monetary policies to respond to other macroeconomic concerns, such as the stability of output, without raising doubts in financial markets about the commitment and ability to contain inflation. This is fully consistent with the normal cyclical movement of monetary conditions needed to achieve and maintain reasonable price stability. Thus, in situations when inflation objectives would not be jeopardized, it is appropriate to guide short-term interest rates lower to help counter recessionary forces or to facilitate the absorption of slack. But it is essential that such a posture be consistent with the overriding need for monetary policy to safeguard a high degree of price stability. And, because of the lags with which changes in monetary conditions affect the economy, monetary policy must necessarily be forward looking: this implies that preemptive tightening is needed when inflationary pressures are in prospect and before they become apparent.

A complication in the conduct of monetary policy, at least for countries that are not using the exchange rate as an intermediate target, is the need to rely on a broad set of indicators to judge the appropriate stance of monetary conditions. This became clear following the unsatisfactory experiences with monetary targets in many countries. Greater reliance on broader indicators does not appear to have been an obstacle to achieving and maintaining reasonable price stability and seems if anything to have enhanced the credibility of monetary authorities. Still, in a number of cases, credibility has not yet been fully established and will require a solid track record over a long period. In this context, the emphasis on meeting explicit inflation targets in many countries should be helpful, even though it will be difficult in practice to keep inflation within the narrow ranges defined by these targets in all circumstances.

The *United States* has been particularly successful in recent years in achieving a high level of employment and maintaining growth at close to its potential rate with low inflation. These achievements can be partly attributed to an exceptionally dynamic and flexible labor market that has accommodated a growing labor force and facilitated macroeconomic management. The authorities have also made good progress on the fiscal front—after more than a decade of excessive deficits—while the soft landing achieved in 1995 testifies to the success of monetary policy in preempting inflationary pressures at a mature stage of the expansion.

Despite these achievements, significant challenges remain in both the monetary and fiscal areas. Following the moderation of growth in 1995, the U.S. economy rebounded in early 1996 and is now again threatening to exceed the level of output consistent with low and stable inflation. So far, the underlying inflation rate has remained fairly stable at about 3 percent or less throughout this expansion. However, margins of unused resources in the economy appear to be virtually exhausted and the unemployment rate has fallen to a level that in the past has been associated with rising wage and price pressures. In these circumstances, some tightening of monetary conditions would seem appropriate to reduce the risk of a pickup in inflation that would require more severe and potentially more disruptive policy actions at a later stage, the effects of which would be felt beyond the United States. In the fiscal area, further efforts are needed to progressively balance the budget over the medium term and to avert a renewed deterioration in the fiscal situation in the long run due to the rapid growth expected in spending on pensions and medical care for the elderly.

Japan's economic recovery has gained momentum since mid-1995 after a protracted slowdown. A broad range of supportive policy actions have helped to counteract the deflationary forces stemming from falling asset prices and difficulties in the banking sector and to correct the excessive appreciation of the yen in the early part of 1995. The authorities are now faced with the challenge of gradually withdrawing stimulus without undermining prospects for continued recovery. Eventually, short-term interest rates will need to be raised from the low levels seen recently, but the large output gap, a virtually stationary price level, exchange market considerations, and the need to facilitate the workout from the nonperforming loan problems all underscore the appropriateness of maintaining the current supportive monetary stance for the time being. Fiscal consolidation will need to proceed at a sustained pace as the recovery gains momentum and the authorities appropriately are planning to unwind the recent stimulus packages and to increase revenues. Over the medium term, the need to prepare for future budgetary outlays associated with the aging of the population suggests that Japan should aim at reestablishing a surplus in its overall budgetary position (for general government), although perhaps not as large as in the early 1990s when it reached almost 3 percent of GDP. Further deregulation to strengthen the role of market forces is essential to support the recovery.

Although *Germany* has already made progress in reducing the large unification-related structural budget deficit that emerged in 1990–91, the actual deficit is projected to widen to about 4 percent in 1996 partly as a result of the renewed cyclical slowdown during the past year. The latest fiscal consolidation package, which also contains important measures to enhance labor market flexibility, is projected to reduce the deficit to 3 percent of GDP in 1997, provided activity continues to pick up as expected during the period ahead, following the rebound in the second quarter. But major fiscal challenges remain to be addressed, including the need to ensure the financial sustainability of public pension plans and to reduce the eastern Länder's dependence on transfers and subsidies.

Inflation in Germany is well under control, and this allowed short-term interest rates to be lowered significantly in late 1995 and early 1996 in response to growing signs that the recovery was faltering. In August, short-term market rates were eased further, triggering corresponding reductions in many of Germany's partner countries (Chart 3). Real long-term interest rates increased somewhat in the opening months of 1996, partly under the influence of higher bond yields in the United States, but more recently exchange market developments and the slack in the economy have allowed German rates to decouple to a large extent from U.S. rates. The growth of M3, the principal monetary aggregate monitored by the Bundesbank, has decelerated in recent months although it is still above its target range; the rise in M3 in 1996 follows very subdued money growth in 1995. The easing of monetary conditions over the past year should help to secure the prospective recovery and was appropriate in view of the absence of inflationary pressure, the continuing efforts at fiscal consolidation, and the strength of the exchange rate. However, it is still too early to conclude that the recent round of interest rate reductions has fully run its course.

In *France*, growth has also been weak since early 1995, raising doubts, as in many other countries, about the ability to meet fiscal targets. The authorities have stood firm, however, on their intention to meet by 1997 the 3 percent fiscal deficit criterion stipulated in the Maastricht Treaty. This firm approach and the subdued inflation picture have contributed to a significant narrowing of interest differentials vis-à-vis Germany; the easing of monetary conditions over the past year should also assist recovery. The 3 percent deficit goal seems within reach provided activity strengthens during the period ahead as envisaged in the staff's projections. But it will be difficult to restore adequate balance in the public finances over the medium term and lower the tax burden without fundamental reforms aimed at better containing public expenditures and at enhancing incentives to create and seek jobs in order to reduce the high level of unemployment. Recent measures to lower social security contributions for workers at or near the minimum wage and to stimulate part-time work are welcome steps but should be followed up by more far-reaching measures that address the root causes of high and persistent unemployment. A comprehensive program of fiscal and labor market reform is necessary to create a basis for robust noninflationary growth over the medium term, which would facilitate other reforms, including measures to address the problem of unfunded liabilities in the public pension system.

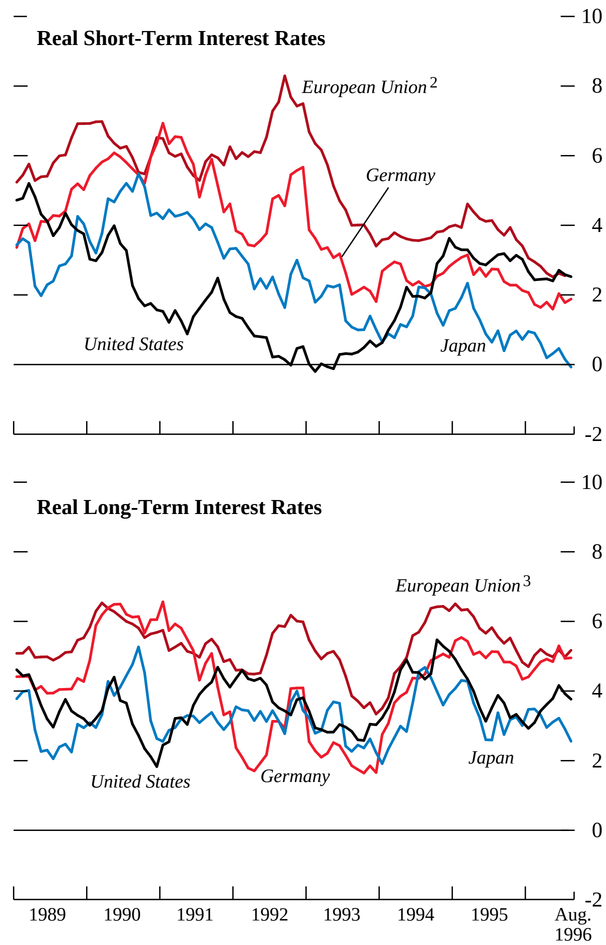
In the *United Kingdom,* where the recent economic slowdown has been much less severe than in Germany and France, underlying inflation has been running slightly above the 2½ percent ceiling of the authorities' inflation target range, but is expected to drop below the ceiling by early 1997. Unemployment has declined steadily since the start of the recovery in 1993 and there may still be room for some further reduction without undue inflationary risks. On the fiscal side, recent revenue shortfalls suggest that government borrowing will be higher than expected in last November's budget and that corrective measures are needed to put the public finances back on track toward the authorities' goal of balance over the medium term. Growth is expected to pick up in the second half of 1996 and to be sustained at a pace higher than the growth of potential next year. There is some risk, however, that financial market confidence and long-term interest rates, which already appear to reflect concerns over the fiscal outlook, could be more adversely affected by continuing fiscal slippage, especially if the authorities were to introduce significant tax cuts before the next general election.

Following a relatively strong performance in 1995, *Italy*'s recovery lost momentum in the first half of 1996 as growth in key export markets slowed, as the correction of the earlier undervaluation of the lira continued, and as domestic demand remained subdued. Progress in reducing the large fiscal deficit and in lowering inflation has helped to reduce interest differentials further vis-à-vis Germany, but real interest rates remain among the highest in Europe. Despite the slowdown in growth, the new government's three-year program confirms the previous plan's targets, centered on achieving the Maastricht objectives by 1998. Furthermore, it does not rule out accelerating adjustment later this year, if growth and interest rate developments turn out better than currently expected. Achievement of the plan's targets is essential for safeguarding stability in financial markets and achieving better balanced economic growth. It is, however, likely to require action in sensitive areas, including the public payroll, health expenditures, and pensions. The 1997 budget will constitute an important test of the government's resolve in this respect.

In *Canada*, efforts at fiscal consolidation since 1993 have reduced the fiscal deficit from over 7 percent of GDP to an estimated 2½ percent of GDP in 1996, which has helped to narrow the long-term interest rate differential vis-à-vis the United States in recent months. Meanwhile, weak growth, subdued inflationary pressures, and a firmer exchange rate have led to a decline in short-term rates well below U.S. levels. Lower domestic interest rates, combined with the strength of the U.S. expansion in 1996, should lead to a significant pickup in growth this year. Achievement of the official objective of balancing the budget is within reach, which would help to reduce real long-

Chart 3. Industrial Countries: Real Interest Rates[1]
(In percent a year)

Real interest rates in Europe have remained considerably above those in the United States and Japan.



Sources: WEFA, Inc.; and Bloomberg Financial Markets.
[1]Real rates are nominal rates minus percent change of consumer prices from a year ago. Price data for January and February 1996 are partly estimated.
[2]Data prior to January 1990 exclude Luxembourg.
[3]Excludes Greece and data prior to June 1993 exclude Finland.

term interest rates further and strengthen the basis for sustained economic expansion. With substantial gains of export market shares in recent years, the external current account, which has been in significant deficit during the past decade, is expected to be close to balance in 1996.

Among the smaller industrial countries, economic conditions vary considerably. *Australia* and *New Zealand* have experienced buoyant growth in recent years with emerging inflationary pressures being met by monetary tightening. *Norway* and *Ireland* also continue to enjoy robust growth, so far with low inflation. While activity has been relatively strong in the *Netherlands*, growth in *Austria* and *Belgium* moderated in 1995 but should gradually firm as their main export markets in Germany and France begin to recover; *Spain, Sweden,* and *Finland* have experienced a slowing of their export-led recoveries but with inflation remaining well within official targets and fiscal consolidation proceeding, interest differentials vis-à-vis Germany have narrowed considerably, and confidence is improving. All of these countries are pursuing relatively tight fiscal policies aimed at fulfilling by 1997 the conditions for participation in the final stage of EMU. (Denmark, Ireland, and Luxembourg are the only countries that are currently considered to meet the Maastricht fiscal criterion.) Economic activity in *Switzerland* remains sluggish, in large part because of the persistent strength of its currency. Relatively easy monetary conditions, deregulation, and other structural reforms are needed to facilitate recovery, to reduce the large external surplus, and to promote further realignment of the exchange rate.

Developing Countries

Growth in the developing countries remained close to 6 percent in 1995 despite a marked slowdown in Latin America in the wake of the Mexican financial crisis. In 1996 and 1997, aggregate growth seems likely to remain in the 6 percent region as Mexico and Argentina recover, growth in Africa strengthens, and the expansion moderates in a number of Asian emerging market countries. 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. In parallel with their remarkable success in expanding exports—both to developed economies and to each other—these countries have become the most dynamic markets for exports from the industrial countries. This has helped to offset the recent weakness in economic activity in many industrial countries, at the same time as strengthened international competition has contributed to the alleviation of global inflationary pressures and to the improvement of living standards worldwide, particularly in those countries that have adjusted quickly and flexibly to changes in relative prices and in their comparative advantages.

The role of domestic policies in fostering conditions conducive to rapid growth in the successful developing countries carries important lessons for those countries where progress has been more limited and that continue to fall behind in relative income positions. Among the strong performers, fiscal imbalances have generally been well contained and the role of the public sector has been mainly geared toward promoting private sector development. Disciplined fiscal policies in turn have reduced the need for monetary financing of budget deficits and facilitated the maintenance of low inflation, which is in single digits in many of these countries. And a stable, predictable macroeconomic environment has provided incentives to save and invest while heavy reliance on market forces, including through the pursuit of outward-oriented trade policies, has helped channel resources toward their most productive uses.

In contrast, although situations differ considerably and it is difficult to generalize, the less successful countries are often characterized by persistent fiscal imbalances exacerbated by loss-making public enterprises; by extensive government intervention in the economy through regulations and restrictions on the private sector and on foreign trade; by poor control of inflation; and by financial repression and the structurally negative real interest rates associated with it, which discourage saving and distort resource allocation. Experience shows that the sustained implementation of policies to address such shortcomings does, over time, lead to substantial improvements in economic performance.

One of the most pressing issues in many emerging market countries has been the question of how they should 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 is underscored by concerns about the vulnerability of banking systems to foreign exchange and financial market crises and domestic policy reversals, particularly when corrective policy actions are implemented belatedly. 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. Appropriate measures and early action will help to limit the risk of contagion from difficulties originating in the banking systems of other countries.

So far, standard price indicators suggest that inflation is relatively well under control in most of the emerging market countries. But the combination of widening deficits on current account and rapid growth testifies to excess demand pressures—as opposed to problems of external competitiveness—in countries such as *Indonesia, Malaysia,* and *Thailand*. Moreover, preliminary staff work to assess the level and growth rate of output that appear to be consistent with stable inflation suggests that the current levels of activity in these countries may be above their sustainable long-term trends. These countries have already taken measures to restrain demand, but further action may be needed to avoid the emergence of excessive pressures on capacity and to contain external imbalances. *Korea* has also been facing a risk of overheating, although growth has been moderating toward a more sustainable pace and pressures on resources appear to be easing.

In *China,* growth has slowed from the unsustainable pace of the early 1990s and inflation has fallen to less than half the rate seen in 1994. Money and credit, however, have continued to expand at a rapid rate and more restrained financial policies, supported by a hardening of budget constraints in state enterprises, are required to sustain the favorable inflation performance. An intensification of state enterprise reform together with further trade liberalization and the removal of the few remaining restrictions on current account payments will help strengthen the role of market forces in resource allocation. *Vietnam* has made substantial efforts to move toward a market-based economy, and has achieved robust growth for the last five years and more recently, single-digit inflation. To sustain this performance, structural reforms need to be deepened, including through restructuring of state enterprises, and macroeconomic policies need to remain cautious, especially in view of the widening deficit on current account.

For *India,* while recent economic performance has been quite favorable, high real interest rates stemming from excessive fiscal deficits and supply-side bottlenecks are likely to slow long-term growth. Moreover, there are risks of rising inflation and external vulnerability unless these issues are forcefully addressed. As long as the fiscal deficit remains high—the overall public sector deficit is still close to 9 percent of GDP even with the modest adjustment planned for this year—it will be necessary to maintain a tight monetary policy stance. But the key to sustained strong performance is ambitious fiscal consolidation that would relieve pressures on prices and the balance of payments, free resources for productive investment, and provide a more conducive environment for needed structural reforms. In *Pakistan*, the recent deterioration in the current account and continued double-digit inflation pose a threat to the medium-term outlook. Fiscal adjustment and financial sector reform are critical to the enhancement of longer-term prospects.

In Latin America, *Chile* remains the most successful economy. With a moderation of growth in 1996 from the unsustainable pace of 8½ percent in 1995, concerns about overheating have abated, but pressures on capacity continue to warrant some degree of monetary restraint. *Brazil* also has been successful in reining in inflation thanks to the Real Plan: in fact, inflation in the year to August 1996, at only 8½ percent, was the lowest 12-month rate since 1973. Fiscal consolidation and structural reforms, especially trade liberalization, are essential to safeguard this progress on the inflation front and to permit stronger growth on a sustained basis. In *Mexico,* activity is now recovering following declines in output in the wake of last year's financial crisis, and there has been progress in containing inflation following the sharp depreciation of the peso. Sustained adjustment efforts should help to strengthen market confidence further and permit growth to become firmly established in the period ahead. Growth has also resumed in *Argentina,* which is currently enjoying the lowest inflation rate in more than fifty years. Following several years of political instability, financial market crises, accelerating inflation, and declining output, *Venezuela* has now begun to implement an economic program designed to restore confidence, reduce inflation, and set the stage for a resumption of growth in 1997.

The recent strengthening of growth in many African countries is promising and the implementation of stronger macroeconomic and structural policies should allow average growth to continue to improve and the overall inflation rate to decline further. Nevertheless, the region continues to face important policy challenges to enhance resource allocation and strengthen saving and investment. It is particularly encouraging that *Benin, Côte d'Ivoire, Togo,* and other CFA franc zone countries are seeing continued recovery following the strengthening of incentives and restoration of external competitiveness brought about by the 1994 devaluation and accompanying policies. *Ghana, Kenya,* and especially *Malawi* and *Uganda* are also experiencing gains in living standards on the basis of continued progress in domestic policies and notwithstanding the adverse effects of volatile commodity prices. In *South Africa,* economic policies have begun to set the stage for a gradual strengthening of growth performance although unemployment will remain relatively high for some time. Several other countries, however, including *Nigeria, Sudan,* and *Zaïre,* have made little progress in the formulation and implementation of appropriate stabilization and structural adjustment policies.

In the Middle East and Europe region, economic performance also remains uneven. *Israel* and *Jordan* are experiencing strong expansions—with Israel recently taking further action to avert overheating—as a result of strengthened policies and capital inflows stimulated in part by progress toward improved regional stability. *Turkey* experienced a strong recovery in 1995, but the sustainability of the economic expansion is threatened by widening fiscal deficits and rising inflation. *Saudi Arabia* and many other oil producing countries are making progress in adjusting to lower oil prices; fiscal deficits have been reduced substantially, but further efforts are needed to contain public expenditures and reverse the rising trend in levels of public debt. *Egypt* has made progress in deregulating the economy and liberalizing foreign trade. As emphasized in the policy program the authorities have put forward for Fund support, privatization of public enterprises, the strengthening of the financial sector, and reforms to further improve the tax system are needed to allow the country to grow at a faster pace. *Morocco*'s economy has rebounded from last year's drought. The needed strengthening of stabilization policies will have to be complemented by stronger efforts at structural reform. In *Algeria*, where greater macroeconomic stability has been achieved, further structural reforms are needed to achieve sustained economic growth over the medium term.

Economies in Transition

As in other parts of the world, the rewards for comprehensive reform and stabilization efforts are very striking among the transition countries, where the results of economic transformation are increasingly visible. While the declines in output during the initial phase of transition were considerably larger than most observers had expected, the countries that are the most advanced in the transition are now clearly experiencing substantial economic growth. Although strong domestic demand has recently been the main factor behind growth in some cases, rapid expansion of exports has continued to play an important role in the recovery, especially given the powerful signals exports provide for investment and restructuring decisions. In addition, many of the advanced transition economies are receiving substantial inflows of foreign direct investment, which complement domestic resources and often bring invaluable transfers of technology and management know-how. The relative success of many of the countries in central and eastern Europe in expanding their exports and attracting foreign investment would not have been possible without determined stabilization and structural reform efforts. Among the central Asian countries, *Mongolia*'s economic performance has also shown the results of considerable reform efforts.

A turnaround in economic activity is expected to materialize relatively soon in many of the countries that started the reform process later, or have only recently succeeded in reducing the high inflation rates that have plagued all of these countries. In *Russia*, strengthened budgetary policies have been essential to support an anti-inflationary monetary stance that has brought down inflation to an annual rate of 22 percent in the first eight months of 1996. Although output is reported to have contracted further in the first half of 1996, conditions appear to be in place for activity to begin to pick up next year. Containment of fiscal imbalances, especially through greater efforts to collect tax revenues, and further deepening of the reform process are essential if the expected recovery is to become firmly established. Progress in structural reform is expected to stabilize output in *Kazakstan* in 1996 and permit moderate growth in coming years. In *Ukraine*, output is expected to contract further in 1996 but progress in implementing the needed reforms and in stabilizing the economy should begin to reverse the economic decline next year. *Bulgaria* has experienced a particularly serious setback in its stabilization efforts as a result of large quasi-fiscal deficits that have undermined confidence in the banking system. The situation is being addressed within the framework of a Fund-supported stabilization program that places a strong emphasis on structural reform.

The experience of the transition countries over the past five years suggests a number of important lessons. First, the reduction of inflation from high levels is critical for halting and reversing the sharp contractions in output that have been an inevitable feature of the first phase of the transformation process. Second, growth is unlikely to resume unless there is substantial progress with structural reform in a broad range of areas. And third, restructuring the enterprise sector and increasing productivity in existing enterprises may result in relatively high levels of open unemployment, at least for a period. Rather than allowing enterprises to maintain soft budget constraints, governments need to support the transformation process by fostering greater labor mobility and flexibility of wages, by establishing retraining schemes to satisfy skill requirements in expanding sectors of the economy, and also by establishing affordable, well-targeted social safety nets to lessen the hardship associated with unemployment. Sustained progress in all of these areas should permit those countries that have been lagging behind to begin to catch up with the early reformers in the period ahead.

Despite the generally positive outlook for the transition countries, considerable uncertainty attaches to their long-term growth potential. Based on the experience of other groups of countries that have experienced relatively rapid growth over extended periods, it is clear that some, but not all, of the conditions are in place for a significant convergence toward income levels in the industrial countries. One of the most encouraging characteristics of the transition countries is the high level and quality of education, which suggests an advantage in terms of human capital, notwithstanding a considerable need for retraining. The transition countries are also characterized, however, by relatively unfavorable demographic trends that imply a progressive aging of their populations and stagnant or even declining labor forces. Rising dependency ratios suggest that their saving performance, which is currently quite weak, may not improve sufficiently in coming years as to reach the levels of many rapidly growing countries. Since this will constitute an important constraint on the level of investment, increases in productivity will need to make a significant contribution if high growth rates are to be sustained. On the basis of preliminary staff analysis, the various factors that influence productivity growth seem to imply potential long-term growth rates on the order of 4 to 5 percent a year, although the margin of uncertainty that attaches to such estimates is obviously very large.

Government policies will clearly have a significant influence on the outcome. In particular, long-term fiscal strategies will need to ensure that social objectives are met without recourse to persistent budget deficits. It is also essential to establish economic and financial conditions that are conducive to private saving and investment. Capital imports may help to complement domestic saving and it is particularly important to foster high levels of foreign direct investment, which does not add to external indebtedness. Transparent legal frameworks and property rights, further progress with privatization (including of land), and facilitating entry for new enterprises are critical in this regard. But experience from other countries suggests that large-scale reliance on foreign saving may not be sustainable. Therefore, major efforts are also needed in most transition countries to put the banking system on a sound footing; this is essential for the mobilization and effective allocation of domestic saving.