CHAPTER I ECONOMIC PROSPECTS AND POLICIES

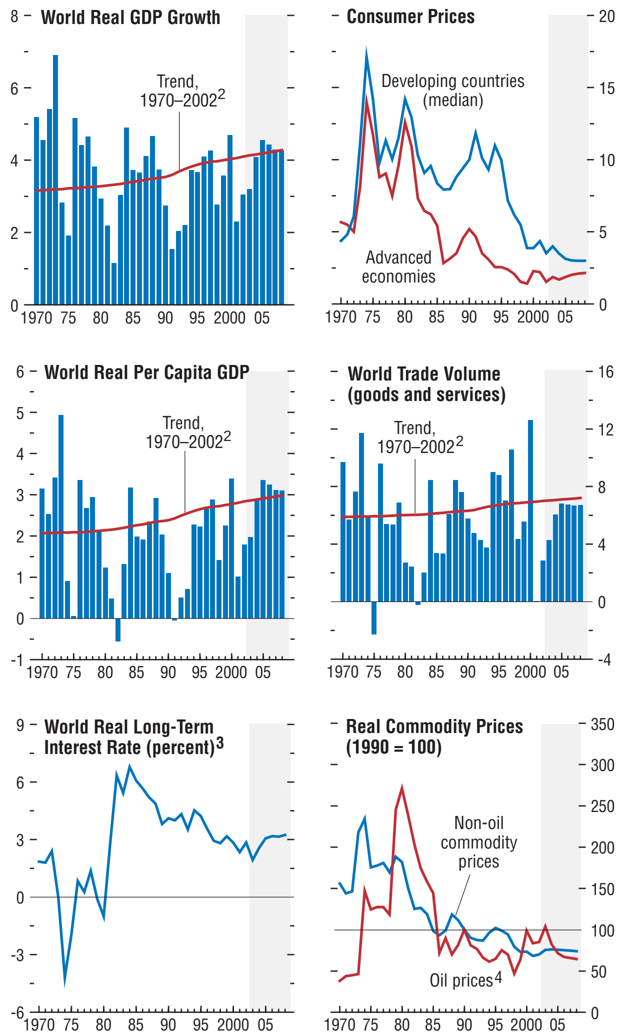
When the last *World Economic Outlook* was published in September 2002, the global recovery was expected to continue at a moderate pace, but the risks to the outlook were seen primarily on the downside. In the event, activity in the second and third quarters of 2002—except in western Europe—proved stronger than expected; correspondingly, global GDP growth for the year as a whole is now estimated at 3 percent, 0.2 percentage point higher than earlier projected (Figure 1.1 and Table 1.1). But since then the pace of the recovery has slowed, particularly in industrial countries, amid rising uncertainties in the run-up to war in Iraq and the continued adverse effects of the fallout from the bursting of the equity market bubble. Industrial production has stagnated in the major advanced countries, accompanied by a slowdown in global trade growth; labor market conditions remain soft; and forward-looking indicators—with a few exceptions—have generally weakened (Figure 1.2). And while global fixed investment has begun to turn up, it does not yet appear strong enough to sustain the recovery if consumption growth—a key support to demand so far in the upturn together with the turn in the inventory cycle—slows.

After strengthening in the last quarter of 2002, mature financial markets fell back in early 2003, with equity markets declining to 40–60 percent below their early 2000 peaks (Figure 1.3).[1] This appears largely to have reflected rising risks and uncertainties, with respect to both the geopolitical situation and the sluggish pace of the recovery, offset in part by some improvement in risk appetite, At the same time, bond markets remained subdued, continuing to price in expectations of sluggish growth, while—perhaps aided by some easing of concerns about corporate governance—corporate spreads declined, particularly for high-yield paper. In

Figure 1.1. Global Indicators[1]

(Annual percent change unless otherwise noted)

The recovery is expected to remain moderate in 2003, with global growth returning to trend in 2004.



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

[2]Average growth rates for individual countries, aggregated using purchasing-power-parity weights; the aggregates shift over time in favor of faster growing countries, giving the line an upward trend.

[3]GDP-weighted average of the 10-year (or nearest maturity) government bond yields less inflation rates for the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada. Excluding Italy prior to 1972.

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

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

			Current Projections		Difference from September 2002 Projections[1]	
	2001	2002	2003	2004	2002	2003
World output	**2.3**	**3.0**	**3.2**	**4.1**	**0.2**	**–0.5**
Advanced economies	0.9	1.8	1.9	2.9	0.1	–0.6
United States	0.3	2.4	2.2	3.6	0.2	–0.4
Euro area	1.4	0.8	1.1	2.3	–0.1	–1.2
Germany	0.6	0.2	0.5	1.9	–0.3	–1.5
France	1.8	1.2	1.2	2.4	—	–1.1
Italy	1.8	0.4	1.1	2.3	–0.3	–1.2
Japan	0.4	0.3	0.8	1.0	0.8	–0.3
United Kingdom	2.0	1.6	2.0	2.5	–0.1	–0.4
Canada	1.5	3.4	2.8	3.2	—	–0.6
Other advanced economies	1.6	2.7	2.5	3.2	0.1	–0.8
Newly industrialized Asian economies	0.8	4.6	4.1	4.5	–0.1	–0.8
Developing countries	3.9	4.6	5.0	5.8	0.3	–0.3
Africa	3.6	3.4	3.9	5.2	0.3	–0.3
Developing Asia	5.7	6.5	6.3	6.5	0.4	—
China	7.3	8.0	7.5	7.5	0.5	0.3
India	4.2	4.9	5.1	5.9	–0.1	–0.6
ASEAN-4[2]	2.6	4.3	3.9	4.3	0.7	–0.3
Middle East and Turkey[3]	1.4	4.5	5.1	4.9	0.9	0.4
Western Hemisphere	0.6	–0.1	1.5	4.2	0.2	–1.5
Brazil	1.4	1.5	2.8	3.5	—	–0.2
Countries in transition	5.1	4.1	4.0	4.1	0.2	–0.5
Central and eastern Europe	3.0	2.9	3.4	4.3	0.2	–0.4
Commonwealth of Independent States and Mongolia	6.3	4.8	4.4	4.0	0.2	–0.5
Russia	5.0	4.3	4.0	3.5	–0.1	–0.9
Excluding Russia	9.1	5.8	5.3	4.9	0.6	0.4
Memorandum						
World growth based on market exchange rates	1.2	1.9	2.2	3.2	0.2	–0.6
World trade volume (goods and services)	**0.1**	**2.9**	**4.3**	**6.1**	**0.8**	**–1.8**
Imports						
Advanced economies	–1.1	2.1	4.7	5.9	0.4	–1.5
Developing countries	2.2	5.4	4.7	8.0	1.6	–2.4
Countries in transition	11.8	6.3	6.1	3.1	–0.7	–2.0
Exports						
Advanced economies	–1.0	2.0	3.8	5.8	0.8	–1.6
Developing countries	3.3	5.1	3.7	7.6	1.9	–2.8
Countries in transition	5.6	6.3	5.9	2.7	1.1	–0.3
Commodity prices (U.S. dollars)						
Oil[4]	–13.9	2.8	24.2	–19.4	2.3	25.0
Nonfuel (average based on world commodity export weights)	–5.4	3.8	9.4	2.3	–0.4	3.7
Consumer prices						
Advanced economies	2.2	1.5	1.9	1.7	0.1	0.2
Developing countries	5.8	5.4	5.8	5.1	—	—
Countries in transition	16.3	11.1	9.4	7.4	–0.3	0.6
Six-month London interbank offered rate (LIBOR, percent)						
On U.S. dollar deposits	3.7	1.9	1.7	3.5	–0.2	–1.5
On euro deposits	4.2	3.3	2.4	2.5	–0.1	–1.4
On Japanese yen deposits	0.2	0.1	0.1	0.3	—	—

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during February 7–March 7, 2003.
[1]Using updated purchasing-power-parity (PPP) weights, summarized in the Statistical Appendix, Table A.
[2]Includes Indonesia, Malaysia, the Philippines, and Thailand.
[3]Includes Malta.
[4]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil. The average price of oil in U.S. dollars a barrel was $25.00 in 2002; the assumed price is $31.00 in 2003, and $25.00 in 2004.

foreign exchange markets, the depreciation of the U.S. dollar resumed in December, reflecting both geopolitical concerns and the continued heavy reliance of the United States on foreign capital inflows. By mid-March, the U.S. dollar had depreciated by 14 percent in trade-weighted terms from its early 2002 peak, accompanied by a 13 percent appreciation of the euro and a 4 percent appreciation of the yen. Since the middle of March, however, as expectations that the war would start shortly—and be over quickly—rose markedly, these trends have reversed, with global equity markets picking up, bond yields rising, and the U.S. dollar appreciating against most major currencies. At the time of writing, markets remain volatile, with the potential for substantial movements in either direction depending on how the geopolitical situation develops.

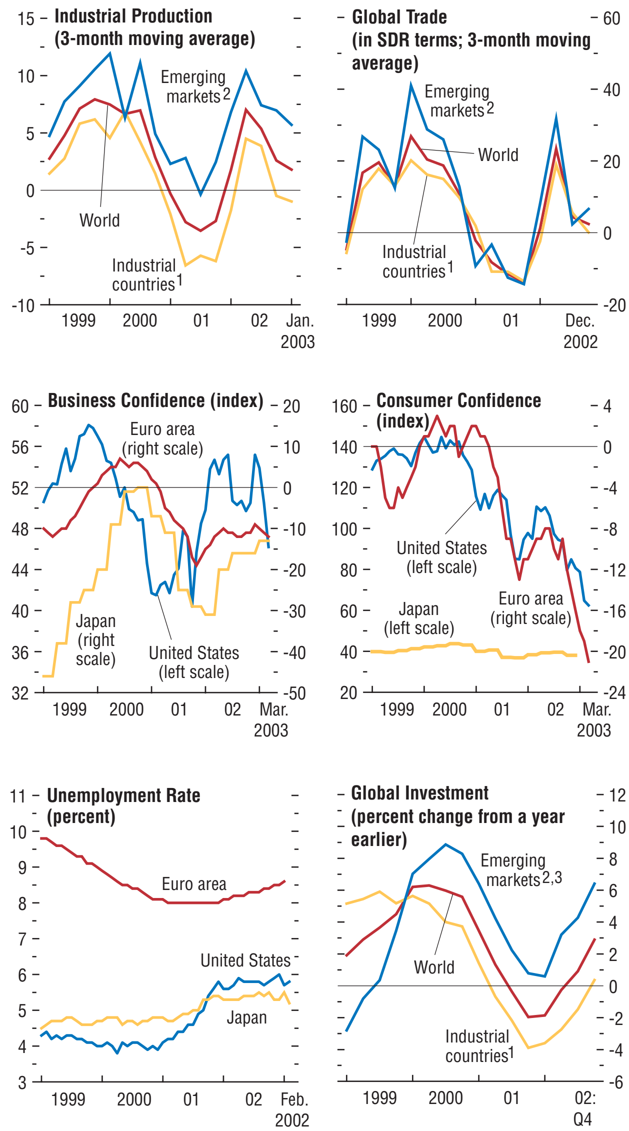
In emerging markets, financing conditions have improved, reflecting improved sentiment toward Brazil and—until recently—Turkey following the elections in those countries; the impact of actual and expected financial support from the international community, including the International Monetary Fund (IMF); and some improvement in risk appetite. During 2002, net capital flows picked up in all major regions except the Western Hemisphere—where foreign direct investment fell very sharply—although they still remain moderate by historical standards (Table 1.2). Emerging market spreads have declined markedly since October (Figure 1.4), although within this substantial tiering has emerged. In some key markets—including Russia, eastern Europe, and Mexico—spreads have declined sharply, in some cases to near historic lows. In contrast, where risks are still perceived to be significant, notably in some countries in South America and Turkey, spreads remain relatively high. A similar tiering is evident in primary markets, where—despite a

[1]See the April 2003 *Global Financial Stability Report* for a detailed discussion of recent financial market developments.

Figure 1.2. Current and Forward-Looking Indicators

(Percent change from previous quarter at annual rate unless otherwise noted)

The recovery in global industrial production and trade has slowed and most forward-looking indicators have turned down.



Sources: Business confidence for the United States, the National Association of Purchasing Managers; for the euro area, the European Commission; and for Japan, Bank of Japan. Consumer confidence for the United States, the Conference Board; for the euro area, the European Commission; and for Japan, Cabinet Office (Economic Planning Agency). All others, Haver Analytics.

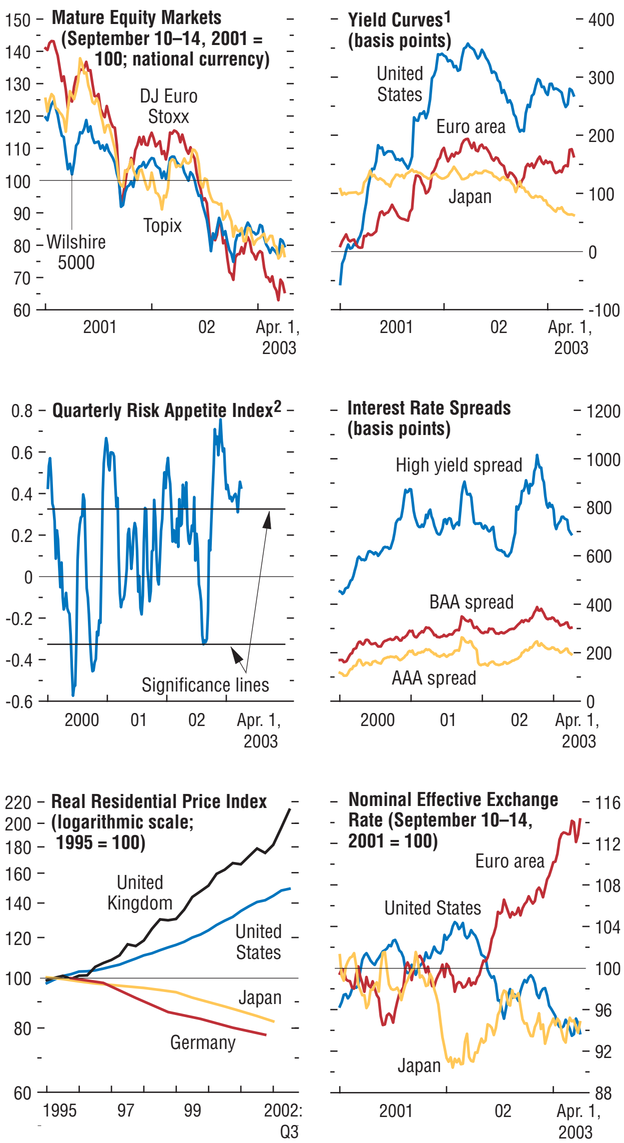
[1]Australia, Canada, Denmark, euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom, and the United States.

[2]Argentina, Brazil, Chile, China, Colombia, Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Pakistan, Peru, the Philippines, Poland, Russia, Singapore, South Africa, Taiwan Province of China, Thailand, Turkey, and Venezuela.

[3]2002:Q1–Q4 data for China, India, and Russia are interpolated.

Figure 1.3. Developments in Mature Financial Markets

While risk appetite has picked up, equity markets remain weak, and the U.S. dollar has again begun to depreciate.



Sources: Bloomberg Financial Markets, LP; State Street Bank; Bank for International Settlements; and IMF staff estimates.
[1]Calculated as the difference between the 10-year government bond rate and 3-month interest rate.
[2]IMF/State Street risk appetite indicators.

marked pickup in issuance since November—only a few sub-investment-grade borrowers in Latin America have been able to access the market, and consequently most of them have been unable to prefinance their 2003 borrowing needs to any significant degree. Emerging equity markets have generally moved in tandem with mature equity markets; in currency markets, outside eastern Europe and South Africa, exchange rates have generally remained constant or fallen in trade-weighted terms (the latter primarily in some countries in Latin America and Asia—including China and Hong Kong SAR, whose currencies are closely linked to the U.S. dollar).

Geopolitical uncertainties have also had a significant impact on commodities markets. After exhibiting considerable volatility throughout much of 2002, oil prices rose sharply in late 2002 and early 2003, owing both to increased expectations of war in Iraq and to supply disruptions associated with the political crisis in Venezuela (see Appendix 1.1, "Commodity Markets"). Despite OPEC's decision in early January to raise its output target by 1.5 million barrels a day, prices continued to climb, peaking in mid-March at $34 a barrel. Since that time, mirroring the developments in financial markets noted above, oil prices have fallen back sharply on expectations that the war would shortly begin and be over quickly, but the market remains exceptionally volatile. Nonfuel commodity prices also rose significantly during 2002, particularly for food, beverages, and agricultural raw materials, although they are still low by historical standards. While this partly reflected the global recovery, it was mostly due to adverse weather conditions in parts of North America, Australia, Brazil, and Africa; correspondingly, if conditions improve, nonfuel commodity prices are likely to increase only moderately further during 2003.[2]

[2]While nonfuel commodity prices are expected to increase by 9 percent on average in 2003, this mostly reflects the carryover effect of the run-up in prices during 2002.

Table 1.2. Advanced Economies: Real GDP, Consumer Prices, and Unemployment
(Annual percent change and percent of labor force)

	Real GDP				Consumer Prices				Unemployment			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
Advanced economies	**0.9**	**1.8**	**1.9**	**2.9**	**2.2**	**1.5**	**1.9**	**1.7**	**5.9**	**6.4**	**6.6**	**6.5**
United States	0.3	2.4	2.2	3.6	2.8	1.6	2.3	2.3	4.8	5.8	6.2	5.9
Euro area[1]	1.4	0.8	1.1	2.3	2.6	2.3	2.0	1.5	8.0	8.3	8.8	8.7
Germany	0.6	0.2	0.5	1.9	2.4	1.3	1.0	0.7	7.8	8.2	8.8	8.8
France	1.8	1.2	1.2	2.4	1.8	1.9	2.0	1.6	8.6	8.8	9.1	9.1
Italy	1.8	0.4	1.1	2.3	2.7	2.6	2.4	1.6	9.5	9.0	9.3	9.1
Spain	2.7	2.0	2.2	3.1	2.8	3.6	3.2	2.8	10.5	11.4	11.4	10.9
Netherlands	1.2	0.3	0.6	1.8	5.1	3.9	2.4	2.2	2.0	2.3	3.4	4.3
Belgium	0.8	0.7	1.1	2.2	2.4	1.6	1.2	1.2	6.7	7.3	7.7	7.8
Austria	0.7	0.9	1.5	2.4	2.3	1.8	1.5	1.4	3.6	4.1	4.5	4.1
Finland	0.7	1.6	2.1	2.8	2.7	2.2	2.0	1.7	9.1	9.3	9.5	9.1
Greece	4.1	4.0	3.6	3.6	3.7	3.9	3.8	3.0	10.4	9.9	9.8	9.7
Portugal	1.6	0.5	–0.3	1.8	4.4	3.7	3.2	2.1	4.1	5.1	6.8	7.0
Ireland	5.7	5.9	3.3	4.5	4.0	4.7	4.4	3.2	3.9	4.4	5.3	5.3
Luxembourg	1.0	0.5	1.5	4.0	2.7	2.1	2.0	1.7	2.6	2.8	3.2	3.3
Japan	0.4	0.3	0.8	1.0	–0.7	–0.9	–0.7	–0.6	5.0	5.4	5.5	5.4
United Kingdom[2]	2.0	1.6	2.0	2.5	2.1	2.2	2.8	2.7	5.1	5.2	5.4	5.3
Canada	1.5	3.4	2.8	3.2	2.5	2.0	3.1	2.1	7.2	7.6	7.6	6.9
Korea	3.0	6.1	5.0	5.3	4.1	2.8	3.5	3.2	3.8	3.0	3.0	3.0
Australia	2.7	3.8	3.0	3.7	4.4	3.0	2.7	2.5	6.7	6.3	6.0	5.7
Taiwan Province of China	–2.2	3.5	3.2	3.7	—	–0.2	0.3	0.8	4.6	5.2	4.9	4.8
Sweden	1.1	1.9	1.6	2.1	2.7	2.0	2.7	1.9	4.0	4.0	4.2	4.2
Switzerland	1.1	0.1	0.6	1.7	1.0	0.7	0.7	0.2	1.9	2.8	4.3	4.0
Hong Kong SAR	0.6	2.3	3.0	3.3	–1.6	–3.0	–1.6	–1.0	5.1	7.3	7.0	6.6
Denmark	1.4	1.6	1.4	2.1	2.2	2.4	2.5	2.2	4.9	5.0	5.2	5.1
Norway	1.4	1.6	1.5	2.0	3.0	1.3	3.1	2.5	3.6	3.9	4.2	4.0
Israel	–0.9	–1.0	0.5	2.2	1.1	5.7	2.8	1.0	9.4	10.3	10.7	10.1
Singapore	–2.4	2.2	3.0	3.5	1.0	–0.4	0.9	1.7	3.3	4.4	4.5	4.0
New Zealand[3]	2.4	4.2	2.7	3.0	2.7	2.7	1.9	2.0	5.3	5.2	5.4	5.3
Cyprus	4.1	2.0	2.2	4.3	2.0	2.8	4.3	2.0	3.0	3.2	3.4	3.3
Iceland	2.9	–0.5	1.6	2.9	6.6	4.8	2.2	2.5	1.4	2.5	3.0	2.5
Memorandum												
Major advanced economies	0.7	1.6	1.7	2.8	2.1	1.3	1.7	1.6	5.9	6.5	6.8	6.6
European Union	1.6	1.0	1.3	2.4	2.5	2.3	2.2	1.8	7.4	7.7	8.0	8.0
Newly industrialized Asian economies	0.8	4.6	4.1	4.5	1.9	1.0	1.8	1.9	4.1	4.1	4.0	3.9

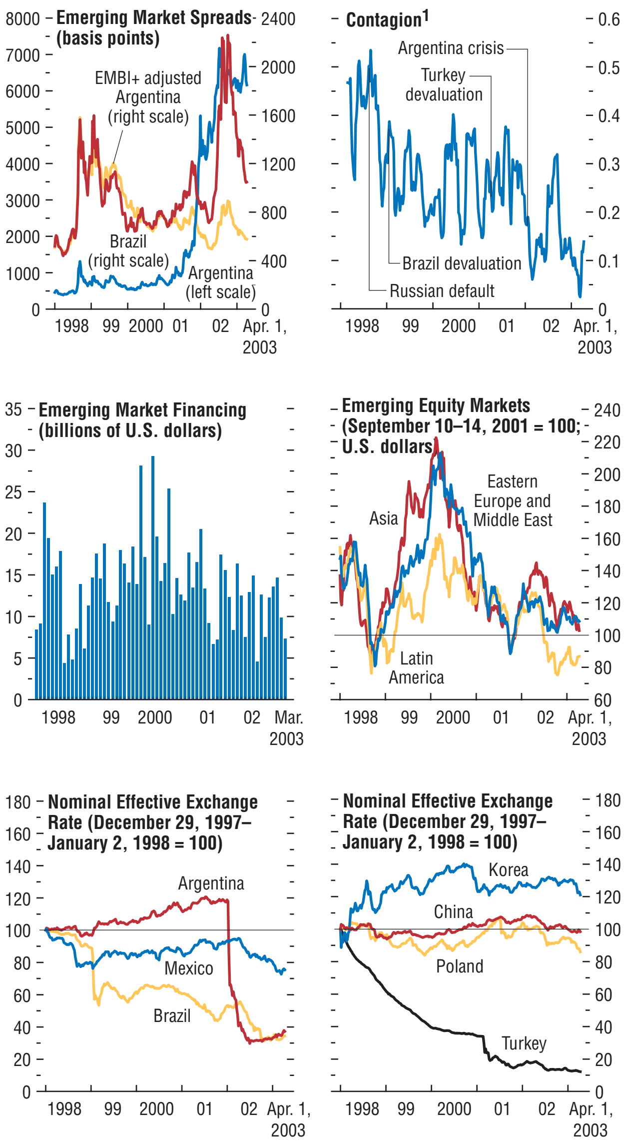
[1]Based on Eurostat's harmonized index of consumer prices.
[2]Consumer prices are based on the retail price index excluding mortgage interest.
[3]Consumer prices excluding interest rate components.

Four features of the current conjuncture appear particularly germane to an assessment of the global outlook:

- *Geopolitical and other uncertainties, and how they are resolved.* In the run-up to the war in Iraq, geopolitical uncertainties increased sharply, reflected among other things in the rising trend (until very recently) in oil and gold prices. This is already having a substantial effect: notably, the upward revision in oil prices since the last *World Economic Outlook* and all the attendant uncertainties associated with it, accounts for a substantial proportion of the downward revision to global growth in 2003. Clearly, much now depends on the speed with which the conflict is resolved, the extent to which it is contained within Iraq, and the damage to infrastructural and other facilities, all of which are impossible to predict at this stage (see Appendix 1.2, "How Will the War in Iraq Affect the Global Economy?"). In contrast to the situation before the 1991 conflict in the Middle East, markets—especially since mid-March—appear to be pricing in a quick and

Figure 1.4. Emerging Market Financial Conditions

Emerging market financing conditions have improved in recent months, although spreads for some countries remain high, and primary market issuance is still modest.



Sources: Bloomberg Financial Markets, LP; J.P. Morgan Chase; and IMF staff estimates.

[1]Average of 30-day rolling cross-correlation of 20 emerging market debt spreads.

relatively costless resolution of the situation. Correspondingly, the upside risks from a benign outcome, while real, may be smaller than the downside risks if matters turn out worse than expected.

- *The continued "headwinds" from the bursting of the equity market bubble, and the extent to which these persist.* In most countries, the direct impact of the past fall in equity markets on demand growth is likely to have peaked in late 2002 or the first half of 2003; thereafter, provided equity prices do not fall further, the drag on GDP growth—while still significant—should start to diminish. This is also broadly consistent with the historical experience, which suggests that GDP growth begins to fully recover two to three years after the bursting of an equity price bubble (see Chapter II). However, considerable uncertainties remain, not least with respect to the impact on the balance sheets of banks and insurance companies, in Japan and some countries in Europe. In corporate sectors, excess capacity, losses on defined benefit pension plans, and still-high corporate debt levels weigh on the investment outlook—to different degrees—in all three major currency areas (Chapter II).
- *The marked differences in the macroeconomic stimulus in the pipeline in the key currency areas.* In the United States, Canada, and United Kingdom, monetary and fiscal policies have been eased significantly more in response to the global slowdown than in the euro area and Japan (Figure 1.5), partly reflecting the smaller room for policy maneuver in the latter two. This pattern—reinforced by recent exchange rate movements—is expected to continue in 2003, and will tend to increase global dependence on U.S. growth.
- *Movements in major currencies.* As noted above, the U.S. dollar has depreciated markedly over the past year, a generally welcome development in light of the continued large imbalances in the global economy, discussed in more detail below. However, geopolitical uncertainties appear also to have played a significant role; correspondingly, currency

markets are likely to remain volatile in the immediate future, with significant movements possible in both directions depending on how events unfold. Such movements have important effects on activity and inflation particularly when—as in Japan—the authorities have relatively little room for offsetting policy maneuver.[3]

IMF staff baseline projections are based on the assumption that the uncertainties surrounding the conflict in Iraq are broadly resolved in the near term, with little spillover outside the region, and that the global economic impact is correspondingly limited. On this basis, the global recovery is expected to continue during 2003, albeit at a relatively subdued pace, with GDP growth in the major currency areas remaining below potential until the end of the year (Figure 1.6). For the year as a whole, global growth is projected at 3.2 percent, 0.2 percentage point higher than in 2002, underpinned by a reduction in geopolitical uncertainties, a gradual ebbing of the headwinds to growth described above, the policy stimulus still in the pipeline, and a turn in the inventory cycle. Monetary policy would be expected to remain accommodative, with some further easing possible in the euro area, and with interest rate increases in the United States and elsewhere deferred until at least late 2003; in Japan, the zero interest rate policy would continue.

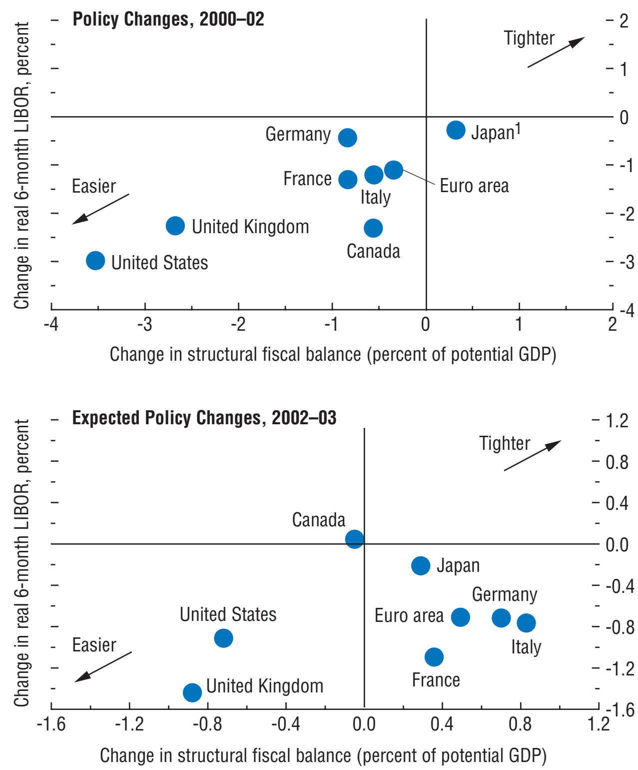
Looking across individual countries and regions:

- In *industrial countries*, the United States is expected to continue to lead the recovery, although GDP growth is projected to be somewhat lower than in 2002, with current weakness partly offset by a recovery in confidence and investment and additional fiscal stimulus (Table 1.3). In the euro area, with domestic demand still quite weak, fiscal policy tighten-

[3]For example, currency movements over the past year are likely, all things being equal, to raise prices in the United States by ½–1 percent over the coming two years, and to lower prices in the euro area by a similar amount.

Figure 1.5. Fiscal and Monetary Easing in the Major Advanced Countries
(Percent)

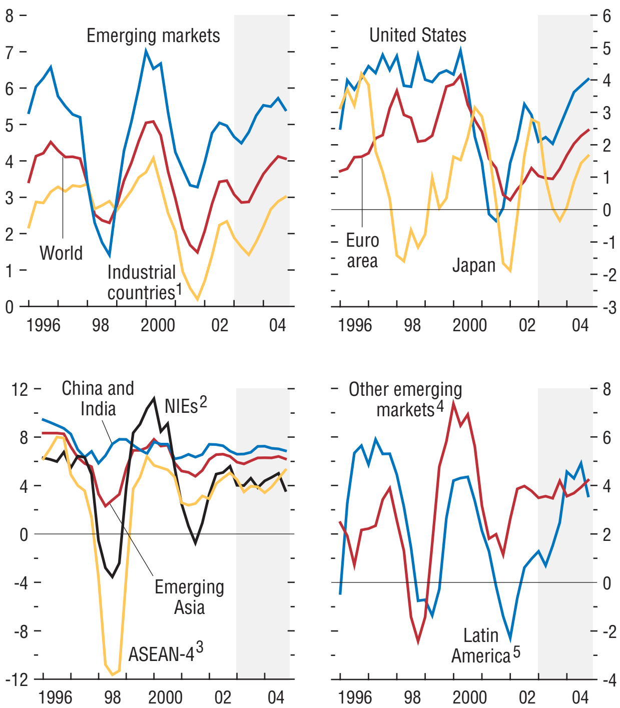
Monetary and fiscal policies have been eased significantly more in the United States and the United Kingdom than in the euro area and Japan.



Source: IMF staff estimates.
[1]The improvement in Japan's structural fiscal balance during 2000–02 reflects the one-off costs of bank support in the base year amounting to 1.2 percent of GDP in 2000 compared with 0 percent in 2002. Excluding such support (and including social security), the structural balance actually deteriorated by about 1 percent of GDP.

Figure 1.6. Global Outlook
(Percent change from four quarters earlier)

GDP growth will be weaker than earlier expected in most regions, and in the United States and euro area will not approach potential until late 2003.



Sources: Haver Analytics; and IMF staff estimates.
[1]Australia, Canada, Denmark, euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom, and the United States.
[2]Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.
[3]Indonesia, Malaysia, the Philippines, and Thailand.
[4]Czech Republic, Hungary, Israel, Pakistan, Poland, Russia, South Africa, and Turkey.
[5]Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

ing, and the euro appreciating, growth projections have been reduced sharply. The situation in Germany, where GDP growth is expected to be well under 1 percent for the third year running and strains in the financial sector are becoming increasingly apparent, is of particular concern. GDP growth is also expected to remain weak in Japan, where deflation persists and domestic demand growth is expected to fade further.

- In *emerging markets*, GDP growth prospects for 2003 have fallen moderately, in part reflecting the weaker outlook in industrial countries. Growth in *emerging Asia* exceeded expectations in 2002, particularly in China, and is expected to remain solid in 2003. However, the recent slowing in the global information technology (IT) sector will, if sustained, have an adverse impact on the newly industrialized economies and the ASEAN-4 (Indonesia, Malaysia, the Philippines, and Thailand), and the recent outbreak of Severe Acute Respiratory Syndrome (SARS) poses a risk to activity in several countries. Domestic demand has generally strengthened, but in most countries is not sufficiently robust to support a self-sustaining recovery, and the region continues to run a very large balance of payments surplus with the rest of the world (Table 1.3). In *Latin America*, after the deep recession in 2001–02, activity has begun to turn up. However, significant vulnerabilities remain in a number of countries, including Argentina, Brazil, and Uruguay, and the political crisis has had a serious impact on activity in Venezuela. In the *Middle East*, many countries have benefited from higher oil prices, but the regional security situation continues to have serious implications for activity, including in those countries with close economic relations with Iraq, and in Israel and the West Bank and Gaza. GDP growth in Turkey has exceeded expectations, but the new government faces significant challenges, especially in light of recent policy slippages and the impact of war in Iraq. GDP growth has also remained solid in the *transition countries*, although in Russia delays in

Table 1.3. Emerging Market Economies: Net Capital Flows[1]
(Billions of U.S. dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total[2]										
Private capital flows, net[3]	208.4	228.3	75.7	53.4	96.0	51.1	38.8	85.9	90.5	113.2
Private direct investment, net	95.0	109.5	136.0	148.8	156.8	149.0	170.5	139.2	147.6	146.7
Private portfolio investment, net	48.8	94.6	48.5	1.7	41.4	12.1	–38.5	–36.6	–3.5	10.3
Other private capital flows, net	64.6	24.2	–108.8	–97.1	–102.2	–110.1	–93.2	–16.7	–53.6	–43.7
Official flows, net	28.3	–2.8	56.3	83.0	14.0	–3.8	38.8	25.8	–1.9	–18.0
Change in reserves[4]	–117.5	–109.9	–62.0	–53.5	–86.8	–113.3	–118.5	–209.0	–199.0	–141.1
Memorandum										
Current account[5]	–93.5	–90.4	–71.8	–51.3	34.0	125.7	84.1	114.3	135.7	65.6
Africa										
Private capital flows, net[3]	11.3	10.0	9.0	10.4	13.7	4.8	6.0	5.5	10.0	8.3
Private direct investment, net	1.9	3.5	7.8	6.3	9.4	7.8	22.4	8.9	11.1	10.8
Private portfolio investment, net	2.5	2.8	7.0	3.7	8.2	–2.2	–9.1	–1.2	–1.4	0.6
Other private capital flows, net	6.9	3.7	–5.9	0.4	–3.9	–0.8	–7.3	–2.3	0.3	–3.1
Official flows, net	5.7	–2.2	3.2	4.2	2.0	3.0	1.6	2.2	1.3	2.1
Change in reserves[4]	–2.5	–7.9	–11.1	2.8	–3.5	–13.2	–11.9	–1.4	–12.0	–11.2
Developing Asia[6]										
Private capital flows, net[3]	98.4	123.2	12.0	–44.9	6.3	–18.3	15.5	69.5	18.4	13.8
Private direct investment, net	52.6	53.7	56.4	59.3	60.3	53.0	46.5	55.3	57.4	56.7
Private portfolio investment, net	22.7	32.8	7.1	–17.9	14.4	4.3	–13.5	–18.1	–3.0	–7.0
Other private capital flows, net	23.1	36.6	–51.5	–86.3	–68.4	–75.5	–17.6	32.3	–35.9	–35.9
Official flows, net	4.3	–12.7	17.1	26.1	4.2	3.2	–6.0	–10.2	–5.8	–1.8
Change in reserves[4]	–43.1	–46.6	–15.0	–67.9	–78.9	–49.0	–84.6	–166.9	–87.6	–79.5
Memorandum										
Hong Kong SAR										
Private capital flows, net[3]	–3.5	–7.1	11.7	–8.5	1.1	20.7	–6.6	–8.9	–17.7	–20.4
Middle East and Turkey[7]										
Private capital flows, net[3]	8.2	9.5	16.9	10.2	–3.9	–18.8	–38.3	–25.3	–6.0	1.9
Private direct investment, net	6.4	4.7	5.2	6.2	5.3	7.7	10.5	7.3	12.7	12.2
Private portfolio investment, net	2.0	1.8	–0.9	–13.2	–3.2	–13.4	–22.0	–14.2	–8.3	–2.4
Other private capital flows, net	–0.3	3.0	12.6	17.1	–6.0	–13.1	–26.9	–18.4	–10.4	–7.9
Official flows, net	4.4	5.9	5.9	3.6	3.7	–2.5	6.3	12.5	3.7	6.1
Change in reserves[4]	–11.6	–22.2	–19.4	9.7	–6.4	–27.3	–4.9	–8.0	–51.5	–28.5
Western Hemisphere										
Private capital flows, net[3]	39.1	65.3	58.7	63.3	50.2	50.5	34.7	2.1	27.6	59.4
Private direct investment, net	21.0	35.2	51.1	56.1	58.1	57.1	65.9	38.5	36.0	42.7
Private portfolio investment, net	7.0	44.1	28.3	23.7	19.6	21.2	2.8	–6.5	6.4	15.9
Other private capital flows, net	11.0	–14.0	–20.8	–16.5	–27.5	–27.8	–33.9	–29.8	–14.9	0.9
Official flows, net	20.0	3.9	14.6	15.5	0.7	–4.3	23.7	18.4	7.0	–21.2
Change in reserves[4]	–22.9	–29.0	–13.2	8.4	8.7	–3.6	0.8	–1.3	–17.7	–10.9
Countries in transition										
Private capital flows, net[3]	51.4	20.2	–20.9	14.5	29.8	32.9	20.9	34.1	40.4	29.9
Private direct investment, net	13.0	12.3	15.5	20.8	23.8	23.4	25.2	29.2	30.3	24.4
Private portfolio investment, net	14.6	13.1	6.9	5.4	2.4	2.4	3.2	3.4	2.7	3.2
Other private capital flows, net	23.8	–5.1	–43.3	–11.8	3.6	7.1	–7.4	1.5	7.4	2.2
Official flows, net	–6.0	2.2	15.5	33.7	3.5	–3.1	13.2	2.9	–8.2	–3.1
Change in reserves[4]	–37.4	–4.2	–3.3	–6.5	–6.7	–20.1	–18.0	–31.4	–30.2	–11.0
Memorandum										
Fuel exporters										
Private capital flows, net[3]	21.9	–7.9	–35.0	–8.4	–14.5	–28.7	–43.1	–40.9	–13.4	–12.6
Nonfuel exporters										
Private capital flows, net[3]	186.5	236.2	110.6	61.8	110.5	79.8	81.9	126.8	103.8	125.8

[1]Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing. Emerging markets include developing countries, countries in transition, Korea, Singapore, Taiwan Province of China, and Israel.
[2]Exludes Hong Kong SAR.
[3]Because of data limitations, "other private capital flows, net" may include some official flows.
[4]A minus sign indicates an increase.
[5]The sum of the current account balance, net private capital flows, net official flows, and the change in reserves equals, with the opposite sign, the sum of the capital and financial account and errors and omissions. For regional current account balances, see Table 27 of the Statistical Appendix.
[6]Includes Korea, Singapore, and Taiwan Province of China in this table.
[7]Includes Israel and Malta.

implementing reforms have weakened investment prospects. In central and eastern Europe, GDP growth continues to be underpinned by strong foreign direct investment inflows as EU accession nears, offsetting the impact of weaker euro area demand.

- Among the *poorest countries*, GDP growth in Africa remained relatively resilient to the global downturn, reflecting improved macroeconomic policies and stability, progress in resolving regional conflicts, rising commodity prices, and debt relief under the Heavily Indebted Poor Countries (HIPC) initiative. While GDP growth is expected to rise in 2003, aided by the continued global recovery, the outlook is clouded by adverse shocks. Poor weather—with the effects exacerbated by governance problems and the HIV/AIDS pandemic—has led to a serious famine in southern Africa, the Horn of Africa, and the western Sahel, now affecting 38 million people. The continuing turmoil in Zimbabwe and the political crisis in Côte d'Ivoire also have serious implications for these countries and their neighbors.

Global inflation remains very low, with consumer prices expected to increase by less than 2 percent in 2003 in advanced countries, and by just under 6 percent in developing countries. Given the expectation that output gaps in the United States and the euro area will widen further in the short term, and the continued moderate deflation in Japan, a number of observers have expressed concern that outright deflation could become a more widespread problem. While declines in price levels for short periods in individual countries cannot be ruled out—indeed, inflation in Germany was close to zero in the second half of 2002, and the risk of a short period of falling prices is significant—the risks of a sustained deflationary spiral currently appear small (see Box 1.1, "Could Deflation Become a Global Problem?"). Inflationary expectations remain well anchored, and excess capacity and output gaps in most countries seem unlikely to increase to levels that would dramatically change those expectations. However, since deflation has large potential costs, these concerns reinforce arguments for erring on the side of monetary accommodation at the present juncture, and underscore the importance of central banks' making it clear that they will act aggressively and preemptively to forestall deflation if the need arises.

While the baseline scenario predicts a continued but only moderately paced recovery, with war in Iraq now under way with consequences that are not knowable at this stage, the outlook is subject to great uncertainty. Correspondingly, forward-looking indicators—such as asset prices and confidence indicators—are likely to remain highly volatile and will be difficult to interpret until these uncertainties are reduced. On the upside, a relatively rapid resolution of the uncertainties surrounding the situation in Iraq could provide a larger boost to global activity from the second half of 2003 than currently assumed, both through a stronger pickup in confidence and through lower oil prices (as the recent fall in oil prices, which at the time of writing are significantly lower than currently assumed for 2003 in this *World Economic Outlook*, attests). And with corporations in both the United States and Europe having relatively high cash balances—as discussed in the March 2003 *Global Financial Stability Report*—it is possible that investment could respond relatively quickly, though overall corporate balance sheets are still not strong. In addition, continued strong productivity growth in the United States remains an important supportive factor (see Box 1.2, "Is the New Economy Dead?").

But on balance, the risks—similar to those identified in the last *World Economic Outlook*—remain distinctly on the downside, the more so, the longer the war continues. Beyond the specific risks in major industrial countries, including Japan and to a lesser extent Germany, they include the following.

- *A more prolonged and destructive conflict in Iraq could have a severe impact on global activity*, through elevated oil prices, falling consumer and business confidence, lower equity prices,

Box 1.1. Could Deflation Become a Global Problem?

There has been a notable increase recently in concerns about global deflation—defined as a sustained decline in an aggregate price index, such as the consumer price index (CPI). This follows the recognition that deflation in Japan continues to be a major problem; the onset of deflation in China and several other Asian emerging markets; and fears that the bursting of the equity price bubble has led to significant excess capacity, which will continue to weigh on prices, especially given weak global recovery and geopolitical uncertainties. Such an environment also gives rise to concerns that deflationary impulses could be transmitted across countries through trade, corporate, and financial linkages. This is the second time in the past five years—the first being in the aftermath of the Asian crisis—that the risks of generalized deflation have come to the fore (Roach, 2002). However, unlike the first time, the global economic situation is now particularly uncertain, with widespread vulnerabilities.

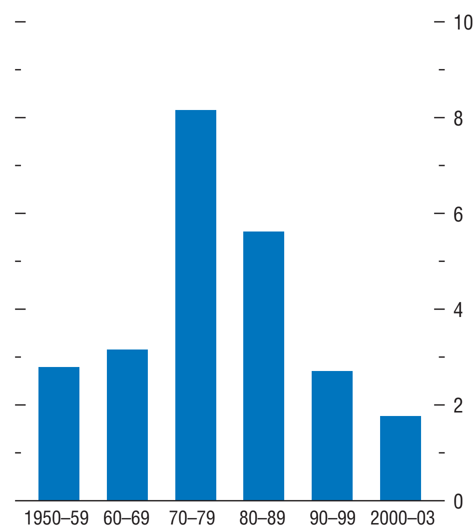
A key background to the concerns about deflation is the marked reduction in inflation rates in recent years. Among industrial countries, CPI inflation has declined to an average of below 2 percent, a level not seen since the 1950s (see the figure). Among emerging market economies, inflation rates are now the lowest since the late 1960s. Low inflation brings substantial benefits in terms of efficiency in resource allocation and a reduction in uncertainty. However, very low inflation—less than 2 percent or so—in the presence of negative demand shocks can increase the risks of moving into deflation (see the April 2002 *World Economic Outlook*).

Deflation can arise from both supply-driven and demand-driven shocks. In the former case, declining prices could be driven by productivity growth and technological innovations, and may be accompanied by an increase in output growth. In contrast, demand side shocks—such as the bursting of an asset price bubble—are

Note: The main author of this box is Manmohan Kumar.

Industrial Countries: Average Inflation Rate

(Consumer price index; percent)



generally accompanied by a slowdown, or a decline, in activity. Deflation is seldom benign, however. Even in a positive supply shock, unless it affects all sectors equally—an unlikely case—a generalized decline in prices can be problematic if wages are rigid downward. This is because sectors not experiencing productivity improvements, with rigid wages and falling prices, may nonetheless face higher real labor costs and a loss in competitiveness. And regardless of the source of the shock, deflation, especially when unanticipated, leads to a redistribution of income from debtors to creditors—that is, from groups with a high propensity to spend to those with a low propensity, depressing demand. Moreover, given the zero-interest-rate floor, the effectiveness of monetary policy is curtailed—of particular concern when output is weakening—and credit intermediation can be severely distorted as collateral loses value.

The biggest concern is that a temporary period of declining prices could develop into a more sustained and self-reinforcing deflationary

Box 1.1 *(concluded)*

Incidence of Deflation and Low Inflation[1]
(percent)

	1980–84	1985–90	1991–96	1997–2002	1997–99	2000–02
Deflation						
All countries	0.9	3.2	1.2	11.4	9.7	13.1
Industrial countries	0.0	3.7	2.5	7.4	6.5	8.3
Emerging countries	1.6	2.8	0.3	14.1	11.9	16.3
Deflation and inflation less than 1 percent						
All countries	1.8	9.8	5.0	23.5	24.8	22.3
Industrial countries	0.1	11.8	10.2	23.7	31.0	16.3
Emerging countries	3.2	8.3	1.4	23.4	20.7	26.3

[1]Number of country months with year-on-year inflation less than 1 percent or negative, as a percent of total. Data based on 35 of the largest industrial and emerging market economies.

spiral, as expectations of falling prices become entrenched, consumption and investment are postponed, and risk appetite drops off. Historically, this has entailed rising real debt burdens, widespread bankruptcies, pressures on banks, and collapsing demand, fueling a self-reinforcing downward spiral in activity, employment, profits and prices (Krugman, 2002).

At the current conjuncture, sustained deflation has been experienced only in Japan, where it has been accompanied by a persistent weakness in activity; Hong Kong SAR, China, Singapore, and Taiwan Province of China have also experienced periods of falling prices. Nonetheless, among the group of industrial and large emerging market economies, episodes of CPI declines have increased from about 1 percent of countries in the first half of the 1990s to over 13 percent in the past three years, with a particularly pronounced increase in emerging markets (see the table). Given that the CPI is subject to upward bias of between ½ and 1 percent (by ignoring substitution possibilities and new or improved products), measured inflation of 1 percent or less may in practice be close to price stability, or even deflation. If so, mild deflation may already be affecting a substantially higher proportion of industrial and emerging market economies.

Looking ahead, a number of factors could exacerbate deflationary pressures. The pace of global recovery is likely to remain sluggish, reflecting geopolitical concerns as well as the continued effects of equity price declines. The latter, particularly through their impact on corporate balance sheets and financial institutions, may restrain activity more than currently anticipated. House prices, which have increased substantially in many countries, thus helping to mitigate effects of equity price declines on consumption, could experience a correction, exacerbating the weakness in household demand. There has also been a notable decline in private sector credit in many countries, reflecting subdued demand but also in several cases banking sector difficulties. Corporate profits remain under pressure, and although labor markets have held up better than during previous downturns, growth in labor incomes has begun to slow. The World Economic Outlook projections suggest that the output gaps—already substantial in many countries—are likely to widen in the near term to levels that are likely to considerably exacerbate the downward pressures on prices. While risk appetite appears to have stabilized, financial markets remain volatile amidst increased risks and uncertainties.

These considerations suggest that in the period ahead there may well be an increase in the number of countries facing deflation, or a worsening in countries already beset by it. Moreover, the vulnerability to deflation could be higher where the room for policy maneuver, both on the monetary and fiscal fronts, is constrained. That said, the risk of a generalized global deflation, or even of a deflationary spiral in the major economies, appears small: financial markets and institutions have remained broadly resilient so far; corporate and household debt burdens appear manageable; and there remains scope for policy adjustment in most countries.[1] The likelihood of imported deflation also appears remote, given the small trade shares of countries experiencing deflation. In the case of China, high productivity combined with a de facto pegged exchange rate has led to sharp price declines in some sectors. But even here, its overall trade shares are too small to lead to a generalized deflation among trading partners.

Nevertheless, a potential increase in the spread of deflation is a cause for concern. Policymakers have the instruments to head it off, and can do so provided they act quickly and preemptively (Rogoff, 2002). Where deflation vulnerabilities are high, the operations of the automatic fiscal stabilizers should be allowed full play, and—if the risks became sufficiently large—well-directed discretionary fiscal measures could play a role in stabilizing demand. With regard to monetary policy, it is important that the inflation targets be high enough to minimize risks of deflation (given the upward CPI bias and the costs of deflation); and an undershooting of inflation targets should be as much a concern as overshooting inflation targets was in the past—that is, targets should be pursued symmetrically (Bernanke, 2002). Moreover, as Japan's experience illustrates, deflation can be difficult to anticipate—both household and business surveys and financial markets in the mid-1990s expected a continuation of moderate inflation, right up to when deflation began (Ahearne and others, 2002). Correspondingly, policymakers need to be alert to the heightened risks, and in some circumstances a more accommodative monetary policy stance may be justified than would be strictly warranted by conjunctural conditions.

[1]For a detailed assessment, see Kumar and others (2003).

and higher risk premia (Appendix 1.2). While quantitative estimates are subject to enormous uncertainty, such a development would clearly slow—and could choke off altogether—the already fragile recovery in industrial countries. There would also be a serious impact on emerging market countries—particularly highly indebted oil importers, as spreads widen—and the poorest countries, which would be doubly hit by higher oil import prices and lower nonfuel commodity export prices. Moreover, even if the war ends quickly, significant uncertainties—both within the Middle Eastern region and outside—could persist for some time. To address this, it will be important that the international community moves quickly to rebuild confidence and to heal the rifts that emerged in the run-up to the war—and in particular, to ensure that these do not spill over into the economic sphere. To this end, supportive macroeconomic policies and early progress toward cooperatively addressing the major challenges that will continue to face the global community in the aftermath of the war—along the lines discussed below—appear particularly important.

- *The recovery continues to depend heavily on the outlook for the United States.* Given the weakness in both Japan and the euro area, this is probably inevitable—and even necessary—in the short run. However, the short-term benefit is bought at the cost of increased medium-term vulnerabilities, notably growing global imbalances (the large U.S. current account deficit and significant surpluses in Japan, emerging Asia, and, to a lesser extent, the euro area) (Table 1.4). These imbalances may adjust benignly; indeed, this possibility has risen somewhat with the depreciation of the U.S. dollar over the past year, although the dollar still appears significantly overvalued. However, the imbalances remain a source of serious concern,

Table 1.4. Selected Economies: Current Account Positions
(Percent of GDP)

	2001	2002	2003	2004
Advanced economies	**–0.8**	**–0.8**	**–1.0**	**–0.9**
United States	–3.9	–4.8	–5.3	–5.1
Euro area[1]	0.3	1.1	1.1	1.1
Germany	0.2	2.5	2.6	2.6
France	1.8	2.1	2.1	1.9
Italy	—	–0.6	—	0.3
Spain	–2.6	–2.1	–1.8	–1.8
Netherlands	2.8	3.0	2.8	2.2
Belgium	4.0	3.8	3.0	3.4
Austria	–2.2	–0.6	–0.8	–1.1
Finland	6.5	6.7	6.1	6.2
Greece	–6.2	–6.5	–7.1	–6.8
Portugal	–9.4	–7.9	–7.0	–6.9
Ireland	–0.3	–0.3	–0.9	–1.1
Luxembourg	9.3	10.4	10.0	9.8
Japan	2.1	2.8	2.7	3.0
United Kingdom	–1.7	–1.9	–2.0	–2.3
Canada	2.8	1.5	1.6	2.0
Korea	2.0	1.3	0.3	0.5
Australia	–2.4	–3.9	–4.2	–3.9
Taiwan Province of China	6.4	9.1	8.6	8.8
Sweden	3.9	4.2	3.4	3.5
Switzerland	8.9	11.1	10.6	10.8
Hong Kong SAR	7.5	11.4	10.9	10.6
Denmark	2.6	2.5	3.9	4.2
Norway	15.4	13.8	14.5	11.5
Israel	–2.0	–2.1	–2.3	–2.2
Singapore	19.0	21.5	22.2	20.5
New Zealand	–2.8	–3.4	–4.6	–4.5
Cyprus	–4.3	–5.4	–5.0	–4.0
Iceland	–4.3	0.8	–0.4	–0.5
Memorandum				
Major advanced economies	–1.4	–1.6	–1.7	–1.6
European Union[2]	–0.2	0.3	0.4	0.3
Euro area[2]	–0.2	0.9	0.9	0.9
Newly industrialized Asian economies	5.8	7.0	6.2	6.1

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

especially since—in contrast to the late 1990s—the fiscal position in the United States is now in substantial deficit. First, historical experience suggests that a reduction in the U.S. current account deficit would likely be associated with lower U.S. growth; with few signs at present that this would be offset by stronger growth in the euro area and Japan, this could have significant global consequences. Second, a disorderly adjustment—involving a further sharp depreciation of the U.S. dollar and sharp currency appreciation elsewhere—remains a risk, especially if that appreciation were relatively narrowly focused on a few countries.[4]

- *The possibility of further declines in mature financial markets cannot be ruled out.* While forward-looking price earning ratios are now close to their historical averages, and earnings expectations have fallen back from earlier optimistic levels, there remains the possibility that—after a long period of overvaluation—markets could overshoot on the downside, having a direct effect on demand and adding to existing pressures on financial institutions and corporates. Higher-than-expected losses on defined benefit pension plans or the emergence of additional corporate scandals could add to such risks. In the United Kingdom, Australia, some of the smaller European countries, and to a lesser extent the United States, housing prices have been surprisingly strong in an environment where equity markets are falling (Chapter II). Correspondingly, the possibility of a slowdown—or even an abrupt adjustment—is also a source of concern. Looking forward, as growth prospects improve, the possibility of a sharp fall in long-term bond prices—which, with interest rates very low, are presently very high—is also a source of risk (as discussed in detail in the *Global Financial Stability Report*).
- *Vulnerabilities in a number of emerging market countries—notably some countries in Latin America and Turkey—remain high.* While financing conditions have recently improved, it is possible that the recent improvement in risk appetite may not prove enduring. A further reduction in spreads—which is necessary to ensure debt sustainability in a number of countries—may depend primarily on strengthened economic fundamentals, rather than on an improvement

[4]See "How Worrisome Are External Imbalances?" *World Economic Outlook*, September 2002, for a detailed discussion of these issues.

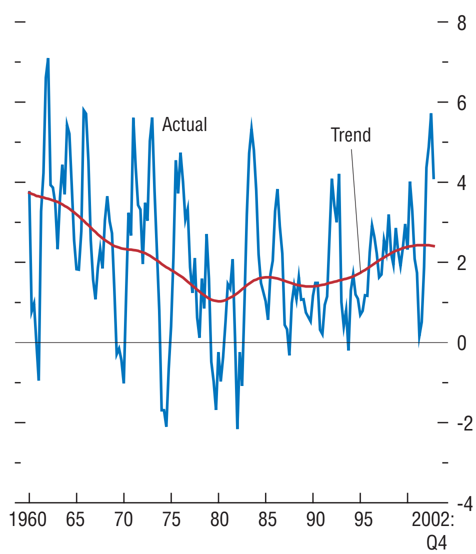
Box 1.2. Is the New Economy Dead?

"Rest in peace, New Economy. It was fun while it lasted" (Dudley, 2002). While the stock market crash and economic downturn in the United States have dashed many of the hopes of New Economy enthusiasts, the increase in labor productivity growth that became evident in the second half of the 1990s has proven to be resilient. The precise magnitude of the increase depends on the dates chosen for the calculation and the methodology for adjusting the data for the business cycle, but there is now almost universal agreement that there has been a rise in trend labor productivity growth in the United States from about 1½ percent in the period from the mid-1970s to the mid-1990s to about 2¼ percent since 1995 (see the figure). This increase is somewhat smaller than the estimates of a 1 percent increase that were prevalent a couple of years ago. This box reviews the recent literature on the links between information technology (IT) and labor productivity growth, updating the chapter on the IT revolution in the October 2001 *World Economic Outlook*.

Most analysts agree that the increase in labor productivity growth is largely due to IT, but there is a debate about the exact sizes of the different channels. Labor productivity growth can be decomposed into the contributions of total factor productivity (TFP) and capital deepening, that is, the increase in capital per worker. There is no doubt that technological advances have raised TFP growth in the production of IT equipment. In recent years, computer prices have continued to fall rapidly, reflecting the doubling of the capacity of semiconductor chips roughly every 18–24 months—a phenomenon known as "Moore's Law." While the steep decline in the price of computer power has clearly stimulated real investment in computers, there is some controversy about the precise magnitude of the contribution of IT-capital deepening to labor productivity growth. Oliner and Sichel (2002) calculate that IT-capital deepening, along with TFP growth in IT production, more than fully accounts for the increase in labor productivity growth.

Note: The main author of this box is James Morsink.

United States: Labor Productivity Growth[1]
(Percent)



Sources: U.S. Bureau of Labor Statistics; and IMF staff estimates.
[1] Change in output per hour in the nonfarm private business sector from four quarters earlier. Trend based on Hodrick-Prescott filter using a smoothing parameter of 6400.

However, Gordon (2003) suggests that these calculations overstate the contribution of IT-capital deepening, because IT investment appears to have been necessary but not sufficient to yield labor productivity benefits. Specifically, firm-level evidence from the retail sector, which accounts for much of the acceleration in labor productivity at the aggregate level, shows that all of the increase in labor productivity growth in the United States in the 1990s was achieved by new establishments and none by establishments that already existed in 1990, no matter how many computers they bought (Sieling, Friedman, and Dumas, 2001, and Foster, Haltiwanger, and Krizan, 2002). In other words, the benefits of higher investment in IT were only felt when

Box 1.2 *(concluded)*

accompanied by a substantial redesign of the store itself.

The corollary of the argument that IT-capital deepening contributed less to the observed increase in labor productivity growth is that an acceleration in TFP outside of IT production may have contributed somewhat. Indeed, Jorgenson, Ho, and Stiroh (2002) find a shift from negative to positive TFP growth in the IT-using sector. For example, in the retail sector, organizational changes in large retailers that occurred in parallel with IT investment were possibly responsible for at least part of the increase in labor productivity growth. This is consistent with the fact that, in Europe, IT-using industries (such as retail, wholesale, and securities) did not see an acceleration in productivity similar to their counterparts in the United States (van Ark, Inklaar, and McGuckin, 2002), reflecting greater difficulties in making organizational changes because of structural impediments (like land-use regulations, shop-closing laws, and restrictive labor rules).[1] Related evidence supporting an increase in TFP growth in IT-*usage* is provided by the positive correlation between the acceleration in TFP and measures of IT intensity, such as the ratio of IT expenditure to GDP (Haacker and Morsink, 2002).

Looking ahead, the impact of the IT revolution on underlying labor productivity growth will depend largely on three things: the pace of technological innovation in the IT sector, the responsiveness of investment to further declines in the prices of IT goods, and the ability of firms to reorganize production to take advantage of IT. First, there is a consensus that technological innovation in IT production will continue at a rapid pace, though perhaps not at the extraordinary pace that prevailed in the late 1990s (Jorgenson, 2001). As IT production constitutes a growing share of total output, technological innovation in this sector will likely continue to support labor productivity growth.

Second, there is an ongoing debate about the extent to which the ever-cheaper supply of IT goods will create end-user demand. Optimists, like DeLong (2002), argue that, just as price declines brought forth new uses in the past, they will continue to do so in the future, as IT is potentially useful for an extremely wide variety of production processes. As a result, the share of IT investment in nominal GDP in the United States, which rose from about 1 percent in 1960 to about 5½ percent in 2000, will rise further. However, skeptics argue that IT spending in the late 1990s reflected a unique set of factors and that nominal IT investment as a share of GDP is likely to fall over the coming decade. Specifically, Gordon (2003) points to the dampening effects on IT investment of excess capacity in telecommunications equipment, limited potential for e-commerce, slowing software innovation relative to hardware innovation, and obstacles to the adoption of broadband by households.

Third, it is likely that TFP growth outside of the IT sector will rise, reflecting the reorganization of production to take advantage of IT along the lines already seen in the retail sector. David (1990) observes that it took nearly half a century before the American economy had acquired enough experience with electric motors to begin to use them to their full potential. Similarly, Crafts (1985) shows that, in the original industrial revolution, the main contribution of steam power and textile machinery to British economic growth occurred in the middle half of the nineteenth century, well after the period of most rapid productivity growth within the steam-power and textile-spinning sectors in the early nineteenth century. It is likely that it will take time for people to figure out how best to reconfigure economic activity to take advantage of IT.

In sum, IT has led to an increase in labor productivity growth in the United States, which has held up through the economic downturn. TFP growth in IT production, as well as IT-related

[1]There is growing evidence on the role of structural impediments in dampening labor productivity growth. See, for example, Gust and Marquez (2002), Scarpetta and Tressel (2002), Vijselaar (2002), and Nicoletti and Scarpetta (2003).

capital deepening, have already boosted labor productivity growth; the mixed macroeconomic evidence regarding an acceleration in generalized TFP associated with IT is not surprising, given that this effect typically emerges only gradually. Looking ahead, rapid technological innovation in the IT-producing sector will likely continue for the foreseeable future. As the price of computer power continues to fall, new uses for IT will likely continue to be found, thus stimulating investment. This will continue to provide support for productivity growth looking forward, albeit to a lesser extent than during the second half of the 1990s. Beyond this—as discussed above—much will continue to depend on the pace at which productivity improvements spread to other sectors of the economy, a process that may have only just begun.

in the external environment. And while contagion remains low for now (Figure 1.4), it remains possible that—as in the past—heightened difficulties in one country may have a significant impact on other countries in a similar situation.

These risks are of more concern given the fragility of the global recovery, and the likelihood that the resiliency of the global economy to shocks may now be weakening. On the macroeconomic side, the substantial monetary policy easing over the past two years has used up a considerable proportion—though not all—of the available room for maneuver, and the scope for additional fiscal policy easing has also become more limited. And while global financial markets have been surprisingly resilient, the shocks of the past two years have taken their toll. This is of particular concern in Japan, but also in some countries in Europe where financial cushions in the banking system have been sharply reduced. In addition, the financial condition of insurers has significantly weakened. One consequence of that has been to reduce insurers' role in the credit derivatives market, diminishing banks' ability to lay off credit risk, and possibly their willingness to extend credit. Both of these factors could limit the ability of the financial system to absorb new shocks and to support the recovery in the period ahead.

Against this background, policymakers in both industrial and emerging market countries continue to face an environment of great uncertainty and risk. With inflationary pressures in general quite moderate, monetary policies in major industrial countries should remain accommodative, providing some insurance against geopolitical uncertainties and other downside risks. However, it is clear that policymakers will need to be flexible and adapt quickly to changing circumstances. If the uncertainties surrounding the war in Iraq are resolved in the near term, no further stimulus may be necessary. But if the conflict were to be prolonged and widespread, further policy stimulus might be needed, particularly if—as may well be the case—the adverse effects of such a shock on demand were to dominate. (The situation would be more complicated if higher oil prices were to lead to substantial second-round pressures on prices, and some central banks might then face a difficult dilemma.)

Looking across the major regions, the following appear to be the main policy priorities.

- *Macroeconomic policies in industrial countries should continue to be accommodative.* In the United States, following the 50 basis point cut in interest rates in November 2002, the present stance of monetary policy appears appropriate for the time being, although further cuts should be considered if the recent weakness in economic indicators is sustained. While the U.S. administration's tax proposals have some merit from an efficiency perspective, there is a risk they may prove pro-cyclical, and if enacted in full they will

Table 1.5. Major Advanced Economies: General Government Fiscal Balances and Debt[1]

(Percent of GDP)

	1987–96	1997	1998	1999	2000	2001	2002	2003	2004	2008
Major advanced economies										
Actual balance	–3.8	–2.1	–1.6	–1.2	–0.3	–2.0	–3.7	–4.3	–3.7	–1.3
Output gap[2]	–0.3	–0.4	–0.4	–0.1	0.7	–1.0	–1.8	–2.5	–2.3	—
Structural balance	–3.6	–1.8	–1.4	–1.1	–1.0	–1.7	–3.0	–3.2	–2.7	–1.3
United States										
Actual balance	–4.2	–1.3	–0.1	0.5	1.2	–0.7	–3.6	–4.6	–3.8	–1.7
Output gap[2]	–1.2	–0.5	0.3	1.1	1.6	–1.2	–1.8	–2.6	–2.1	—
Structural balance	–3.8	–1.1	–0.2	0.1	0.6	–0.4	–2.9	–3.6	–3.1	–1.7
Net debt	54.6	57.0	53.4	49.0	43.9	43.2	45.3	48.1	49.3	47.1
Gross debt	68.6	70.3	66.6	63.5	57.7	57.7	59.2	61.5	62.0	57.3
Euro area										
Actual balance	. . .	–2.6	–2.3	–1.3	0.1	–1.5	–2.2	–2.4	–2.0	0.0
Output gap[2]	. . .	–1.4	–0.8	–0.4	0.7	–0.1	–1.4	–2.5	–2.4	–0.1
Structural balance[4]	. . .	–1.6	–1.6	–0.9	–1.3	–1.6	–1.6	–1.1	–0.8	—
Net debt	. . .	62.9	61.4	60.8	58.7	57.9	58.2	58.1	57.0	55.0
Gross debt	. . .	75.4	73.7	72.6	70.2	69.2	69.4	69.9	69.3	61.8
Germany[3]										
Actual balance	–2.4	–2.7	–2.2	–1.5	1.1	–2.8	–3.6	–3.6	–2.7	–0.4
Output gap[2]	0.4	–0.6	–0.5	–0.3	0.7	–0.4	–1.7	–2.7	–2.5	—
Structural balance[4]	–2.1	–1.9	–1.6	–1.1	–1.7	–2.5	–2.5	–1.8	–1.0	–0.4
Net debt	31.2	53.4	53.3	54.9	52.8	52.2	53.8	56.3	56.9	53.5
Gross debt	46.4	61.0	60.9	61.2	60.2	59.5	61.2	63.7	64.2	60.9
France										
Actual balance	–3.6	–3.0	–2.7	–1.6	–1.3	–1.4	–3.1	–3.5	–3.0	0.5
Output gap[2]	–0.8	–3.1	–1.8	–1.1	0.6	—	–1.2	–2.4	–2.3	—
Structural balance[4]	–3.0	–1.0	–1.6	–1.0	–1.6	–1.5	–2.5	–2.1	–1.5	0.5
Net debt	32.6	49.6	49.8	48.8	47.5	48.2	49.4	50.9	51.8	44.8
Gross debt	41.6	59.3	59.5	58.5	57.2	56.8	59.1	60.6	61.5	54.4
Italy										
Actual balance	–10.0	–2.7	–2.8	–1.6	–0.6	–2.6	–2.3	–2.4	–2.3	–0.8
Output gap[2]	0.2	–1.2	–1.3	–1.7	–0.8	–0.9	–2.5	–3.3	–3.0	—
Structural balance[4]	–9.9	–1.9	–2.2	–0.9	–1.5	–2.4	–2.0	–1.2	–1.0	–0.8
Net debt	101.5	113.8	110.1	108.4	104.5	103.7	101.0	99.8	97.4	88.0
Gross debt	107.3	120.2	116.4	114.6	110.4	109.5	106.7	105.4	102.9	92.9
Japan										
Actual balance	–0.7	–3.8	–5.5	–7.1	–7.4	–7.2	–7.7	–7.4	–6.5	–1.9
Excluding social security	–3.4	–5.8	–7.1	–8.6	–8.5	–7.4	–7.6	–7.2	–6.4	–2.4
Output gap[2]	0.9	1.1	–1.5	–2.5	–1.1	–1.8	–2.6	–2.9	–3.0	–0.1
Structural balance	–1.0	–4.2	–5.0	–6.1	–7.0	–6.5	–6.7	–6.4	–5.4	–2.0
Excluding social security	–3.6	–6.1	–6.8	–8.0	–8.2	–7.0	–7.0	–6.6	–5.8	–2.4
Net debt	13.4	27.8	38.0	45.4	57.5	65.4	74.0	81.8	88.1	91.4
Gross debt	73.8	97.2	108.4	121.5	135.7	144.8	154.4	162.4	168.6	164.1
United Kingdom										
Actual balance	–3.6	–2.2	0.2	1.1	4.0	0.9	–1.2	–2.6	–2.8	–2.3
Output gap[2]	–0.2	0.2	0.5	–0.3	0.1	–0.2	–0.9	–1.5	–1.5	—
Structural balance[4]	–3.5	–2.1	—	1.1	1.7	0.9	–0.9	–1.8	–1.8	–2.3
Net debt	28.8	45.5	42.5	40.3	34.4	33.1	33.3	33.1	34.6	36.2
Gross debt	43.0	50.6	47.4	44.9	41.8	38.8	38.5	39.0	40.6	42.1
Canada										
Actual balance	–6.1	0.2	0.1	1.7	3.1	1.8	1.4	1.4	1.4	1.4
Output gap[2]	0.2	–0.9	–0.8	0.5	1.2	–0.8	–0.7	–0.7	–0.2	—
Structural balance	–6.1	0.8	0.5	1.6	2.5	2.2	1.9	1.9	1.6	1.5
Net debt	73.1	85.6	81.8	75.6	65.4	61.2	57.1	52.7	48.7	35.1
Gross debt	105.1	118.8	115.3	112.6	102.1	100.9	95.0	88.7	82.9	63.5

Note: The methodology and specific assumptions for each country are discussed in Box A1 in the Statistical Appendix.

[1]Debt data refer to end of year; for the United Kingdom they refer to end of March. Debt data are not always comparable across countries. For example, the Canadian data include the unfunded component of government employee pension liabilities, which amounted to nearly 18 percent of GDP in 2001.

[2]Percent of potential GDP.

[3]Data before 1990 refer to west Germany. For net debt, the first column refers to 1988–94. Beginning in 1995, the debt and debt-service obligations of the Treuhandanstalt (and of various other agencies) were taken over by general government. This debt is equivalent to 8 percent of GDP, and the associated debt service to 1/2 to 1 percent of GDP.

[4]Excludes one-off receipts from the sale of mobile telephone licenses (the equivalent of 2.5 percent of GDP in 2000 for Germany, 0.1 percent of GDP in 2001 and 2002 for France, 1.2 percent of GDP in 2000 for Italy, and 2.4 percent of GDP in 2000 for the United Kingdom). Also excludes one-off receipts from sizable asset transactions.

significantly worsen the medium-term fiscal position. In the euro area, interest rates have also been reduced, most recently in March; with inflation projected to decline, additional cuts should be considered, and would be needed if the outlook remains weak or the euro appreciates significantly further. Given the difficult medium-term fiscal situation, some structural fiscal tightening in the larger euro area countries appears appropriate, notwithstanding the short-term impact on demand (Table 1.5). However, automatic stabilizers should be allowed to operate fully around a sustained consolidation path toward the Stability and Growth Pact (SGP) norm of close to balance, even if this were to result in deficits in 2003 above the 3 percent of GDP limit. In Japan, despite recent measures, monetary policy needs to be much more aggressive to combat deflation. A start toward medium-term fiscal consolidation is now needed to begin to rein in Japan's high and rising public debt, unless more ambitious corporate and financial sector restructuring—which could exert a near-term drag on the economy—is undertaken.

- *In emerging markets*, the situation continues to vary substantially across countries. In those countries experiencing external financing difficulties, macroeconomic policies must continue to be aimed at rebuilding external confidence; elsewhere—particularly in many countries in Asia—there is more room for policy maneuver in response to adverse shocks. As noted above, a number of emerging market countries could be seriously affected by a prolonged war in Iraq, and in some cases additional assistance from the international financial community may be necessary.
- *A greater sense of urgency is needed in implementing policies to reduce global dependence on the United States and foster an orderly reduction in global imbalances over the medium term.* As has long been argued in the *World Economic Outlook*, a broad-based and multilateral effort is required, including aggressive steps to address the serious corporate and financial sector problems in Japan; accelerating labor and product market reforms in Europe; reestablishing a sound medium-term fiscal position in the United States; and shifting from external to domestic sources of growth in emerging Asia, including through additional financial and corporate reforms (in China, greater exchange rate flexibility is also desirable). The broader such efforts, the less the burden of an eventual adjustment on individual countries or regions, and the greater the prospect of an orderly resolution. In the event, notwithstanding some welcome but still rather partial moves in Japan, progress over the last six months has been limited (although, if implemented, the recent proposals announced by the German authorities appear an important step in the right direction); moreover, in the United States, if the administration's budget proposals are adopted, significant budget deficits will remain well into the next decade. Beyond the multilateral aspects, this lack of progress significantly increases medium-term vulnerabilities and reduces medium-term growth prospects in individual economies themselves. For example, as discussed in Chapter IV, if the euro area reduced product and labor market rigidities to U.S. levels, GDP could be boosted by 10 percentage points over the medium term.
- *Fiscal consolidation remains a central medium-term priority around the globe.* In the industrialized world, public debt is already very high in Japan and some parts of the euro area, and almost all countries face mounting fiscal pressures from aging populations. While the scope for short-term tightening is inevitably constrained by the current cyclical situation, additional action to ensure medium-term sustainability is required in many cases, including by reforming pension, health, and benefit systems and in some cases reining in substantial shadow economic activity. In emerging markets, the size and structure of public debt are significant sources of macroeconomic vulnerability in Latin America, and public debt accumulation—including off–balance sheet

liabilities—is also an increasing concern in some countries in emerging Asia, including India and China. The key priorities include civil service reform, broadening tax bases and improving tax administration, addressing governance problems, and reducing contingent liabilities (including by strengthening banking and pension systems).

- *Among the poorest countries, the central priority is still to put in place the policies needed to reduce poverty, and to make progress toward meeting the other Millennium Development Goals.* This will require, among other things, an enduring increase in GDP growth, which—particularly in sub-Saharan Africa—remains well below the levels necessary to achieve these goals. While action is needed in many areas, one overarching priority is to strengthen institutions, a central theme of this issue of the *World Economic Outlook*. As discussed in Chapter III, the quality of domestic institutions plays a key role in explaining differences in income levels, growth rates, and growth volatility across countries. Improvements in this area could have a profound effect on economic performance: for example, other things being equal, the estimates in Chapter III suggest that real GDP per capita in sub-Saharan Africa could be 80 percent higher if its institutions were on a par with those in developing Asia.

While the importance of institutions is clear, there is no simple or unique path to success. A certain amount of adaptation of what has worked elsewhere, and innovation to suit local circumstances, history, and culture is required, and domestic ownership is essential. That said, external incentives have often played an important supporting role. For example, the European Union (EU) accession process appears to have anchored recent improvements in institutional quality in central and eastern Europe, as have membership requirements for the WTO in China and elsewhere. In other cases, including the New Partnership for Africa's Development (NEPAD), which places strong emphasis on institutional development, collective commitments and peer pressure are expected to be the driving mechanisms.

The efforts of the poorest countries to improve their economic management and institutions must be accompanied by additional assistance from industrial countries. Despite recent welcome increases, aid flows from most countries are still well below the UN target of 0.7 percent of GNP; most immediately, additional assistance is required to address the famine in Africa. Even more important, rapid action is required to improve access by the poorest countries to industrial country markets, particularly in agriculture. In 2001, agricultural sector support in the Organization for Economic Cooperation and Development (OECD) countries totaled over $300 billion, six times the level of official development aid, and accounting for nearly one-third of OECD farmers' incomes.[5] As the IMF's Managing Director noted recently, "If poverty reduction in developing countries is to be tackled seriously, this discrepancy must be addressed now."[6] In this connection, it is particularly unfortunate that multilateral trade negotiations under the Doha Round appear to be falling behind schedule, and all parties need to make renewed efforts to address the key roadblocks to further progress, especially in the areas of agriculture and public health. Indeed, progress in addressing these issues before or at the upcoming WTO Ministerial in Cancún could play a critical role in rebuilding global confidence.

North America: How Long Will the "Soft Spot" in the United States Last?

The U.S. economy failed to sustain in the second half of last year the momentum it assumed

[5]See "How Do Industrial Country Agricultural Policies Affect Developing Countries?" *World Economic Outlook*, September 2002.

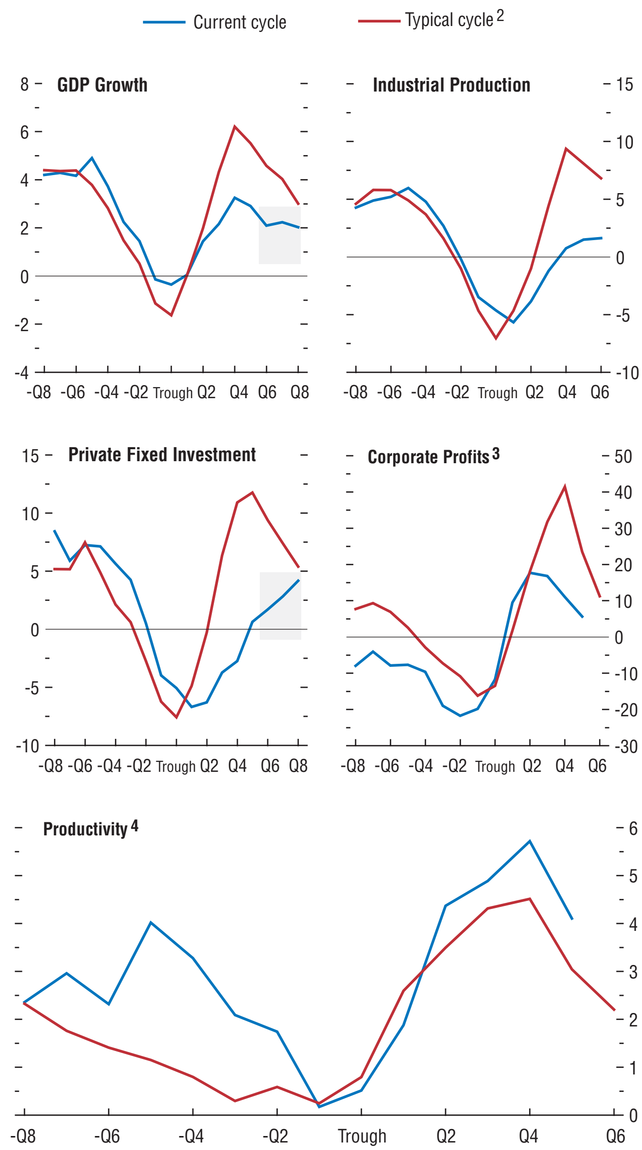
[6]"Strengthening the Framework for the Global Economy," address by Horst Köhler on the occasion of the Award Ceremony of the Konrad Adenauer Foundation Social Market Economy Prize, Berlin, November 15, 2002.

as it emerged from recession at end-2001, with growth in the fourth quarter of 2002 in particular turning very low—the "soft spot" (Figure 1.7). Apart from the stock cycle, activity in the first half of 2002 benefited from a number of factors—the mortgage refinancing boom, motor vehicle purchase incentives, and tax cuts—which buttressed consumer spending. But with labor market conditions softening—the unemployment rate rose to 6 percent at year-end—and volatile stock prices, consumer confidence fell sharply and consumption slowed in the fourth quarter, while lackluster demand, ample spare capacity, and still-high credit spreads (which peaked in October) dampened investment. Weaker recoveries abroad and the still-strong dollar led to a sizable negative contribution from net exports.

In early 2003, although the fundamentals driving the medium-term outlook—notably productivity—remain sound, the sense is that the soft spot will fade only gradually, particularly given the impact of the uncertain geopolitical environment on investment. Household spending seems unlikely to continue to provide the same support to activity as in recent years. Household debt has continued to outpace disposable income while households' net worth, in the face of housing gains that have only partly offset stock market losses, has been cut significantly; the potential for boosting spending from mortgage refinancing has probably run its course, while auto discounting is now a thing of the past. And consumer confidence and the labor market remain soft, with firms continuing to face pressures to bear down on costs to support the pickup in earnings embedded in current equity market valuations in the face of lackluster sales. The evidence on capital spending is mixed: while the new orders component of the Institute for Supply Management (ISM) index rose sharply in early 2003, ongoing risks and uncertainties relating to the geopolitical situation, still-weak investor confidence, high levels of corporate debt, and the scarcity of venture capital suggest a sluggish pickup initially. This said, the policy stimulus in the pipeline—

Figure 1.7. United States: Business Cycle[1]
(Percent change from four quarters earlier)

Economic activity, business investment, and corporate profits have picked up more slowly during this upswing than in a typical recovery. However, productivity—which held up during the slowdown—has recovered more quickly during the upswing than is typical.



Sources: Haver Analytics; and IMF staff estimates.
[1]Shaded areas indicate IMF staff projections.
[2]Simple average of previous trough cycles.
[3]Nonfinancial corporate profits before tax, adjusted for inventory valuation and capital consumption.
[4]Nonfarm business sector—output per hour for all persons.

following the cut in the target for the federal funds rate to 1¼ percent last November and the large turnaround in the structural unified balance, including (if implemented) from the U.S. administration's tax cut proposals announced in January—is likely to help cement recovery, with growth picking up after midyear but held to 2.2 percent for 2003 as a whole.

While the potential for a quick resolution of geopolitical uncertainties represents an upside risk to the outlook, remaining risks are mainly weighted to the downside. Clearly, the most immediate risk relates to the potential for a protracted war with Iraq, which would worsen the fiscal position temporarily and—through higher oil prices and weaker confidence and stock market prices—create potential for a double-dip recession, even with an appropriate further easing of monetary policy. Beyond this, a key risk relates to whether bubble-period excesses have fully worked themselves out. While the evidence is mixed on the extent of the capital overhang following the investment boom of the late 1990s, capacity utilization indicators do suggest significant spare resources throughout the economy, including in the IT, airline, automobile, and energy sectors. Stock prices—which are still pricing in a significant pickup in earnings—are another source of risk, given uncertainties about the speed of pickup in sales growth and the limited further mileage from cost cutting on profits. The potential for housing prices to fall following the heady rises in some metropolitan areas is a further concern, given the stabilizing role of housing wealth in recent years. A third risk relates to the slow adjustment of the U.S. current account deficit—which is now mostly debt financed—and could engender an abrupt drop in the dollar that could in turn trigger upward pressure on interest rates and a disruption of recoveries both in the United States and abroad.

These risks are tempered, however, by the impressive productivity performance of the U.S. economy. Going forward, recent data give cause for guarded optimism—indeed, just as employment fell less than is typical during the downswing, output has expanded without significant job growth during the recovery and productivity has remained very solid. Nonetheless, the size of the medium-term gains from the IT revolution remains uncertain at this stage—recent studies suggest sizable benefits within the sector in terms of multifactor productivity, but the evidence remains mixed about the gains outside apart from those from capital deepening (Box 1.2). Strong productivity growth remains essential to support incomes in the medium term and would thereby lower downside risks for profitability, stock prices, investment, and growth.

The monetary policy response to the economy's "soft spot" appears appropriate. The decision by the Federal Reserve in November to reduce the federal funds rate by 50 basis points should help to secure a more robust rebound in the second half of this year. Monetary policy going forward will need to remain attuned to evolving risks, but the authorities still have room to reduce rates further if the economic outlook deteriorates. On fiscal policy, the U.S. administration's FY2004 budget proposals—expected to cost 1½ percent of GDP in FY2003 and FY2004—raise concerns in light of the insurance for the recovery already provided by interest rate cuts and the uncertain costs of the war, which have not yet been factored in, not least because of the deterioration in the fiscal position to date (larger in structural terms than in any previous downturn in four decades) and the adverse impact on the medium-term deficit path (which will continue to face pressures from rising social security and Medicare costs and still-optimistic projections for discretionary spending). The objective at this point should instead be to establish a framework that sets the clear goal of balancing the budget (excluding social security) over the cycle, underpinned by base-broadening revenue reforms (e.g., reducing tax expenditures for households and corporations) and reforms to social security and Medicare to put these programs on a sound financial footing over the medium term. Strict enforcement of enhanced corporate governance rules remains essential to reestablish investor confidence, including the provisions of the Sarbanes/Oxley Act and new stock exchange listing rules.

In Canada, projected growth of 2.8 percent this year is again likely to surpass that in the other major industrial countries. This said, prospects remain uncertain as a result of the slower pickup in the United States since mid-2002 and would clearly be affected were downside risks to the U.S. recovery to materialize. The soft spot in the United States has so far been transmitted mainly through weaker U.S. spending on autos and other durables, which contributed to a marked slowdown in industrial production in the latter half of 2002; consumer and business confidence have also been dampened. Despite output nearing potential, interest rates were held steady from mid-summer 2002 to early 2003, following a cumulative hike of 75 basis points earlier in 2002—an appropriate response given that inflationary expectations remained well anchored and given the weight of downside risks to growth. In March, with core inflation having breached the 1–3 percent target range, the Bank of Canada moved to raise the overnight rate by 25 basis points, and further withdrawal of monetary stimulus may nevertheless be necessary in coming months, particularly if geopolitical uncertainties are resolved speedily. Sound fiscal management has also helped to support recovery (through both the operation of automatic stabilizers and some discretionary measures) while continuing to pay down public debt, but pressures from population aging and the still-high debt/GDP ratio underscore the need for a continued commitment to debt reduction and reforms to contain rising health care costs.

Western Europe: Weak Growth (Particularly in Germany) and Delayed Recovery

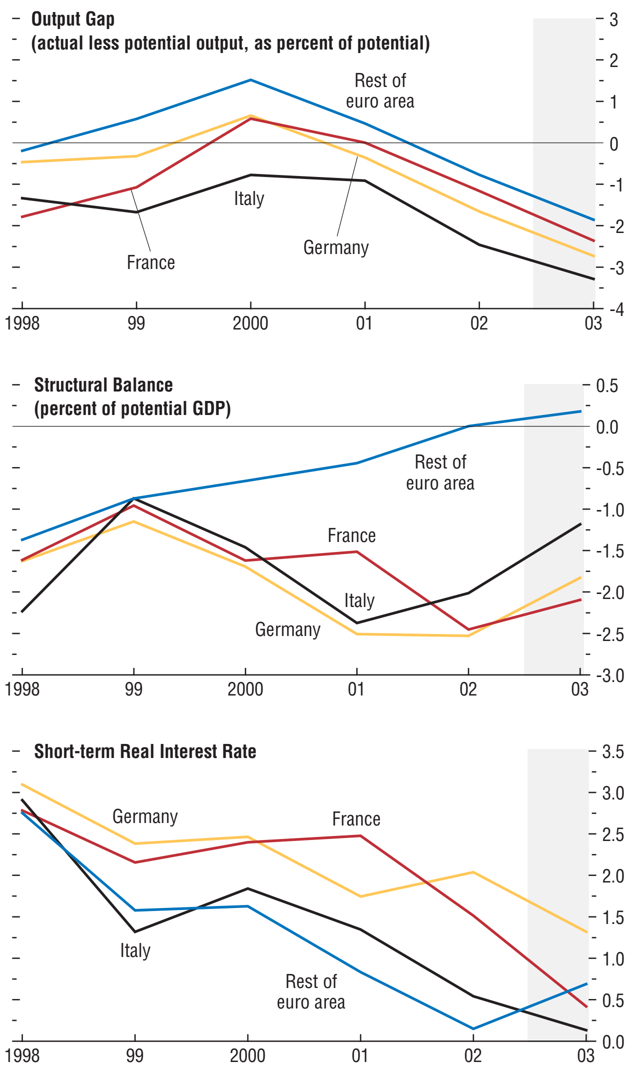
Euro area growth continued to disappoint in the second half of last year, especially in Germany, and prospects remain lackluster. While rising exports helped to initiate recovery in early 2002, they failed to ignite a robust pickup in domestic demand thereafter. Consumption—boosted by higher real wages and the impact of generous automatic stabilizers on take-home pay—grew modestly, while investment cuts continued, reflecting subdued demand, the poor profits outlook, and labor market rigidities that encourage labor hoarding. Indicators suggest a weak recovery going into 2003, with consumer sentiment depressed, industrial production flat, and unemployment rising slightly. Growth for 2003 as a whole is projected at 1.1 percent, some 1¼ percent lower than in the September 2002 *World Economic Outlook,* and well below potential.

Despite weak confidence, consumption is again likely to underpin activity this year, as the fading impact of earlier price shocks boosts real disposable incomes. Other supportive factors include the inventory cycle—surveys suggest destocking may now have run its course—and exports, reflecting the impact of somewhat stronger global demand, which offsets the effect of the stronger euro. The outlook for investment—which has contracted continuously since mid-2000—is more tentative, especially given the prospect of wider output gaps and spare capacity this year, weak business confidence, and excess corporate leverage.

The risks to this disappointing outlook are, moreover, tilted to the downside. An immediate uncertainty relates to the potential for a protracted war with Iraq, especially through its impact on oil prices and confidence. Beyond this, a key uncertainty relates to corporate behavior, and the potential for more drawn-out balance sheet adjustments to the equity price slump (larger in Europe than in the United States) going forward. This could have implications not only for investment, but also for employment and consumption. A larger impact of financial strains (including from losses by life insurers and pension funds on their equity holdings) is also possible. Interactions between bank and firm weaknesses—particularly in Germany where bank profits are weak, corporate insolvencies are surging, property prices continue to

Figure 1.8. Euro Area: Divergences in Cyclical Positions, Structural Fiscal Balances, and Real Interest Rates

Despite relatively large (and widening) output gaps, Germany and Italy are set to experience relative large fiscal contractions in 2003, and Germany will also face relatively high real interest rates.



slump, and equity price declines have eroded hidden capital reserves—could heighten banks' risk aversion and undercut the credit process (Box 1.3).

Within this overall picture, Germany's stagnation remains a particular concern, the more so given the dearth of evidence of a turnaround, with industrial production, business confidence, and retail sales continuing to slump, and the jobless rate at a three-year high. Macroeconomic policies, moreover, will be less supportive than elsewhere in the euro area (Figure 1.8), with planned fiscal contraction, to be achieved in part through higher taxes and social security payments, already dampening consumer sentiment. The outlook for France has also been marked down, reflecting among other factors weak consumer confidence and the soft labor market. In Italy, the slow pace of recovery in the second half of 2002, and subdued consumer and business confidence, point to a slower pickup in economic activity than previously forecast. Elsewhere, relatively strong growth is expected this year in Spain, Greece, and Ireland—reflecting, among other things, relatively supportive monetary conditions as inflation exceeds the area average—but activity in Belgium and the Netherlands is likely to be weaker, while a contraction in output is expected in Portugal—in the latter case owing to the continuing difficult fiscal situation after the 2001 breach of the SGP deficit ceiling, as well as to rising financial strains from high levels of household and firm debt.

The silver lining in the growth outlook is that inflation should decelerate significantly in 2003–04 (provided oil prices come down as assumed in the baseline); encouraging signs in this direction appeared already toward the end of last year, aided by the recent strength of the euro. While recent wage settlements in Germany should prevent inflation from sinking too far, risks of deflation are likely greater there than elsewhere in the industrial world outside Japan (Box 1.1). Against this background and the improving prospects for price stability across the euro area, the decision of the European

Box 1.3. How Important Are Banking Weaknesses in Explaining Germany's Stagnation?

Over the past several years, the German banking system has come under increasing pressure from low profitability and deteriorating credit quality, as well as the impact of the global downturn. At the same time, corporate balance sheets have also come under strain: as in the United States and the rest of the euro area, German enterprises took on more debt during the recent boom phase, resulting in a significant increase in leverage.[1] As experience elsewhere (notably in Japan during the 1990s) has shown, the confluence of stresses in the banking and corporate sector can have a serious effect on growth, raising questions as to how far such problems—as yet less serious in Germany than those in Japan—may have contributed to Germany's disappointing recent economic performance and the implications for the pace of recovery.

The weakness in the German banking system reflects a combination of structurally low profitability and the cyclical downturn. Low profitability stems from a number of factors, including overdependence on low interest rate margin business; stubbornly high cost ratios; and a traditionally large role of public financial intermediation. To improve profitability, banks have sought to diversify into more commission-based business (such as equity brokerage), reduce staff, and close expensive branch networks. However, to date these measures have only been partially effective: commission-based business fell off sharply in the downturn, and Germany's inflexible labor markets have made it more difficult to reduce overstaffing, though renewed efforts in 2002 met with some success. Private banks' problems have also been exacerbated by poor strategic plans and competition from some subsidized public banks (mainly due to lower funding costs obtained from public guarantees). Limitations on merger activity across types due to differing legal charters (e.g., Landesbanken by each Land, savings banks by their local municipalities) have also reduced the scope for consolidation with the sector, resulting in one of the most "overbanked" economies in Europe, despite mergers among a number of smaller institutions in recent years.

German banks' financial condition and credit growth has also been seriously affected by the cyclical downturn. While measures of nonperforming loans (NPLs) do not appear to have increased—although supervisors receive regular information, data on system-wide NPLs are not publicly available on a timely basis—the sharp rise in bankruptcies to near-record highs suggests that the credit quality of loans is likely to have worsened.[2] At the same time, as noted above and in Chapter II, corporate balance sheets have come under increasing strain. Correspondingly, banks have been less willing to supply loans at previous spreads and enterprise surveys suggest that credit has become harder to obtain.[3]

The bursting of the equity bubble has also had a substantial impact on German banks, which—being universal banks—are permitted to hold shares in other enterprises. Until recently, German banks used capital gains on such holdings to build up reserves, providing a cushion to offset low profits in lean years. Although there is little information on the current value of these reserves, market analysts believe that they may now be largely eliminated. (Equity sales prompted by the 2000 tax reform, under which realized capital gains went untaxed, also reduced reserves.) That said, unrealized reserves may only be counted toward Tier-2 capital if the Tier-1 capital ratio is above 4.4 percent, and even then they are limited, making equities' effect on capitalization less of an issue in Germany than in Japan. While housing prices in Germany have also declined since the post-

Note: The main author of this box is Laura Kodres.

[1]See Chapter II and Jaeger (2003).

[2]The rise in bankruptcy filings may not be due entirely to the sluggish economy. The German bankruptcy code was amended recently to allow firms to declare bankruptcy more easily and exit from bankruptcy as going concerns.

[3]See Creditreform (2002).

Box 1.3 *(concluded)*

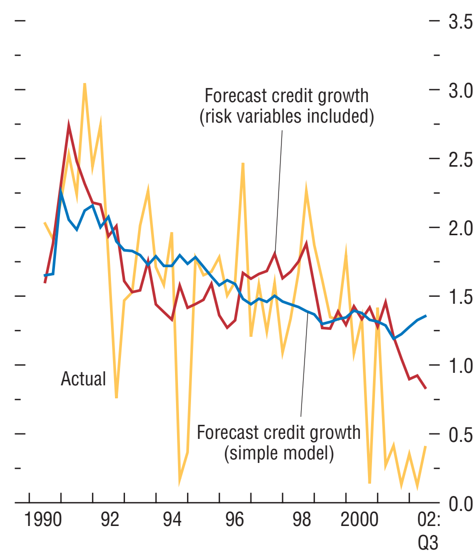
unification real estate boom, the impact on banks has been limited, owing to the application of conservative loan-to-value ratios. In addition, most of the inflated real estate values appear to have been in eastern Germany—specifically Berlin—and the impact has so far been limited to a few banks in that region.

To what extent can the recent weakness in credit growth in Germany be ascribed to declining credit demand in a downturn, and how much to underlying problems in the banking system? Recent econometric analysis suggests that factors influencing the demand for credit (including expected growth and interest rates) alone cannot account for the depth or length of the credit slowdown, and that factors influencing banks' willingness to lend—proxied by measures of their financial health (including capital adequacy and loan-loss provisions)—add explanatory power (see the figure).[4] These results, combined with other survey evidence, indeed suggest that supply factors have played some role in constraining credit growth.[5]

Could the poor health of German banks have implications for the rest of Europe or the world? One key transmission channel would be through interbank lines between German banks and foreign banks, although these are important mostly for the largest private banks and Landesbanken (publicly owned banks).[6] If liquidity problems were to arise, the "Liquiditäts Konsortialbank," owned by a consortium of banks, including the central bank, is available to provide short-term liquidity support to small and medium-sized banks, though it is unclear what precise mechanisms would operate to provide support in the case of a large-bank liquidity problem. A second channel is through a reduction in lending by German banks to foreign nonbank firms: some 15 percent of total lending to nonbanks is outside Germany. Through end-September 2002, Bank for International Settlements (BIS) statistics suggest that total German bank exposures are already down from their peak at end-September 2001 by 3 percent ($55 billion) for developed countries and by 6 percent ($12 billion) for developing countries.

Overall, while the decline in credit growth is clearly being driven in part by the cyclical slowdown, banking weaknesses are likely also having an effect. While most analysts believe that these problems are not systemic at present,[7] they could nevertheless grow over time, particularly if economic recovery is delayed and the deteriora-

Credit Growth[1]
(Quarterly percent change)



[1]Credit to domestic enterprises and private persons.

[4]See IMF (2002) and Deutsche Bundesbank (2002).

[5]Small and medium-sized enterprises may be particularly constrained as traditionally they have not sought to borrow from other sources, such as foreign banks. Some believe that the early adoption of credit risk management techniques under the new Basel II Accord, which may have revealed previously undetected credit risks, has also played a role in reducing the supply of loans.

[6]These banks carry about one-third of total domestic loans and the Landesbanken maintain explicit state guarantees until 2005.

[7]Moody's Bank Risk Monitor, November 2002.

tion in corporate balance sheets and profitability are not reversed. While there are no quick fixes, banking policies should focus on improving banks' ability to raise their profitability, including by fostering consolidation within the sector; facilitating labor retrenchment; and leveling the playing field for all bank intermediaries by facilitating the removal of public guarantees. Increasing transparency and the availability of timely information on banks' financial health is also key to coming to early solutions, ultimately lowering the costs of dealing with banking problems. Germany's participation in the IMF's Financial Sector Assessment Program (FSAP), now under way, should provide further insights into the health of the financial sector and adequacy of the supervisory arrangements.

Central Bank (ECB) to ease monetary policy in late 2002 and early 2003 was appropriate. Further cuts should be considered, and action will be needed if the recovery remains weak or the euro appreciates further. The ongoing ECB review of its monetary framework is welcome, and could foster better understanding of how the ECB interprets its price stability objective and how it applies the two-pillar strategy in practice.

Fiscal pressures in the euro area continued last year, with the area-wide deficit rising to 2¼ percent of GDP (compared with Stability Program projections of 1 percent), and Germany joining Portugal as the second country breaching the SGP's 3 percent limit. In 2003, the euro area deficit is set to rise somewhat further, to 2½ percent of GDP, with Germany and France posting deficits of about 3½ percent of GDP. While Germany is likely to undertake significant structural adjustment in an attempt to bring its deficit below the SGP ceiling in 2004, the projected structural deficit reduction in France depends critically on carrying through recent expenditure restraint measures. In Italy, concerns continue to center around the large component of temporary measures in the 2003 budget and the extensive use of tax amnesties, which puts at risk future tax compliance. The dilemma in the near term remains to avoid unduly adding to economic headwinds through excessive retrenchment (especially, as in Germany, through reliance on ad hoc revenue measures rather than durable fiscal reforms), without compromising the credibility of the SGP itself. This demands continued reductions in structural deficits toward the medium-term norm of close to balance, but with full play of automatic stabilizers around such paths. In the longer term, most area economies face the need to strengthen further their fiscal positions—likely well beyond SGP norms—to provide scope to reduce tax burdens and meet pension and health care expenses associated with population aging.

While steps taken in recent years to rationalize unemployment benefits and reduce tax wedges in Europe's labor market have helped to boost job creation (especially for low-skilled and part-time workers) and labor market flexibility, unemployment remains high, and participation rates—especially of people aged over 55—are still much lower than in other advanced countries. Further efforts to address still-generous out-of-work benefits and cumbersome job regulations could have a sizable impact on unemployment and potential growth over the medium term (see Chapter IV). In this connection, the recent proposals put forward by the German authorities to improve incentives to work and begin dismantling excessive job protection are welcome. Efforts in the euro area to improve the flexibility of labor makets should be combined with an accelerated approach to financial sector integration—including extending the Lamfalussy process to fast-track banking and insurance legislation—and steps to liberalize the internal market for services, including harmonizing standards and regulations that limit cross-border retailing.

Turning to the other major European economies, strong domestic demand has helped to sustain healthy growth in the United Kingdom. While consumer spending—which held up very well last year as the potential bubble in house prices contributed to a surge in housing-related wealth—may slow somewhat this year (given the rise in household debt to record levels and the fall in equity wealth), this should be offset by continued strong public demand and a modest recovery in net exports, resulting in GDP growth of 2 percent. While fiscal stimulus since 2000—driven by the widespread demand for improved public services in the context of a strong rules-based framework—has been helpful to support growth, vigilance is needed to safeguard the efficiency of spending. In February, in light of weakening prospects for external and domestic demand, the Bank of England eased its policy rate by 25 basis points (to 3.75 percent) for the first time since November 2001. If the balance of risks tilts further to the downside and house prices continue to soften, there may be scope for additional monetary policy easing.

Elsewhere, the economies of Denmark, Norway, and Sweden are expected to post growth of about 1½ percent this year, similar to 2002. Consumption will be supported by solid gains in disposable income in the context of a tight labor market, although low business confidence could constrain the pickup in manufacturing activity and business investment this year. With core inflation expected to fall below their respective inflation targets over the next one to two years in part owing to the slower-than-expected global recovery, monetary easing in Sweden and Norway in late 2002 and early 2003 was appropriate. In Switzerland, the economy has been stagnating, and leading indicators suggest that the recovery will be later and weaker than in the euro area, in part owing to the renewed appreciation of the Swiss franc. The Swiss National Bank has appropriately reacted by reducing its target interest rate to 25 basis points at the end of last year. Further easing, perhaps through foreign exchange intervention, may be warranted if the economy seems unlikely to rebound in the second half of this year as currently projected.

Japan: Weak Economy Underlines Need to End Deflation

Japan's entrenched deflation and weak economic prospects underline the urgency of taking aggressive action to reestablish positive inflation. Prices of goods and services have now fallen for four consecutive years, which is unprecedented in industrial countries in the past half century. Persistent deflation is dangerous because it limits monetary policy flexibility, increases real debt burdens, and provides an incentive to delay spending, which reinforces deflation, thus risking a deflationary spiral. One key determinant of persistence is expectations, and there is evidence that deflationary expectations are worsening (Figure 1.9). For the past four years, CPI inflation has turned out to be more negative than the year-ahead forecast, so initial expectations are ratcheting down. Deflationary expectations are becoming more widespread, with an increasing proportion of survey respondents expecting prices to fall rather than rise. Finally, a recent survey suggests that most people expect deflation to last at least two more years.

The recovery that began in the second quarter of 2002 seems to have waned. Revisions to the national accounts data indicate that GDP in the first half of 2002 was significantly stronger than estimated at the time of the September 2002 *World Economic Outlook*, which contributed to an upward revision of the growth estimate for the year as a whole. However, the recovery lost steam in the fourth quarter of 2002, as domestic demand slowed markedly, reflecting a sharp drop-off in consumption growth and a drawdown in inventories. Moreover, monthly economic indicators painted a weaker picture of economic activity in the fourth quarter than did the national accounts data. Excess capacity remained substantial, with the unemployment rate at a record level, capacity utilization in manufacturing declining, and Tokyo office vacancy rates rising.

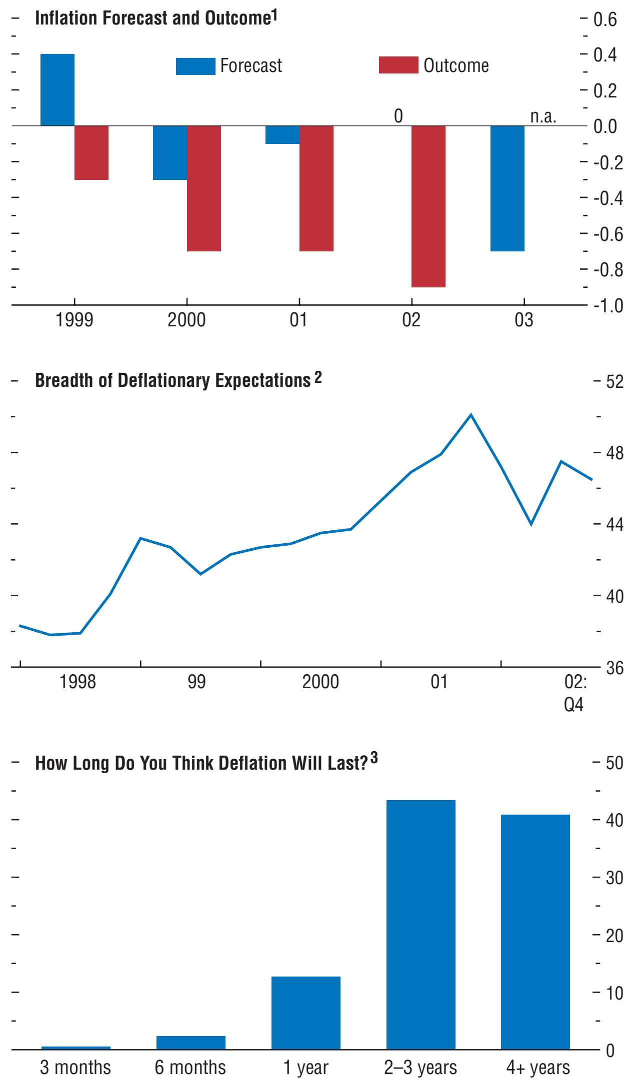
Looking ahead, the economy is unlikely to gain much momentum in the short term. Private consumption is expected to remain weak, reflecting difficult labor market conditions. The March 2003 *Tankan* survey predicted some deterioration in business conditions in the second quarter of 2003 and firms' expectations for sales, profits, and fixed investment for the year ending in March 2004 were mixed. In financial markets, equity prices plummeted to around 20-year lows, reflecting the weakness in global equity markets, concerns about the outlook for banks and highly indebted corporates, and questions about the sustainability of the recovery. Yields on 10-year government bonds fell below 80 basis points (a record low). Reflecting the weakness of recent indicators and the decline in equity prices, the growth forecast for 2003 has been revised down to 0.8 percent.

The risks to the outlook are predominantly on the downside. In the immediate future, geopolitical risks are a central concern. A protracted war in Iraq could have a significant impact on growth through higher oil prices, falling equity prices, and weaker consumer confidence and investor sentiment, especially in view of Japan's fragile economic situation and the weaknesses in financial institutions. More generally, the most significant risk remains a worsening of banking problems, possibly prompted by further declines in equity prices or mismanaged efforts to strengthen banks, such as forcing the recognition of problem loans without adequate measures to replenish bank capital. A related risk is a credit crunch, as some banks may curtail lending in attempts to improve their capital adequacy ratios.

To improve medium-term growth prospects, aggressive action is urgently needed to end deflation. Despite the Bank of Japan's efforts to combat deflation through quantitative easing, including the increases in late 2002 in its targets

Figure 1.9. Japan: Deflationary Expectations Worsening
(Percent)

In recent years, CPI inflation has turned out to be more negative than the year-ahead forecast; an increasing proportion of survey respondents expects price to fall; and most people expect deflation to last at least two more years.



Sources: Consensus Forecasts; and Ministry of Economy, Trade and Industry.
[1] Forecast refers to the Consensus Forecast in January of the previous year, and outcome refers to the Consensus Forecast in December of the current year.
[2] Proportion of survey respondents that expects prices to fall minus proportion that expects prices to rise.
[3] Ministry of Economy, Trade and Industry Survey, August 2002.

for bank reserves and outright purchases of government bonds, prices continue to decline, in part because the inflation process is driven as much by expectations of future monetary policy as by present monetary conditions. To reverse deeply ingrained deflationary expectations, the Bank of Japan could be more aggressive in both its actions and communications. It would be helpful for the Bank of Japan to state clearly to the public that it will do whatever is necessary to restore inflation within a reasonably short time frame, and that it will in the medium term target a sufficiently positive inflation rate to minimize the risk of again becoming constrained by the zero lower bound on interest rates. If the yen depreciated sharply, the regional impact would likely be manageable given the movement toward flexible exchange rates and healthier reserve and external debt positions.

Restoring positive inflation will help medium-term prospects, but the benefit would be substantially larger if aggressive quantitative easing were accompanied by broad restructuring of the banking and corporate sectors. At present, large bad loans and weak capital bases reduce banks' willingness to lend. The government's new plan to strengthen banks, announced in October 2002, contains a number of welcome measures and has prompted some banks to strengthen their capital bases by raising private funds. However, more needs to be done to resolve banking problems. Specifically, it is necessary to accelerate adequate provisioning against bad loans, improve the calculation of regulatory capital, amend the law to facilitate injecting public capital into weak banks, strengthen bank profitability, and cover smaller and regional banks in the plan.

More rapid progress in bank restructuring is essential to accelerate corporate restructuring, because underprovisioning against bad loans reduces banks' willingness to restructure or liquidate companies. To promote corporate restructuring, banks need to be adequately provisioned against their bad loans, and subject to deadlines to agree upon realistic restructuring plans with viable firms or liquidate unviable ones. It will also be important to limit government involvement in this process, including by limiting the role of the new Industrial Revitalization Corporation to buying bad loans from banks and reselling them to the private sector, rather than "picking winners" to be restructured with the help of public funds. Other policies are also needed, including measures to ease the reallocation of labor and deregulation in the retail, real estate, and health services sectors. As some of these reforms may have an adverse impact on employment in the short term, it is important that an adequate social safety net be in place.

The general government structural deficit is projected to decline modestly in 2003. Unless more ambitious structural policies are implemented, gradual fiscal consolidation is warranted, given the large government budget deficit and high level of public debt. Further progress could be made in establishing a credible medium-term strategy for fiscal consolidation and implementing key fiscal reforms, such as reforms of the social security system, de-earmarking road-related tax revenues, and reforming public road corporations. Measures are also needed to strengthen the tax base, such as lowering the income tax threshold, introducing taxpayer identification numbers, and reducing deductions.

Latin America: Spreads Declining But Significant Vulnerabilities Remain

Latin America as a whole experienced in 2001–02 its worst downturn in two decades, and prospects are still uncertain. In the second half of 2002, industrial production recovered and preliminary figures suggest that real GDP grew modestly (Figure 1.10). The turnaround was driven primarily by net exports, as the substantial real exchange rate depreciations earlier in the year boosted exports and curtailed imports. Financial market indicators improved somewhat after October, reflecting the global increase in risk appetite as well as the reduction in political uncertainties in Brazil. While equity markets have strengthened, spreads on sovereign bonds are still high and financing conditions remain difficult for sub-investment-grade borrowers.

Economic performance in 2002 varied considerably across countries (Table 1.6). The declines in output in some countries were due to the economic crisis in Argentina and its spillover effects on Uruguay and Paraguay, as well as the ongoing political crisis in Venezuela. Brazil was also affected by weakening market sentiment, but—following the presidential election in October—clear signals that future macroeconomic policies will be geared to safeguarding macroeconomic stability have begun to reassure investors. Mexico and Chile suffered least from the deterioration in external financing conditions, reflecting their strong policy records and relatively high integration with the world economy.

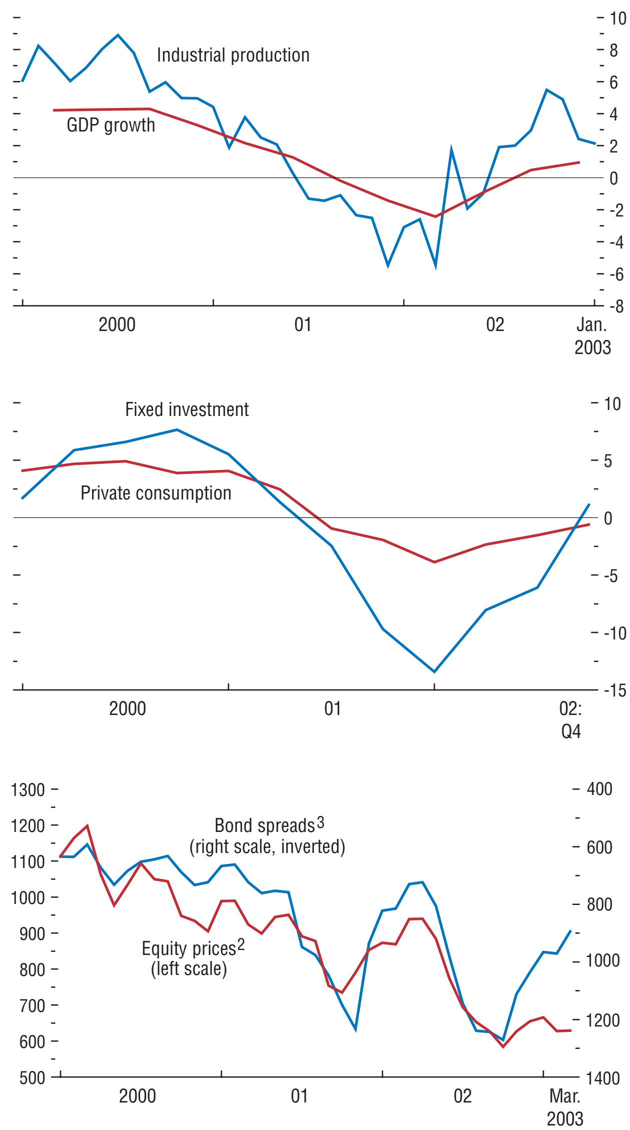
In most countries, there was limited scope for using macroeconomic policies to mitigate the impact of external shocks. Large public sector financing requirements and debt burdens forced governments to respond to falling tax revenues (reflecting weaker activity) and rising debt service (reflecting higher interest payments) by tightening fiscal policies to keep borrowing requirements under control and shore up investor sentiment. Similarly, the vulnerability of financial systems to balance sheet strains arising from currency depreciation—reflecting the significant dollarization of public debt and private bank deposits—forced many countries to respond to currency weakness by tightening monetary policy and intervening to support their currencies in the foreign exchange market. By contrast, some countries with stronger fiscal positions and lower inflation were able to cut interest rates and increase government spending.

The economic outlook remains fragile and dependent on developments in the United States, though short-term prospects are generally better in countries with stronger policy fundamentals. In the immediate future, geopolitical risks remain a key concern: most countries would suffer from a prolonged war in Iraq, as this would likely lead to a deterioration in exter-

Figure 1.10. Selected Western Hemisphere Countries: Economic Activity and Financial Indicators[1]

(Percent change from a year earlier unless otherwise indicated)

Economic activity stabilized in the second half of 2002, supported by a turnaround in net exports, as consumption and investment bottomed out. Bond spreads have narrowed, but remain high, and equity prices appear to have reached a trough.



Sources: Bloomberg Financial Markets, LP; and Haver Analytics.
[1]Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.
[2]MSCI Index.
[3]EMBI+.

Table 1.6. Selected Western Hemisphere Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
Western Hemisphere	**0.6**	**–0.1**	**1.5**	**4.2**	**6.4**	**8.7**	**11.0**	**6.9**	**–2.8**	**–1.0**	**–1.1**	**–1.6**
Argentina	–4.4	–11.0	3.0	4.5	–1.1	25.9	22.3	13.0	–1.7	8.3	7.8	6.7
Brazil	1.4	1.5	2.8	3.5	6.8	8.4	14.0	5.5	–4.6	–1.7	–1.5	–2.3
Chile	2.8	2.0	3.1	4.8	3.6	2.5	3.3	2.9	–1.8	–0.9	–1.5	–1.1
Colombia	1.4	1.6	2.0	3.3	7.8	6.3	5.6	4.3	–1.9	–2.0	–0.8	–1.6
Ecuador	5.1	3.0	3.5	5.2	37.7	12.6	7.4	5.5	–2.4	–6.6	–5.9	–3.9
Mexico	–0.3	0.9	2.3	3.7	6.4	5.0	4.3	3.3	–2.9	–2.2	–2.2	–3.1
Peru	0.6	5.2	4.0	4.5	2.0	0.2	2.5	2.5	–2.0	–2.0	–1.9	–2.0
Uruguay	–3.1	–10.8	–2.0	4.5	4.4	14.0	27.9	21.2	–2.9	1.2	2.3	1.6
Venezuela	2.8	–8.9	–17.0	13.4	12.5	22.4	37.5	40.9	3.1	8.1	4.9	5.6
Central America[3]	**1.9**	**1.9**	**2.4**	**3.1**	**7.3**	**5.4**	**5.5**	**4.9**	**–5.9**	**–5.2**	**–5.8**	**–5.7**
Caribbean[4]	**1.9**	**2.8**	**2.3**	**3.1**	**7.5**	**5.4**	**10.0**	**4.6**	**–4.1**	**–4.3**	**–4.0**	**–3.7**
Other Latin America[5]	**1.9**	**–0.3**	**1.2**	**3.3**	**4.0**	**4.9**	**9.5**	**6.9**	**–3.2**	**–3.8**	**–3.9**	**–3.8**

[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 during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Includes Belize, Costa Rica, El Salvador, Honduras, Guatemala, Nicaragua, and Panama.
[4]Includes Antigua and Barbuda, Bahamas, The, Barbados, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, Netherlands Antilles, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, and Trinidad and Tobago.
[5]Includes Bolivia and Paraguay.

nal financing conditions, slowing global growth, and higher energy costs for oil importers. More generally, the forecast assumes that political uncertainties in the region are resolved and access to international capital markets is broadened. Given the still-large investor allocations to Latin America, an adverse development—such as a disorderly debt default—could result in broad-based selling of many Latin American assets, though investment-grade borrowers like Mexico and Chile would likely be largely insulated. To improve prospects for medium-term growth and reduce the likelihood of future crises, the key policy priorities for many countries in the region remain to lower public debt, orient monetary policy to low inflation with exchange rate flexibility, deepen domestic financial intermediation, reduce balance sheet fragilities related to heavy informal dollarization, liberalize trade further, move ahead with labor market reform, and improve social safety nets and reduce corruption (to promote popular support for action and thus ensure the sustainability of reforms).

Turning to individual countries, there are signs in Argentina that the economy may be over the worst. Since mid-2002, these has been a modest recovery in real GDP and strong growth in industrial production and construction; consumer confidence is rising; and unemployment has fallen, which partly reflects the growth of beneficiaries under employment support programs. During the course of 2002, the exchange rate fell by about 70 percent, but consumer prices rose by only 40 percent (reflecting the depressed economy and tight control over public spending), which implies a significant real depreciation. In recent months, the currency has appreciated, monthly inflation rates have declined significantly, interest rates have fallen, and there has been a steady increase in private sector bank deposits. However, real GDP is still almost 20 percent lower than in 1998, unemployment is about 18 percent, poverty rates remain extremely high, and signs of price stabilization partly reflect continued controls on utility prices. Important fragilities in the outlook include the inflationary risks posed by the planned release of frozen bank deposits in 2003, as well as the court orders *(amparos)* to accelerate the release, and the pressures on public spending in the run-up to elections in April. The key policy priorities are to strengthen the monetary anchor and the credibility of the fiscal framework, and take further steps to substantially strengthen the banking system.

In Brazil, the new government's pledge to maintain macroeconomic stability, which President Lula da Silva has stressed is a prerequisite for his social agenda, has helped to reduce uncertainties in financial markets. Since last fall, the interest rate spread on sovereign bonds has declined substantially, equity prices have risen, and the currency has appreciated modestly. Real GDP is projected to accelerate somewhat this year, while the 12-month inflation rate is forecast to decline. However, external financing conditions remain difficult, reflecting the large public debt rollover requirements and the sensitivity of debt dynamics to the exchange rate and interest rates. The vulnerabilities to the outlook underscore the importance of fully implementing the government's economic program, including a sufficiently tight fiscal policy, consistent with a reduction in the debt to GDP ratio over the medium term; tax and pension reforms; monetary policy oriented toward restoring low inflation, within the inflation targeting framework; and further progress in structural reform.

In Venezuela, the ongoing political crisis has disrupted oil production and increased uncertainties in the non-oil sector. Real GDP is estimated to have fallen sharply in the second half of 2002, and inflation rose from 20 percent (year-on-year) in June to 31 percent in December. Even with the recent resolution of the strike at the national oil company, real GDP is projected to contract by 17 percent and end-year inflation to rise to about 40 percent in 2003. Any sustained economic recovery will depend on a resolution of the political crisis in a manner that improves consumer and investor confidence. The immediate challenge of reestablishing macroeconomic stability will require addressing the government's large borrowing requirement and removing the recently imposed exchange and price controls.

Elsewhere in the Andean region, a number of countries have made progress in strengthening economic fundamentals in the context of broad-based adjustment programs, although important domestic and external vulnerabilities remain. In Colombia, the government has implemented important fiscal reforms, including a broadening of the base of the value-added tax, reform of the pension system (although further measures are needed—and under consideration—to address unfunded pension liabilities), and has begun to improve labor market flexibility. In Peru, the first stage of tax reforms has been enacted, preparations have been made for a sound fiscal decentralization, and the inflation target has been strengthened; however, there is a need to further accelerate structural reforms, and for continued close and proactive monitoring of the banking system. In Ecuador, the new government has moved quickly to address the difficult fiscal position, including by adjusting energy prices and freezing public sector wages; it will be critical to adhere strictly to the expenditure ceiling established in the new Fiscal Responsibility and Transparency Law, while making progress in liquidating closed banks and moving forward the agenda on civil service and customs reforms. By contrast, in Bolivia, political instability and a widening fiscal deficit have eroded confidence in the banking system, contributing to a further weakening of bank and corporate balance sheets. Rapid adoption of deficit-reducing measures and restructuring programs for corporates and banks is required to attain lasting macroeconomic stability.

Relatively strong economic performances in Mexico and Chile are underpinned by generally sound policies and high degrees of integration with the world economy. In Mexico, the government budget for 2003 continues to be reasonably consistent with lowering public debt in the medium term, although concerns about still-weak economic activity have moderated the pace of the fiscal consolidation. Monetary policy, which has been appropriately geared toward achieving a decline in inflation, has been tight-

Table 1.7. Selected Asian Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
Emerging Asia[3]	**5.0**	**6.3**	**6.0**	**6.3**	**2.6**	**1.8**	**2.3**	**3.1**	**2.8**	**3.5**	**2.7**	**2.3**
Newly industrialized Asian economies	**0.8**	**4.6**	**4.1**	**4.5**	**1.9**	**1.0**	**1.8**	**1.9**	**5.8**	**7.0**	**6.2**	**6.1**
Hong Kong SAR	0.6	2.3	3.0	3.3	–1.6	–3.0	–1.6	–1.0	7.5	11.4	10.9	10.6
Korea	3.0	6.1	5.0	5.3	4.1	2.8	3.5	3.2	2.0	1.3	0.3	0.5
Singapore	–2.4	2.2	3.0	3.5	1.0	–0.4	0.9	1.7	19.0	21.5	22.2	20.5
Taiwan Province of China	–2.2	3.5	3.2	3.7	—	–0.2	0.3	0.8	6.4	9.1	8.6	8.8
ASEAN-4	**2.6**	**4.3**	**3.9**	**4.3**	**6.6**	**5.9**	**5.3**	**4.9**	**5.0**	**5.3**	**3.1**	**2.7**
Indonesia	3.4	3.7	3.5	4.0	11.5	11.9	9.0	8.4	4.9	4.2	2.2	2.2
Malaysia	0.4	4.2	5.0	5.8	1.4	1.8	2.5	2.5	8.3	7.7	7.5	5.6
Philippines[4]	3.2	4.6	4.0	4.0	6.1	3.1	4.0	4.0	0.4	3.8	0.3	0.5
Thailand	1.9	5.2	4.2	4.3	1.7	0.6	1.7	0.9	5.4	6.0	2.8	2.6
South Asia[5]	**4.1**	**4.7**	**5.1**	**5.8**	**3.8**	**4.1**	**4.2**	**5.3**	**–0.2**	**1.1**	**0.6**	**0.1**
Bangladesh	5.3	4.4	5.2	5.5	1.6	2.4	5.2	4.5	–2.2	0.5	—	–2.0
India	4.2	4.9	5.1	5.9	3.8	4.3	4.1	5.5	—	0.9	0.5	0.2
Pakistan	3.6	4.6	5.0	5.1	3.1	3.1	3.9	4.0	0.4	4.0	3.0	0.8
Formerly centrally planned economies[6]	**7.2**	**7.9**	**7.5**	**7.5**	**0.7**	**–0.6**	**0.3**	**1.6**	**1.5**	**1.8**	**1.3**	**1.0**
China	7.3	8.0	7.5	7.5	0.7	–0.8	0.2	1.5	1.5	1.9	1.4	1.1
Vietnam	5.0	5.8	6.2	7.0	–0.4	4.0	3.8	3.3	2.2	–1.4	–2.1	–1.5

[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 during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Includes developing Asia, newly industrialized Asian economies, and Mongolia.
[4]For the current account balance, IMF staff preliminary forecasts are subject to revision pending the release by the Philippine authorities of the adjusted import statistics for 2002.
[5]Includes Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka.
[6]Includes Cambodia, China, Lao People's Dem. Rep., Mongolia, and Vietnam.

ened several times in the past few months to offset inflationary pressures emanating from high nominal wage increases and the depreciation of the currency. Regulatory oversight of the banking system is being strengthened further. To boost growth over the medium term, further structural reforms are needed, including reform of the value-added tax, electricity sector reform, and labor code deregulation. In Chile, public debt is low, monetary policy is based on an inflation-targeting regime and floating exchange rate, official international reserves are high, and the banking system is sound. The budget for 2003 allows room for automatic stabilizers and incorporates employment support programs, while appropriately maintaining an unchanged structural balance. The policy interest rate was reduced during the course of 2002, helping domestic demand to begin to recover, while inflation stayed in the bottom half of the target band. The medium-term credibility of the inflation target was apparent in the low spreads seen on new, unindexed paper issued by the central bank.

Asia-Pacific Region: Has Growth Become Less Reliant on Global Developments?

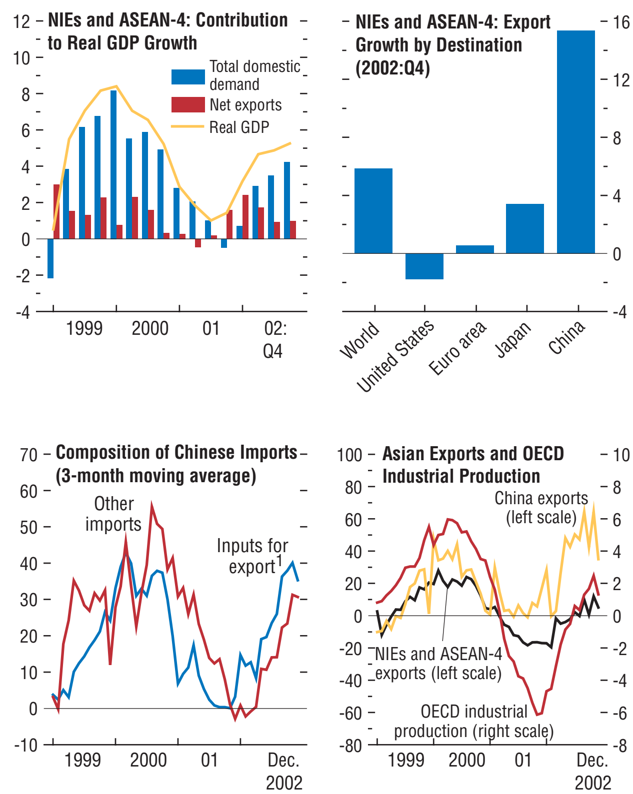
Economic performance in the Asia-Pacific region (excluding Japan) has been impressive, with real GDP increasing by over 6 percent in 2002, and the smaller relatively open economies of east Asia experiencing a particularly sharp turnaround relative to 2001 (Table 1.7). This strong growth—at a time when the recovery in industrial countries has been relatively weak—has raised the issue of whether Asian economies have become less reliant on demand from outside the region following the WTO-linked opening of China and increased inter-regional trade. With the rapid export growth seen in the first half of 2002 now slowing, the question of whether growth in Asia has become more self-sustaining is important for the outlook, particularly if the weakness in the global electronics sector evident since mid-2002 persists.

Several factors, however, suggest that the global environment remains the key driver of regional activity, although ongoing reforms in China and elsewhere in the region have contributed to the recent strong growth performance. First, exports—which are large relative to GDP—remain closely correlated with activity in industrial countries. Second, much of the increase in regional trade is due to strong import growth in China, which has been the fastest-growing destination for the exports of other countries in the region (Figure 1.11). While this import growth has partly been related to domestic demand, much appears linked to China's own rapidly expanding exports, which are influenced by the global cycle. Third, while accommodative macroeconomic policies and financial sector reforms have helped stimulate spending, domestic demand—especially investment—is heavily influenced by export earnings, particularly in countries with large traded-goods sectors.

Consequently, while the anticipated strengthening of the world economy is expected to underpin real GDP growth of about 6 percent in the region during 2003–04, current global uncertainties present a downside risk to this outlook. A protracted war in Iraq would have a negative impact on Asia through higher oil prices (most Asian countries are oil importers), weaker growth in trading partners, and lower equity prices. Some countries would also be affected by lower remittance income and tourism revenues, and reduced access to international capital markets. Further, were the demand for electronic products to remain weak, exports would be adversely affected, which in turn would hurt industrial production, con-

Figure 1.11. Asia: External Demand and Growth
(Percent change from a year earlier)

External demand has been an important driver of the recovery in Asia. China has been a major market for exports from other regional economies, but these have been principally related to China's own strong export performance, which remains dependent on the global economic cycle.



Sources: CEIC Data Company Limited; IMF, *Direction of Trade Statistics;* SourceOECD; and China's Customs Statistics.
[1]Includes imports for processing and by foreign-invested enterprises.

sumption, and investment. Strong growth in China would provide only a limited cushion for other regional countries, despite its growing importance as a trading partner. The tensions with North Korea and the recent outbreak of SARS in a number of countries in the region are additional risks to the outlook.

Against the background of strong economic growth, Asian equity markets performed relatively well in 2002, particularly in the first quarter, and bourses in India, Indonesia, Pakistan, and Thailand bucked the global trend and recorded gains during the year. Sovereign bond spreads in the region narrowed during the first half of 2002, but have generally widened since. While most flexible currencies have appreciated against the U.S. dollar, they have depreciated in nominal effective terms owing to the yen's appreciation against the dollar, further enhancing regional export competitiveness.

With inflation largely in check—indeed, prices are declining in several countries—and the risks to the outlook mostly on the downside, a "wait and see" approach to macroeconomic policies is generally appropriate, although there is a need to push ahead with structural reforms.

- The continuation of accommodative monetary policies is generally appropriate, and there is scope for further easing if growth falters. Most countries can also allow the automatic fiscal stabilizers to operate if recovery flags. Countries with strong fiscal positions, such as Korea, have scope for discretionary easing if necessary, but those with larger deficits and higher debt are more constrained, with policymakers needing to trade off short-term demand management concerns with the need to begin fiscal consolidation. In India, Indonesia, and the Philippines, however, fiscal consolidation is essential to reduce high debt levels.
- Progress with structural reforms has varied, but countries that have moved most vigorously in this area have seen more robust recoveries. Among the key issues are resolving nonperforming loan problems (China, Indonesia, Philippines, Thailand); strengthening insolvency laws to facilitate loan workouts and corporate restructuring (India, Korea, Philippines, Thailand); and returning banks to private ownership to ensure market-based intermediation practices (Indonesia, Korea).

In the newly industrialized economies (NIEs), growth has been strongest in Korea, although recent regulatory steps to moderate household credit growth have contributed to a slowing in private consumption. Activity in Taiwan Province of China has also picked up strongly, but the recovery in Singapore has been weaker and more uneven. In Hong Kong SAR, domestic demand has remained weak as consumption has been undermined by deflationary pressures, rising unemployment, and asset price declines. Among the ASEAN-4, private consumption has boosted growth in Thailand and to a lesser extent in Malaysia, where there has also been considerable fiscal stimulus. In the Philippines, growth exceeded expectations in 2002, but the fiscal situation and uncertain external financing conditions present risks to the outlook and the peso has been under downward pressure. In Indonesia, growth has been steady, but projections have been pared back following the terrorist attack in Bali.

In China, real GDP grew by 8 percent in 2002. Strong export growth has been underpinned by China's entry into the WTO, more active private sector participation in export activities, and the transfer of foreign production facilities to China, which has also boosted investment spending. Imports have grown strongly, providing a fillip to other regional economies; foreign direct investment has accelerated; and reserves increased by $76 billion in 2002 (the largest contributor to the $170 billion reserve accumulation among emerging Asian countries during the year). China's need to facilitate adjustment in the face of ongoing structural change suggests that a gradual move toward a more flexible exchange rate regime is warranted, particularly in light of its strong external position. Meanwhile, the modest deflationary pressures evident since late 2001 have recently eased. Fiscal policy has been supportive of economic activity, but in view of the large contingent liabilities associated with banking and pension reform and continued strong growth prospects, a start toward consolidation is needed. Bank and state-owned enterprise reform remains at the top of the structural reform agenda.

In India, growth strengthened in 2002 despite a severe drought that has adversely affected agricultural output. Inflation has risen in recent months but remains modest. The external position has continued to strengthen, and this provides a good opportunity to allow greater exchange rate flexibility and to accelerate trade liberalization. The large general government fiscal deficit, which has reached 10 percent of GDP in recent years, remains unchecked, and establishing a credible fiscal consolidation strategy is imperative. Welcome steps have been taken to further open the economy to foreign direct investment and to move toward market-based pricing of petroleum products, but more progress is needed in pushing through other key reforms, including early passage of the proposed fiscal responsibility legislation. Further action is also needed to strengthen the financial sector, building on the progress made so far, including the approval of the Securitization Ordinance and the restructuring of a major unit trust fund. The situation in Pakistan has continued to improve, with real GDP growth accelerating, inflation remaining subdued, and the balance of payments strengthening. Efforts, however, are needed to lower the fiscal deficit to reduce vulnerabilities. In Bangladesh, a comprehensive reform strategy—including measures to increase government revenues and strengthen state-owned banks—is needed to address vulnerabilities and to sustain the recent improvement in growth and the external position.

In Australia and New Zealand, growth has been robust, but the pace of activity is expected to moderate. Domestic demand, led by housing, has been strong in both countries, aided by low interest rates and strong immigration inflows in the case of New Zealand. Reflecting uncertainties about the global outlook, both the Reserve Bank of Australia and the Reserve Bank of New Zealand have left monetary policy unchanged since the middle of 2002. Meanwhile, the latest Policy Targets Agreement in New Zealand has charged the Reserve Bank of New Zealand with keeping the average inflation rate between 1–3 percent over the medium term. The fiscal positions in both countries remain sound. Recently implemented welfare reforms in Australia are expected to increase work incentives for the unemployed, while government policy in New Zealand continues to focus on encouraging innovation and skill development.

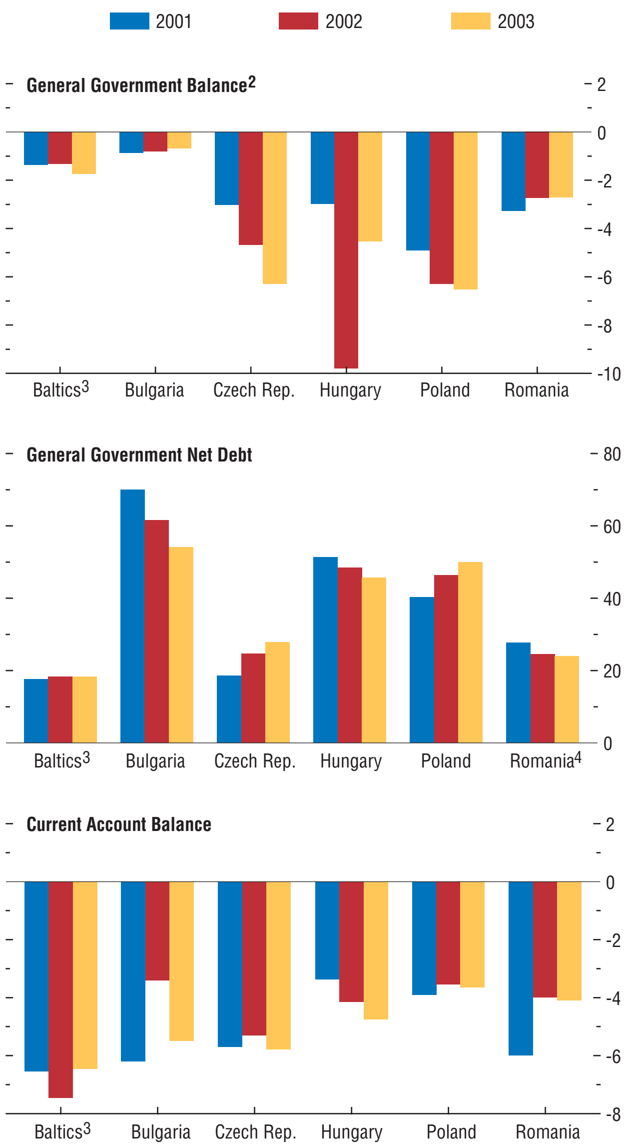
European Union Candidates: Accession Underlines Fiscal Challenges That Lie Ahead

The historic agreement reached at the conclusion of the Copenhagen Summit last December, which paves the way for enlargement of the European Union by 10 new members in May 2004, highlights both the progress made over the past decade in transforming these countries into well-functioning market economies and the challenges ahead as governments look beyond accession to the requirements associated with adoption of the euro. Although the nature of required adjustments varies across countries, the need for fiscal restraint is likely to remain a central focus of policy, not only owing to spending pressures from complying with EU environmental standards and absorbing development funds (which require domestic fiscal cofinancing), but also because of a range of country-specific factors—including high current account deficits, overly strong exchange rates, demographic pressures, and fragile market sentiment (Figure 1.12). The timing of entry into Exchange Rate Mechanism II (ERMII) is also likely to be a driving force for fiscal adjustment going forward, with laggard countries likely to face continuing capital flow and exchange rate volatility that would frustrate their goal of early adoption of the euro.

Fortunately, fiscal adjustment in the period ahead is likely to take place in a broadly favor-

Figure 1.12. Selected European Union Accession Countries: Accession Underlines Fiscal Challenges[1]
(Percent of GDP)

Recently concluded accession agreements are providing an additional focal point for fiscal adjustment, which is also warranted by sizable current account deficits and high levels of public debt in some cases.



[1]Data for 2002 and 2003 are IMF staff projections.
[2]The data should be treated with caution, as some quasi-fiscal activities are not reflected in the general government balance and countries have not yet adopted European Standardized Accounts (ESA-95).
[3]Weighted average of Estonia, Latvia, and Lithuania.
[4]Gross debt.

able macro environment in the accession countries, which have shown resilience during the global slowdown, notwithstanding a weaker-than-expected upturn in the European Union (Table 1.8). Indeed, apart from Poland, these countries generally managed to post growth rates of 2–6 percent in 2002, as robust domestic demand helped to offset the impact of slowing exports. For 2003, growth is expected to top last year's performance in the accession countries, as private absorption remains well sustained, and there is some modest pickup in foreign demand.

Many of the countries in the region share a number of common risks to their growth outlook this year. An immediate risk relates to the potential for a protracted war with Iraq, which would affect the central European economies and Bulgaria through higher oil prices and reduced exports to the European Union (given the strong trade linkages). Romania and the Baltics might be less affected owing to local oil production or oil transit receipts, but Turkey could be hit hard by a protracted war in Iraq, which would weaken tourism and export receipts, raising interest rate and inflationary pressures and deteriorating the external position and prospects for public debt rollover. Beyond this, with the improvement in prospects heavily dependent on the pickup in western Europe, a weaker recovery in the European Union this year would affect the region by dampening export growth, foreign direct investment inflows, and capital spending—the impact of disappointing growth in western Europe on accession candidate countries' exports was evident already in the second half of last year. A third key risk relates to fiscal policy itself, where lack of progress in reining in excessive deficits could undercut market sentiment and economic activity in countries with large external deficits or large demographic pressures on state pension schemes.

Turning to individual countries, Poland's cyclical position remains the weakest in the region. Notwithstanding signs that the economy is reviving after two years of lackluster growth,

Table 1.8. European Union Candidates: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
EU candidates	**—**	**3.9**	**3.9**	**4.5**	**21.1**	**15.8**	**10.2**	**7.5**	**–2.8**	**–3.3**	**–3.6**	**–3.4**
Turkey	–7.5	6.7	5.1	5.0	54.4	45.0	24.7	14.5	2.3	–1.0	–1.8	–1.1
Excluding Turkey	3.0	2.8	3.4	4.3	9.8	5.7	4.7	4.7	–4.6	–4.2	–4.4	–4.3
Baltics	**6.3**	**5.8**	**5.3**	**5.7**	**2.7**	**1.7**	**2.7**	**2.7**	**–6.5**	**–7.5**	**–6.5**	**–5.9**
Estonia	5.0	5.0	4.9	5.2	5.8	4.3	3.6	2.9	–6.1	–10.1	–5.0	–5.1
Latvia	7.9	6.1	5.5	6.0	2.5	1.9	3.0	3.0	–9.6	–8.7	–8.5	–7.1
Lithuania	5.9	5.9	5.3	5.7	1.3	0.3	2.1	2.5	–4.8	–5.4	–5.8	–5.4
Central Europe	**2.2**	**2.1**	**2.8**	**3.9**	**6.2**	**2.8**	**2.6**	**3.5**	**–4.2**	**–4.0**	**–4.2**	**–4.2**
Czech Republic	3.1	2.0	1.9	3.3	4.7	1.8	1.1	3.0	–5.7	–5.3	–5.8	–5.3
Hungary	3.8	3.3	3.6	3.9	9.2	5.3	5.3	4.8	–3.4	–4.1	–4.8	–4.6
Poland	1.0	1.3	2.6	4.1	5.5	1.9	1.1	2.4	–3.9	–3.5	–3.7	–4.0
Slovak Republic	3.3	4.4	4.0	4.2	7.3	3.3	8.8	7.5	–8.6	–8.2	–6.6	–6.3
Slovenia	3.0	2.9	3.2	3.8	8.4	7.5	5.7	5.0	0.2	1.8	1.9	1.7
Southern and south-eastern Europe	**4.8**	**4.2**	**4.7**	**5.0**	**25.1**	**16.9**	**12.3**	**9.5**	**–5.7**	**–4.2**	**–4.7**	**–4.4**
Bulgaria	4.0	4.0	5.0	5.5	7.5	5.8	3.0	4.1	–6.2	–3.4	–5.5	–4.6
Cyprus	4.1	2.0	2.2	4.3	2.0	2.8	4.3	2.0	–4.3	–5.4	–5.0	–4.0
Malta	–0.8	2.7	2.8	3.3	2.9	2.2	2.0	2.0	–4.7	–6.1	–6.5	–6.5
Romania	5.7	4.9	4.9	5.0	34.5	22.5	16.2	11.6	–6.0	–3.4	–4.5	–4.5

[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 during the year as is the practice in some countries.
[2]Percent of GDP.

high unemployment, uncertain prospects for an investment recovery, and dependence on Germany's pickup are downside risks. Despite the easing of monetary policy last year and in early 2003, real interest rates remain high in relation to the economy's cyclical position, and the fiscal deficit continues to pose risks for market sentiment. Both factors underscore the need to redress the policy mix. With general government debt set to rise to 50 percent of GDP this year (from 40 percent in 2000), lack of structural adjustment in the 2003 budget is a risk. Fiscal restraint—including the recently advanced comprehensive fiscal reform package—is essential to leave room for further monetary easing, which is warranted by the lack of inflationary pressures in the economy. Accelerated privatization is needed to promote enterprise restructuring and reduce recourse to capital markets.

Hungary's cyclical position is substantially stronger than Poland's, but there is a similar need to rebalance the policy mix to foster growth and macroeconomic stability. Indeed, while Hungary's expansion is expected to continue to be well sustained this year, the key policy challenge is to rein in a widening fiscal deficit—9½ percent of GDP in 2002—and an associated external imbalance, which is mostly debt financed. Meeting this challenge, in part through public sector wage restraint, would also help mitigate related sources of risk, including relatively rapid economy-wide wage inflation, and deteriorating competitiveness. Against this background, the sizable fiscal adjustment targeted by the authorities this year is appropriate, and needs to be supplemented by structural reforms to improve the mix of current versus capital spending. Fiscal restraint and wage moderation would also help to unburden monetary policy, which has faced conflicts between Hungary's exchange rate and inflation objectives, as seen by the string of recent interest rate cuts in response to upward forint pressures despite inflation that was projected to remain above its end-2003 target.

Recent sovereign rating downgrades have also drawn attention to the size of fiscal deficits in the Czech Republic, which is expected to see growth sustained at about 2 percent this year. That focus is driven by the relatively slow prospective adjustment of fiscal balances to Maastricht norms over the medium term, relatively adverse demographic pressures, and the need to provide monetary policy with additional flexibility to respond to adverse shocks (including a further strengthening of the koruna), now that domestic interest rates have been reduced below the ECB rate. In Slovakia, with recovery gaining momentum, the significant tightening of the fiscal stance in the 2003 budget is an appropriate response to surging capital inflows. An even greater fiscal effort could nevertheless be needed if inflows are sustained, particularly following the substantial (150 basis point) policy easing last November.

Turning to southeastern Europe, the economies of Bulgaria and Romania continued to expand at a healthy pace in 2002, and are set to be among the fastest-growing countries in the region this year. Nevertheless, the high projected current account deficit in Bulgaria and high inflation in Romania underscore the need for budgetary restraint and structural reforms to improve efficiency and profitability of state-owned enterprises. In this context, Bulgaria's 0.7 percent of GDP deficit target in 2003 represents a critical support for reducing the external deficit, and should be underpinned by structural measures to improve tax administration and expenditure management. In Romania, the sharp increase in the minimum wage in January and ongoing losses in state-owned enterprises are potential setbacks to the disinflation process and underscore the need to achieve the targeted fiscal adjustment in the 2003 budget and to further harden budget constraints in state-owned enterprises.

The Baltic economies continued to enjoy solid growth last year despite the EU slowdown, as domestic demand—underpinned by lower unemployment, rapid real wage growth, and a pickup in EU and NATO accession–related investment projects—took up the slack from slower net exports. A track record of strong policy implementation also contributed to sovereign rating upgrades last year. However, large current account deficits represent an ongoing risk to the outlook and underscore the need for continued progress with medium-term fiscal consolidation, which is facing pressures from rising expenses associated with EU accession and, in some cases, the electoral cycle. These pressures demand a careful review of government spending priorities and tax cut commitments to secure the momentum of fiscal consolidation in 2003–04 and the credibility of medium-term balanced budget targets, which are key to managing risks to market confidence in the face of very large external deficits.

Following a better-than-expected performance last year, economic and financial conditions in Turkey deteriorated in early 2003—with spreads widening sharply—offsetting the favorable market reaction to the new government following last November's elections. The main cause appears to be fiscal and banking policy slippages—which heighten vulnerabilities associated with rolling over Turkey's public debt—and the geopolitical situation. To sustain confidence, there is an urgent need to establish the government's fiscal credentials, including by backing up its pledge to achieve the 6½ percent of GNP primary surplus target with strict implementation of supporting measures. The recent tax amnesty legislation missed a critical opportunity to strengthen future tax compliance. Only by taking early strong action, especially in the fiscal area, can doubts about debt sustainability be dispelled. A solid budget framework is also needed to underpin disinflation this year and the transition to inflation targeting. Sustained progress with structural reforms remains critical, including with respect to the banks, state-owned enterprises, and privatization.

Commonwealth of Independent States: Oil Strength Masking Non-oil Weaknesses

Recent economic performance has been relatively good in the CIS countries, but slowing

Table 1.9. Commonwealth of Independent States: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
Commonwealth of Independent States	**6.4**	**4.8**	**4.4**	**3.9**	**20.4**	**14.5**	**12.3**	**9.1**	**7.7**	**6.9**	**7.6**	**4.4**
Russia	5.0	4.3	4.0	3.5	20.7	16.0	13.4	9.7	10.5	8.8	10.1	6.3
Excluding Russia	9.2	5.8	5.3	4.9	19.9	11.6	10.1	7.6	–0.3	1.0	–0.8	–2.3
More advanced reformers	**9.9**	**6.5**	**6.0**	**5.5**	**9.4**	**2.7**	**5.1**	**4.7**	**0.2**	**1.8**	**–0.3**	**–2.4**
Armenia	9.6	12.9	7.0	6.0	3.1	1.1	2.2	1.8	–8.9	–5.1	–6.9	–6.1
Azerbaijan	9.9	10.6	9.2	8.8	1.5	2.8	2.7	2.5	–0.9	–12.6	–29.7	–34.6
Georgia	4.5	5.4	4.8	4.5	4.7	5.6	5.0	5.0	–5.0	–6.7	–13.7	–13.3
Kazakhstan	13.5	9.5	8.5	8.0	8.3	5.9	6.4	5.0	–3.2	–1.8	1.9	–0.7
Kyrgyz Republic	5.3	–0.5	5.2	5.0	7.0	2.1	3.9	4.0	–1.2	–2.3	–3.8	–4.3
Moldova	6.1	7.2	5.0	5.0	9.8	5.3	4.6	6.0	–6.0	–7.2	–8.2	–8.2
Ukraine	9.2	4.6	4.5	4.0	12.0	0.8	5.0	5.0	3.7	7.6	4.7	2.8
Less advanced reformers[3]	**4.6**	**4.1**	**3.8**	**3.7**	**54.7**	**39.2**	**24.4**	**15.1**	**–1.9**	**–1.2**	**–2.8**	**–2.9**
Belarus	4.7	4.7	4.0	3.5	61.1	42.6	28.6	18.9	–2.3	–1.9	–2.2	–2.9
Tajikistan	10.2	7.5	6.0	4.0	38.6	12.2	9.5	5.3	–7.1	–4.2	–4.0	–3.9
Uzbekistan	3.8	2.8	3.1	4.0	48.9	38.8	21.1	11.6	–1.0	0.3	–3.8	–2.6
Memorandum												
Net energy exporters[4]	6.1	4.8	4.4	3.9	19.2	14.8	12.5	9.3	9.2	7.6	8.8	5.2
Net energy importers[5]	7.1	4.6	4.4	4.0	25.0	13.7	11.4	8.4	0.7	3.1	0.6	–0.4
CIS-7[6]	5.9	5.5	5.2	5.2	22.5	16.9	10.6	6.9	–2.6	–5.0	–12.7	–13.6

[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 during the year as is the practice in some countries.
[2]Percent of GDP.
[3]Updated data for Turkmenistan not available.
[4]Includes Azerbaijan, Kazakhstan, Russia, and Turkmenistan.
[5]Includes Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Tajikistan, Ukraine, and Uzbekistan.
[6]Includes Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan.

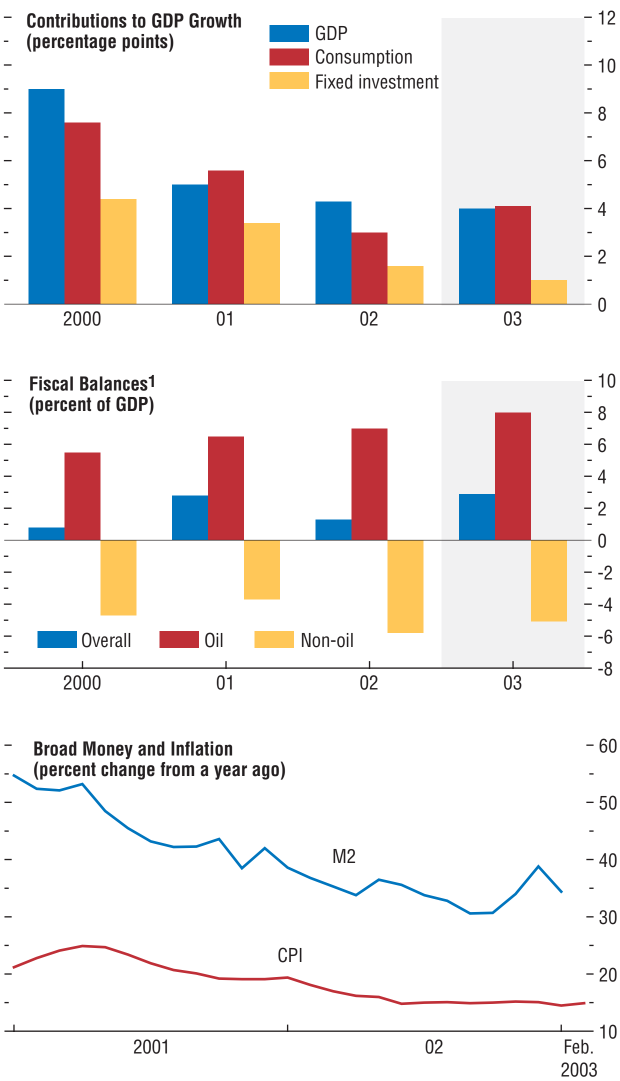
investment growth—notably in Russia—raises concerns about the medium term. Real GDP growth in the region held up well in 2002, buoyed by strong energy prices (Table 1.9 and Figure 1.13). Net energy exporters, which together account for over 75 percent of GDP in the CIS, increased both the value and the volume of oil exports during 2002, reflecting higher oil prices and increased market share. Despite the strength of oil prices, current account balances in oil exporters generally deteriorated, reflecting surging private consumption fueled by large real wage increases in Russia and oil-related foreign direct investment in Azerbaijan. In oil-importing countries, the negative effects of higher oil prices on growth and the current account balance were mitigated by increased export demand from stronger economic activity in oil exporters. In Ukraine, growth moderated from its exceptionally rapid pace in 2001, partly reflecting a slowdown in the metal processing sector, which in turn was related to market access restrictions imposed by other countries.

Growth in the region is projected to weaken somewhat in 2003, as the boost from higher oil prices is more than offset by slowing investment in the non-oil sector. In Russia, fixed investment is being dampened by stagnating structural reforms; total factor productivity is projected to grow at about 1½–2 percent a year in the coming years, about 1½ –2 percent a year less than achieved by the more advanced reformers in eastern Europe.[7] The most important risk to the

[7]The slowdown in fixed investment in Russia in 2002 was also due in part to the elimination of the corporate tax-deductibility of investment spending.

Figure 1.13. Russia: Oil Strength Masking Non-oil Weaknesses

Favorable GDP growth has masked the falling contribution of investment; the strength of oil-related revenues has hidden the deterioration in the non-oil fiscal balance; and rapid money growth risks fueling inflationary pressures.



Sources: Haver Analytics; and IMF staff estimates.
[1]Federal budget operations (commitments).

outlook is a protracted war in Iraq, which would have mixed effects on oil exporters but would unequivocally hurt oil importers. Oil exporters would benefit from higher oil prices but would suffer from slowing global growth. Highly indebted countries—Georgia, Kyrgyz Republic, Moldova, and Tajikistan, which are all energy importers and nonfuel commodity exporters—would be hurt by both adverse shifts in the terms of trade and worsening global financial conditions. Conversely, a sharp fall in oil prices that could accompany the end of the war would have adverse implications for oil exporters.

High oil prices are helping to improve fiscal balances in some energy-exporting countries, though—in Russia—the non-oil fiscal balance has deteriorated. The widening of the non-oil deficit in Russia in 2002 stemmed from wage increases, increased spending on security, and the revenue losses related to the ongoing tax reform. With fiscal stimulus putting upward pressure on inflation and the real exchange rate and leaving little room for future spending on infrastructure and structural reforms, further tax cuts in the absence of offsetting expenditure reductions would be unhelpful at this point. More fundamentally, some institutional mechanism to avoid excessive sensitivity of fiscal policy to oil price swings, such as the oil funds that exist in Azerbaijan and Kazakhstan, would be helpful. While fiscal balances in most oil-importing countries are projected to remain roughly unchanged in 2003, the high level of public debt remains a threat to fiscal sustainability in most of the seven low-income CIS countries (the CIS-7 group includes Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan).

Inflation in most CIS countries dropped further in 2002, helped in some cases by declines in food prices related to good harvests. However, broad money in many countries continued to grow rapidly, reflecting in part attempts to stem exchange rate appreciation. Looking forward, there is a risk that remonetization (the rise in money demand) may not keep up with the fast pace of broad money growth, which would give rise to inflationary pressures. In some countries, including Russia, a sustained fall in inflation would be aided by the introduction of greater exchange rate flexibility and, ultimately, the development of a monetary policy framework based on inflation targeting and underpinned by more effective monetary policy tools.

Rapid monetary expansion is related in most countries to high growth rates of bank credit, which raises concerns about the soundness of banking systems. Rapid credit growth poses a threat to asset quality, given banks' limited capacity to undertake proper credit risk assessments and weaknesses, in many countries, of banking supervision. A related risk is the high dollarization of credit in many countries, which could lead to a rapid deterioration in credit quality if exchange rates depreciate. Also, local currency real interest rates remain high in many countries, owing to poor protection of creditors. Thus, the strengthening of banking supervision and systems to support creditors' rights, as well as guarding against unwarranted government interference in bank operations, are a priority. Especially important is the strict and uniform enforcement of prudential norms, notably on single-party exposure.

Beyond the financial sector, stepped-up structural reforms would help to strengthen medium-term growth prospects. The pace of structural reforms generally slowed in 2002 in the larger countries (Russia, Ukraine, and Kazakhstan), reflecting resistance from vested interests and, in energy exporters, the easing of financial constraints associated with higher oil prices. Progress was varied in other countries, with reform momentum apparent in the Kyrgyz Republic, Armenia, and Tajikistan. The difficulties of making headway—even when the macroeconomic environment is relatively favorable—on policy measures that do not deliver obvious and immediate benefits underline the value of having an external anchor for structural reforms (as discussed in Chapter III).

Africa: Stability and Reforms Remain the Keys to Growth

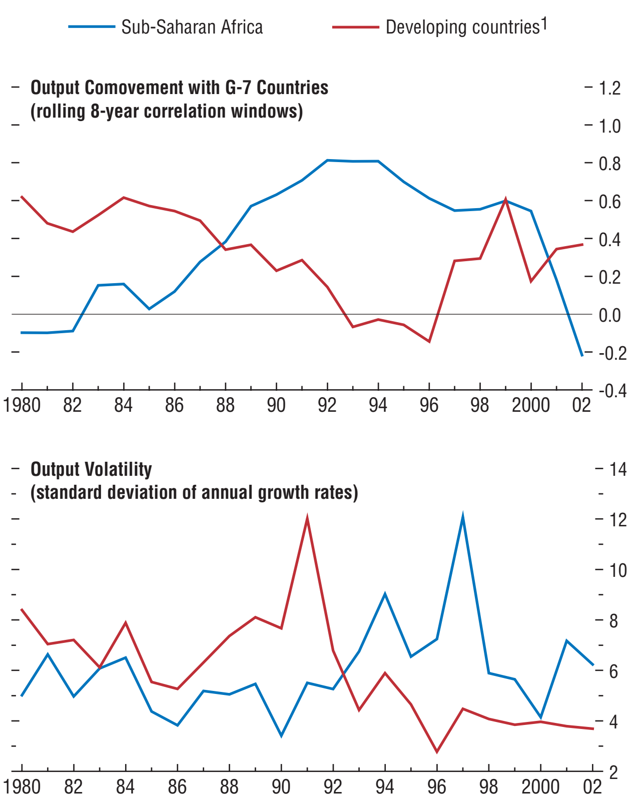
During 2000–01, Africa was generally resilient to the global slowdown (Figure 1.14), aided by improvements in the security situation, strengthened macroeconomic stability, and debt relief under the Highly Indebted Poor Countries (HIPC) Initiative. However, despite the global recovery and higher nonfuel commodity prices, GDP growth in the region slowed in 2002, reflecting lower oil production in Nigeria as well as renewed adverse shocks. In particular, poor weather conditions resulted in a sharp decline in agricultural output in many countries in the Horn of Africa, southern Africa, and the western Sahel in the second half of 2002. With food shortages aggravated by weak governance and the HIV/AIDs pandemic, this has led to a disastrous famine, affecting some 38 million people. In addition, the continuing turmoil in Zimbabwe and an insurgency in Côte d'Ivoire has had serious effects on growth in these economies and their neighbors (particularly landlocked countries such as Mali, Burkina Faso, and Niger, which can no longer use the port facilities in Abidjan).

Looking forward, African GDP growth is projected to pick up to 4 percent in 2003 (just under 2 percent in per capita terms) aided by continued policy strengthening, the global recovery, and higher nonfuel commodity prices (Table 1.10). However, such an outcome will depend critically on an early improvement in weather conditions and a marked improvement in the security situation in west Africa.[8] Moreover, as discussed in Appendix 1.2, if the war in Iraq is prolonged, or its aftereffects more serious

[8]Partly reflecting the impact of unexpected adverse shocks, WEO forecasts of growth in Africa have been consistently overoptimistic; between 1991 and 2000, the spring forecast of GDP growth for the current year was an average 1.2 percentage points too high.

Figure 1.14. Africa: Growth Is Highly Influenced by Country-Specific Shocks

Growth correlations with the G-7 countries have fallen sharply since 2000, partly reflecting positive country specific shocks, including an improved security situation. GDP growth across the continent remains very diverse, much more so than for developing countries as a whole.



[1]Excludes countries in sub-Saharan Africa.

than currently anticipated, there could be a substantial impact on the continent. While fuel exporters would benefit, many of the poorest countries would face a substantial terms of trade shock from lower nonfuel commodity prices and higher oil prices and, in some cases, declining tourism.

Macroeconomic policies in Africa have improved considerably in recent years. While inflation remains a serious concern in a few countries—notably Zimbabwe and Angola, and to a lesser extent Somalia and Nigeria—in most it is now in single digits, aided by a significant reduction in fiscal deficits since the mid-1990s. However, macroeconomic management of Africa's substantial natural resource endowments—which have contributed far less than they should have to Africa's social and economic development—remains a concern. This has been particularly evident among Africa's oil exporters, where fiscal policies have often been driven by short-term developments in oil prices, leading to periods of boom and bust. A more rules-based approach—for instance, saving oil revenues when oil prices are higher than average—could help reduce such macroeconomic instability; also, since oil resources are exhaustible, greater consideration should be given to intergenerational equity (as envisaged in Chad). Governance problems have also been a concern, underscoring the need to strengthen legal institutions and enforcement capabilities, and for greater transparency, including through independent and published audits of the oil sector accounts of government, and domestic and foreign oil companies. Such considerations are also relevant, to different degrees, in managing other natural resources.

The central challenge in Africa remains to put in place the conditions necessary to achieve the Millennium Development Goals—notably, a sustained reduction in poverty. On present trends, many countries in sub-Saharan Africa will fall far short of these goals unless GDP growth is sharply accelerated to levels close to those experienced in developing Asia over the past two decades. This very ambitious target

Table 1.10. Selected African Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
Africa	**3.6**	**3.4**	**3.9**	**5.2**	**13.0**	**9.3**	**10.1**	**7.6**	**–0.1**	**–1.8**	**–0.5**	**–0.9**
Maghreb	**4.1**	**3.3**	**4.5**	**4.3**	**2.6**	**2.2**	**3.3**	**3.1**	**7.2**	**4.4**	**5.8**	**4.1**
Algeria	2.1	3.1	3.5	4.3	4.2	1.4	4.2	4.0	12.9	8.6	12.7	8.7
Morocco	6.5	4.5	5.5	3.4	0.6	2.8	2.0	2.0	4.8	2.9	1.5	2.0
Tunisia	5.2	1.9	5.0	6.0	1.9	3.1	3.3	2.9	–4.3	–3.7	–4.5	–3.3
Sub-Sahara[3]	**3.8**	**3.5**	**4.2**	**6.4**	**21.6**	**12.2**	**13.9**	**10.3**	**–3.9**	**–5.8**	**–3.9**	**–4.1**
Horn of Africa	**6.1**	**5.0**	**3.2**	**6.2**	**1.8**	**2.3**	**5.9**	**5.4**	**–7.4**	**–7.5**	**–6.9**	**–7.6**
Ethiopia	7.7	5.0	–2.0	6.4	–7.1	–7.2	4.5	3.0	–4.2	–6.4	–7.8	–6.6
Sudan	5.3	5.0	5.8	6.2	4.9	6.0	5.0	5.0	–10.3	–9.6	–8.3	–10.6
Great Lakes	**2.3**	**4.1**	**4.5**	**5.3**	**54.6**	**7.0**	**5.9**	**4.0**	**–3.9**	**–4.5**	**–5.7**	**–6.9**
Congo, Dem. Rep. of	–2.1	3.0	5.0	6.0	356.7	25.7	13.3	6.1	–4.7	–3.3	–4.1	–8.1
Kenya	1.2	1.2	1.8	3.1	5.8	2.0	4.8	2.4	–3.5	–4.3	–6.2	–7.2
Tanzania	5.6	5.9	6.0	6.0	5.2	4.7	4.2	3.8	–1.5	–2.6	–3.7	–4.2
Uganda	5.5	6.6	5.7	6.2	4.5	–2.0	1.0	3.5	–6.8	–6.8	–7.5	–8.0
Southern Africa	**2.9**	**2.7**	**3.0**	**6.8**	**35.2**	**38.8**	**46.4**	**31.8**	**–4.8**	**–5.3**	**–5.1**	**–2.9**
Angola	3.2	17.1	4.7	10.6	152.6	108.9	75.6	19.3	–2.0	6.6	8.3	1.9
Zimbabwe	–8.8	–12.8	–11.0	5.1	76.7	140.0	450.0	350.0	–9.7	–12.3	–13.9	–9.5
West and Central Africa	**4.0**	**3.1**	**5.0**	**6.7**	**12.0**	**7.7**	**8.1**	**6.3**	**–2.7**	**–6.0**	**–2.1**	**–2.7**
Ghana	4.2	4.5	4.7	5.0	32.9	14.5	11.8	6.5	–6.6	–2.2	–5.6	–4.6
Nigeria	2.8	0.5	6.7	4.2	18.9	12.9	15.3	12.6	2.7	–8.0	1.8	–0.8
CFA franc zone	**4.9**	**4.5**	**3.9**	**8.9**	**4.2**	**3.6**	**3.3**	**2.8**	**–6.7**	**–4.8**	**–4.1**	**–3.4**
Cameroon	5.3	4.3	4.7	5.0	2.8	4.5	3.4	2.7	–1.7	–3.7	–6.3	–7.0
Côte d'Ivoire	0.1	0.5	–2.0	3.0	4.4	3.5	4.0	3.5	–2.0	0.1	1.7	–0.1
South Africa	**2.8**	**3.0**	**2.8**	**3.2**	**5.7**	**10.0**	**8.5**	**5.7**	**–0.1**	**0.1**	**–0.8**	**–0.5**
Memorandum												
Oil importers	3.8	3.3	3.7	5.2	11.9	8.5	9.3	7.3	–2.4	–3.2	–3.6	–2.8
Oil exporters	3.0	3.6	4.8	4.9	16.8	12.3	13.0	8.4	6.2	2.0	8.1	4.6

[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 during the year, as is the practice in some countries.
[2]Percent of GDP.
[3]Excludes South Africa.

can only be achieved if there is a substantial improvement in what remains a generally inhospitable climate for private investment. The rate of return on capital in Africa is estimated to be one-third lower than in other regions; since the 1980s, the private capital stock per worker has declined by 20 percent, and now stands at about one-third the level in south Asia (Collier and Gunning, 1999). And outside the natural resource sector, foreign direct investment remains very low (with a few exceptions, such as Mauritius, Mozambique, and Uganda, which have made significant progress in improving the investment climate).

As stressed in the New Partnership for Africa's Development (NEPAD), an improved investment climate will require action in a host of areas, including restoring peace and political stability; improving infrastructure, health, and education; strengthening public service delivery; liberalizing markets, including trade; improving governance; and addressing the HIV/AIDS pandemic (see Box 3.3). A common element across many of these is a strengthening of institutions, to which the NEPAD gives particular attention: as discussed in Chapter III, bringing Africa's institutions to developing Asian standards could, other things being equal, raise its GDP by 80 percent. As described in the last *World Economic Outlook*, progress continues to be made in the areas identified above, but much remains to be done, both in individual countries and at the regional level, where the challenge now is to turn the NEPAD from a vision into a reality (the next key step being to implement an effective peer review process). Africa's efforts, in turn, need to be accompanied by additional assistance from the international community, including higher aid, debt relief, and, most important, improved market access. Eliminating industrial country protectionism on agricultural exports could raise sub-Saharan African GDP by 0.6 percent in the short run and by several times more in the long run.

Turning to the region's largest economies, South Africa continues to enjoy moderately strong economic growth. External vulnerabilities have been reduced, with the current account registering a modest surplus in 2002, the net forward position of the Reserve Bank of South Africa almost eliminated, and sovereign spreads at historic lows. The rand, which depreciated sharply through late 2001, has since appreciated by about 30 percent against the U.S. dollar, aided by rising metals prices and relatively high domestic interest rates. Even so, with inflation running well above target, monetary policy will need to remain cautious to ensure that the 3–6 percent inflation target for 2004 can be met. However, with the fiscal deficit in 2002/03 likely to be lower than originally expected, the 2003/04 budget appropriately allows for a slightly more relaxed stance through the medium term, which will help address South Africa's pressing social needs. Over the medium term, the central issue is to reduce the very high levels of unemployment and poverty, including by encouraging foreign direct investment and further labor market reform.

In Nigeria, macroeconomic imbalances have widened considerably over the past two years to unsustainable levels. Despite high oil prices, the fiscal deficit has risen sharply, accompanied by mounting short-term debt and external arrears to official creditors; recently, ethnic clashes in the oil-rich delta area have led to disruptions in oil production. Expansionary fiscal policy, along with an inflexible exchange rate policy in the first half of 2002, led to a significant fall in international reserves. Notwithstanding efforts to rein in capital expenditures and somewhat more flexible exchange rate management since the second half of 2002, the situation remains extremely difficult, and Nigeria is highly vulnerable to a fall in oil prices. Futher, the current accommodative monetary stance risks reigniting inflationary pressures. While the 2003 budget approved by the National Assembly would generate a surplus at the WEO baseline for oil prices, a significant deficit is possible were the recent declines to be sustained; tighter monetary policy and greater exchange rate flexibility to reduce pressure on external reserves are also key policy priorities. Following the April elections, the challenge facing the new government will be to make a decisive break with the boom and bust policies of the past—along the lines described above—accompanied by determined efforts to reduce public expenditure to sustainable levels over the medium term, especially on the civil service.

In Algeria, economic activity continues to be constrained by civil unrest and political violence, and—as in much of the Maghreb and Mashreq—high unemployment remains a critical concern. The macroeconomic situation remains solid, with inflation low, the external current account in surplus, and net external debt declining steadily. GDP growth is projected to pick up moderately in 2003, aided by a recovery in hydrocarbon and cereals production, but remains well below the level needed to reduce unemployment substantially in coming years. With investment already very high, a key issue is to improve its efficiency through more vigorous efforts to encourage private sector development, especially reducing the size of government, streamlining cumbersome administrative procedures, rationalizing access to land, and banking reform.

Middle East: Managing the Demographic Transition

In contrast to most other regions, GDP growth in the Middle East continued to weaken in 2002

Table 1.11. Selected Middle Eastern Countries: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change unless otherwise noted)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
Middle East[3]	**4.0**	**3.9**	**5.1**	**4.8**	**8.1**	**9.2**	**9.7**	**9.1**	**7.3**	**4.9**	**9.0**	**4.2**
Oil exporters[4]	**4.1**	**4.4**	**5.8**	**5.3**	**10.1**	**11.5**	**12.1**	**11.3**	**10.0**	**6.4**	**11.6**	**5.6**
Saudi Arabia	1.2	2.1	4.0	3.1	–0.8	–0.4	1.1	1.0	7.8	6.4	13.7	6.3
Iran, Islamic Rep. of	5.7	6.0	6.5	5.9	11.4	15.5	17.0	15.0	4.8	2.3	2.7	–1.1
Kuwait	–1.1	–0.9	2.0	2.1	1.7	2.0	2.0	2.0	26.1	21.4	17.6	12.4
Mashreq[5]	**4.0**	**2.3**	**3.1**	**3.5**	**1.8**	**2.3**	**2.8**	**2.7**	**–1.6**	**–0.9**	**–1.6**	**–1.8**
Egypt	3.5	2.0	3.0	3.5	2.4	2.5	3.0	2.7	—	—	–0.3	–0.4
Jordan	4.2	4.9	5.0	5.5	1.8	1.8	2.5	1.8	–0.1	4.3	0.2	0.9
Memorandum												
Israel	–0.9	–1.0	0.5	2.2	1.1	5.7	2.8	1.0	–2.0	–2.1	–2.3	–2.2

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

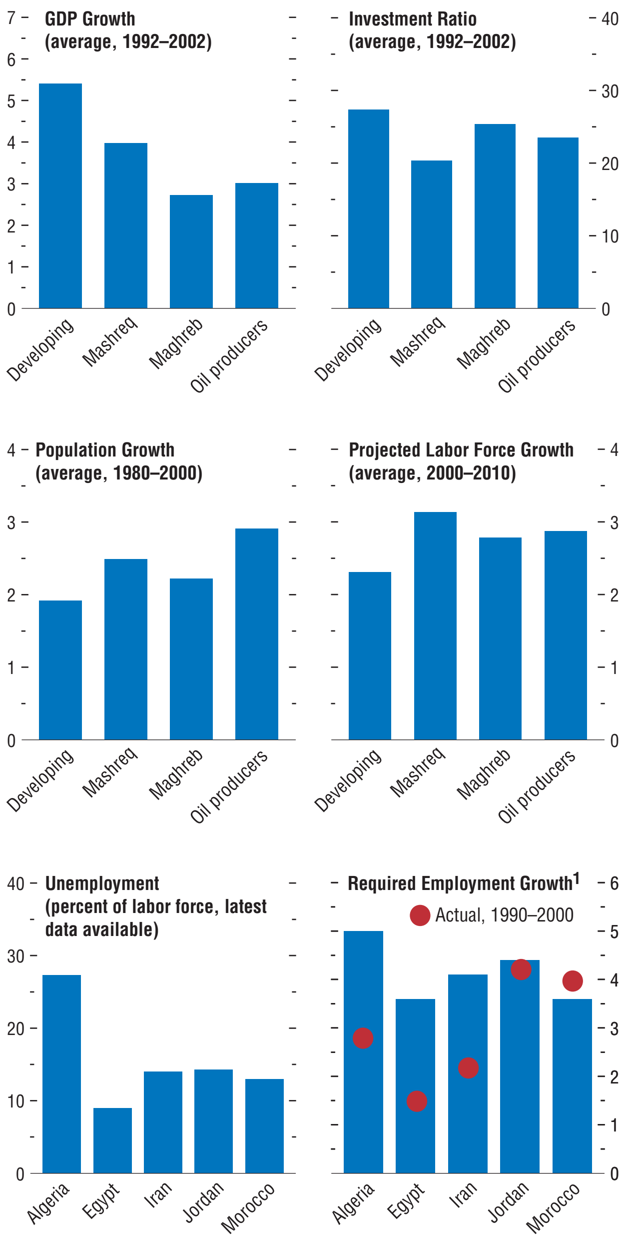
(Table 1.11), reflecting lower oil production as OPEC quotas were reduced, the aftereffects on tourism of the September 11 attacks, and the continued difficult political and security situation. Within this, however, the picture varied considerably across countries, with those countries where reforms have progressed fastest in recent years tending to experience more rapid economic growth. Macroeconomic imbalances—with the important exception of Lebanon—are generally moderate, although fiscal pressures in a number of countries remain sources of vulnerability. Over the long term, the key challenge across the region remains to achieve the enduring acceleration in GDP growth needed to reduce unemployment and absorb the rapidly growing labor force.

For 2003, GDP growth is projected to pick up across the region, underpinned by higher oil prices and oil production, the continued global recovery, and the ebbing of earlier shocks. However, there are significant downside risks to this outlook, not least associated with the war in Iraq (Appendix 1.2). While higher oil prices and production have benefited oil-producing countries, oil importers in the region are suffering, and some countries in the region are already experiencing declines in tourism and disruptions to trade and investment flows. Those countries with close economic links to Iraq, notably Jordan and Syria, will be most seriously affected, and—particularly if the war is protracted—countries already under economic stress will face heightened pressures, especially those vulnerable to higher oil prices and lower tourism receipts. In the aftermath of the conflict, it is possible that oil prices could fall sharply—as recent oil market developments underscore (Appendix 1.1)—a development that would have significant implications for oil exporters in the region.

Among the major oil-producing countries, Iran's economy has performed strongly over the past two years, with rising external confidence in economic prospects and management, reflected in two successful Eurobond issues in the second half of 2002. However, with inflation on the rise, additional measures are required to rein in liquidity growth, most importantly through a more ambitious adjustment in the non-oil fiscal deficit than incorporated in the approved 2003/04 budget. The continued rapid growth in credit aggregates, and its implications for banking system soundness, should also be closely

Figure 1.15. Middle East and North Africa: Managing the Demographic Transition

In coming years, a key challenge will be to raise GDP growth and employment across the region to absorb the rapidly growing labor force and reduce high unemployment.



Sources: World Bank, *World Development Indicators, 2002;* and IMF staff estimates.

[1]See Dhonte, Bhattacharya, and Yousef (2001).

monitored. In Saudi Arabia, lower oil prices and budgetary overspending led to a weakening in the fiscal position in 2001 and 2002. While the recent rise in oil prices will provide a temporary boost to revenues in 2003, with government domestic debt close to 90 percent of GDP at end-2002, the authorities should move ahead expeditiously with their plans to achieve budget balance or a small surplus by 2005 through broadening the non-oil tax base and expenditure restraint. Looking forward, a key issue for Saudi Arabia and other Gulf Cooperation Council (GCC) countries will be to build the institutional framework for macroeconomic policies necessary for the proposed move to economic and monetary union in 2010.

In Egypt, following a slowdown after the events of September 11, GDP growth may have begun to recover in late 2002, aided by higher tourist arrivals. However, the recovery is not yet deeply rooted and the war in Iraq will likely lead to a renewed decline in tourism. Greater exchange rate flexibility was introduced, leading to a significant depreciation since mid-2000. However, a parallel market reemerged, reflecting continued shortages in the official market. The introduction of a freely floating exchange regime in late January 2003 was therefore welcome and has the potential to reduce Egypt's vulnerability to external shocks, but needs to be accompanied by a move to market-clearing exchange rate quotes by banks. Looking forward, greater exchange rate flexibility will need to be accompanied by a strengthened monetary framework (the recent introduction of new monetary instruments and an overnight market is a useful step forward). On the fiscal side, the modest consolidation targeted for FY2002/03 is welcome, with further fiscal strengthening likely to be needed over the medium term in light of emerging budgetary strains and rising public sector net debt (now about 60 percent of GDP). Elsewhere in the Mashreq, macroeconomic developments in Jordan have been relatively favorable, underpinned by buoyant exports, although—as noted above—the country is vulnerable to geopolitical developments. In

Lebanon, despite substantial improvement in the past two years, the fiscal deficit—at 15 percent of GDP—remains very high, while gross domestic debt stands at 175 percent of GDP. The further fiscal consolidation proposed in the 2003 budget, combined with the authorities' strategy of large-scale privatization, seeking out concessional external financing ($4.3 billion was pledged at the recent donors' conference), and negotiating reductions in the interest rate cost of government debt to domestic banks can, if fully implemented and realized, be expected to substantially reduce the debt ratio over the medium term, but public debt dynamics remain very difficult.

For most of the countries in the Middle East and North Africa, the central challenge is the forthcoming demographic transition, as the high population growth of the past two decades translates into rapid labor force growth (Figure 1.15). To absorb this growth, and also to reduce the very high unemployment rates across the region, employment growth will need to rise sharply—in many cases, to significantly higher rates than in the past. Against this background, it will be critical to raise labor productivity, partly through higher investment, but most importantly through reforms to energize the private sector and raise the efficiency with which labor and capital are used. The priorities vary across countries, but key issues include the reform of the state and its institutions; liberalization of trade, investment and prices; public enterprise reform and privatization; and labor market reforms. While progress in these areas is being made—particularly in Iran and Jordan, and to varying degrees elsewhere—reforms are often incomplete and, in some countries, some key reforms have yet to begin. As discussed in the last *World Economic Outlook*, given the relatively closed nature of many regional economies, the gains from further regional and international integration appear particularly large.

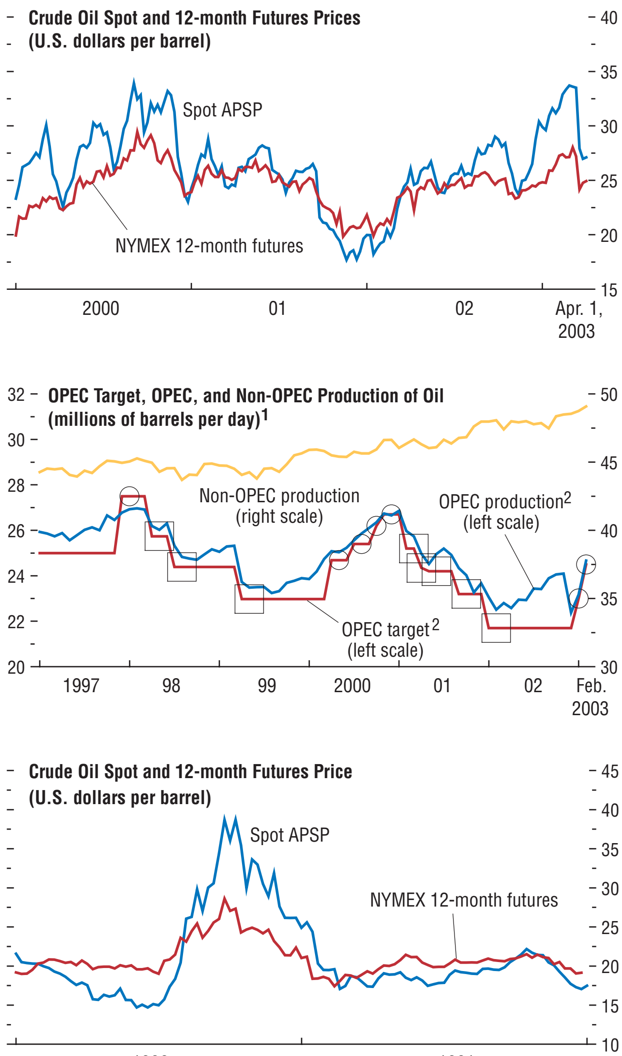
Israel has been experiencing the deepest recession in its history, reflecting the joint impact of the bursting of the information technology bubble and the deterioration in the regional security situation. The situation was made more difficult by a temporary loss of confidence in macroeconomic policymaking in mid-2002, accompanied by a sharp fall in the shekel, which substantially constrained the authorities' room for policy maneuver. While GDP growth has begun to pick up, domestic and external demand remain very weak and the economy remains vulnerable to geopolitical risks. Given the high level of the fiscal deficit and concerns about public debt dynamics, fiscal consolidation is crucial. While the 2003 budget was a welcome step in this direction, the new government needs to take additional measures urgently (as underscored by lower-than-expected tax revenues). With inflationary risks on the downside, there is likely to be room to ease monetary policy in the future, especially if the shekel were to strengthen. The situation in the West Bank and Gaza remains very difficult, with activity plummeting and widespread destruction of infrastructure owing to the deteriorating security situation. Substantial reconstruction and development assistance from the international community will be needed.

Appendix 1.1. Commodity Markets[9]

Primary commodity prices continued to recover in the second half of 2002, driven mainly by a series of supply-side shocks. For the year as a whole, the overall index of primary commodity prices rose by over 3 percent in U.S. dollar terms, partly reversing the decline in 2001. The increase through the year, particularly in the second half, was much greater, with petroleum and nonfuel primary commodity prices rising by 50 percent and 17 percent, respectively, in December 2002 in relation to a year earlier.

[9]The main authors of this appendix are Aasim Husain, Bright Okogu, and Ximena Cheetham. Ivan Guerra and Paul Nicholson provided research assistance.

Figure 1.16. Oil Prices and Production



Sources: Bloomberg Financial Markets, LP; OPEC; and International Energy Agency.
[1] Circles denote increases in OPEC target production and squares denote decreases in OPEC target production.
[2] Excluding Iraq.

Crude Oil

Following the decline in crude oil prices to under $20 a barrel in late 2001 as the pace of global economic activity slowed and growth prospects weakened, petroleum prices climbed steadily in 2002, reaching about $34 a barrel in early March 2003 (Figure 1.16).[10] Futures prices also rose markedly, with prices for 12-month futures contracts climbing by about $8 a barrel over the same period. In mid-March, however, as military action in Iraq was launched, spot and futures prices fell back sharply.

The increase in oil prices, at least until late 2002, appears to have been related mainly to market perceptions of potential supply disruptions rather than to an actual shortage of supply. Geopolitical developments over the past year, particularly the increased tensions between the United States and Iraq over UN arms inspections, sparked concern over the possibility of military action in the Middle Eastern region, where close to two-thirds of the world's proven crude oil reserves are located. As a result, petroleum prices rose sharply despite a significant expansion in global production during the course of the year. Indeed, according to International Energy Agency (IEA) data, global oil output in November 2002—at about 78.6 million barrels a day (mbd)—was more than 3 percent higher than in the first quarter and 2½ percent higher than in the last quarter of 2001. Although the Organization of the Petroleum Exporting Countries (OPEC) cut its production target at the start of 2002 and OPEC output fell in January to its lowest level in recent years, production subsequently rose steadily. By November 2002, production by OPEC members excluding Iraq (OPEC-10) was running over 10 percent (equivalent to about 2.4 mbd) in excess of the OPEC-10 target, and was about 7 percent and 4 percent, respectively, higher than in the first quarter of 2002 and the last quarter of 2001.

[10] Unless otherwise noted, prices noted here refer to the simple average petroleum spot prices (APSP) of West Texas Intermediate, U.K. Brent, and Dubai crude oil.

In early December, however, a general strike that virtually halted oil production in Venezuela resulted in a sharp tightening of supply in global oil markets. Prices were also boosted by OPEC's mid-December call on its member countries to bring actual output down to a new production target that, while higher than the previous target, amounted to a cut of almost 5 percent (equivalent to about 1.5 mbd) from the actual OPEC-10 production level in November. In the event, however, with the strike in Venezuela continuing and Venezuelan output falling sharply, other OPEC members increased output in an effort to cover the supply shortfall[11] and, in mid-January, an additional 1.5 mbd increase in the OPEC-10 production target was announced. Although Venezuelan production gradually recovered—reportedly to about three-fourths of prestrike levels by late March—further escalation in U.S.-Iraq tensions over arms inspections continued to push up prices through early March. While oil prices declined sharply as the war in Iraq began, price volatility increased further as markets reacted to military developments in Iraq and civil unrest in Nigeria, which reportedly resulted in a loss of 0.8 mbd of Nigerian crude oil output in late March.

Actual and prospective developments in the demand for petroleum may also explain some of the increase in crude oil prices over the past year. After rising by an average of about 1.5 percent a year during the 1990s, global oil consumption growth eased to less than 0.5 percent in 2001. As global economic activity started to recover in early 2002 and prospects improved, the outlook for oil demand strengthened. Although the pace of global recovery in the second half of the year proved weaker than previously anticipated and oil consumption is estimated by the IEA to have grown at broadly the same pace in 2002 as in 2001, near-term prospects for global economic activity appear brighter today than they did at end-2001. In recent months, colder-than-expected weather in the northern hemisphere and increased use of oil in place of nuclear energy in Japan have also boosted consumption, especially of heating oil. Indeed, both the IEA and the U.S. Energy Information Administration project oil consumption growth to pick up to over 1 percent in 2003. Hence, even in the absence of the geopolitical developments of the past year in the Middle Eastern region and the recent supply disruptions in Venezuela and Nigeria, crude oil prices would likely have been somewhat higher in early 2003 than a year earlier.

The near-term outlook for oil prices appears closely tied to geopolitical developments in the Middle East and elsewhere, and their associated impact on crude oil supply. Near-term price developments will depend on the duration of the war in Iraq, the extent of damage to production facilities and pipelines, and the production response by other producers. Developments in Nigeria and Venezuela could also have an important bearing on world oil prices in the near term.

The experience with the oil supply shock of 1990–91, which led to a short but sharp spike in prices, may be helpful in assessing the oil price impact of the war in Iraq in the near term. Iraq's invasion of Kuwait in August 1990 and the subsequent embargo of Iraqi supplies and loss of Kuwaiti production removed some 4 mbd of crude oil from the international market. Combined with rising military tension and the associated risk to neighboring countries' oil fields, the supply shock pushed spot prices to an average of over $35 a barrel during mid-September–mid-October, compared with about $18 a barrel in July. After mid-October, prices weakened as other OPEC countries, particularly Saudi Arabia, made up the supply shortfall. In January 1991, after the start of allied military

[11]The decline in Venezuelan crude oil output in December amounted to about 2 mbd; including petroleum products, the decline in production was about 2.5 mbd. By February 2003, however, OPEC-10 production was 0.6 mbd higher than in November, with the continuing shortfall in Venezuelan crude oil production (1.1 mbd for crude oil and 0.6 mbd for petroleum products in the last week of February) more than offset by increased production by other OPEC-10 members.

action against Iraq, prices ebbed further but volatility remained high until mid-March. At the time, two countervailing factors were at work. First, world production excluding Iraq and Kuwait was close to capacity and there was considerable uncertainty about if and when Iraqi exports might resume and under what conditions. Second, global economic activity had weakened sharply and recovery prospects were uncertain, implying a bleak outlook for oil demand.

Recent analysis by the IEA suggests that military action in Iraq could result in a temporary loss of about 3 mbd in global oil supply, somewhat less than the supply shock of 1990–91.[12] The war-related tightening of supply conditions could, of course, be partly offset by a further increase in production by OPEC countries other than Iraq and Venezuela, where IEA estimates place existing spare capacity at 1.7 mbd,[13] and by a further recovery in Venezuelan production. In addition, there may be some scope for major non-OPEC producers to further expand output, at least temporarily. A drawdown of strategic public oil stocks held by IEA member countries could also be used to help make up a temporary supply shortfall.[14] Indeed, as the war began, markets appeared to believe that its impact on supply would be limited, as suggested by the sharp initial decline in oil prices. However, if the war leads to a prolonged loss of Iraqi output, or if there are further production losses in Nigeria or renewed difficulties in Venezuela, global supply conditions could tighten significantly, especially in view of the unusually low level of global oil inventories at present.[15]

If the war in Iraq ends without significant spillovers to neighboring countries and damage to production facilities is limited, Iraq's production capacity can be expected to be restored to prewar levels (about 2.8 mbd) reasonably soon. Venezuelan and Nigerian output would also gradually recover following the resolution of current political tensions, as long as production facilities have not incurred major damage. In such circumstances, crude oil could well stabilize at a level significantly below $30 a barrel. Indeed, with other countries having increased production markedly in recent months, the international oil market could well be faced with a situation of excess supply and an even larger decline in prices once inventories have been replenished. There is also considerable risk, however, that the conflict becomes prolonged and/or significant damage is inflicted on production facilities. In that event, the recent decline in oil prices may prove short-lived, and prices could rebound and remain elevated for a considerable period.

Nonfuel Primary Commodities

Market conditions for agricultural commodities in the second half of 2002 were influenced principally by weather and other developments affecting supply. In particular, a developing mild El Niño weather pattern in the Pacific Ocean damaged crops through extended drought in some areas and, subsequently, persistent rains in other regions. Hence, despite a weaker-than-previously-anticipated pickup in demand, tighter supply conditions resulted in some drawdown of inventories

[12]Iraq's crude oil output averaged about 2.5 mbd in early 2003; Iraqi exports are estimated at about 2 mbd. According to the IEA, about 0.7 mbd of Kuwaiti production may be affected in the event of military action against Iraq (see IEA's *Oil Market Report,* March 2003).

[13]Some estimates of OPEC spare capacity, including some by OPEC members themselves, are significantly higher.

[14]In January 1991, for example, the IEA activated its contingency plan to deal with the potential supply disruption. The plan included a drawdown of IEA member countries' strategic stocks (including the U.S. Strategic Petroleum Reserve) at a rate of 2.1 mbd.

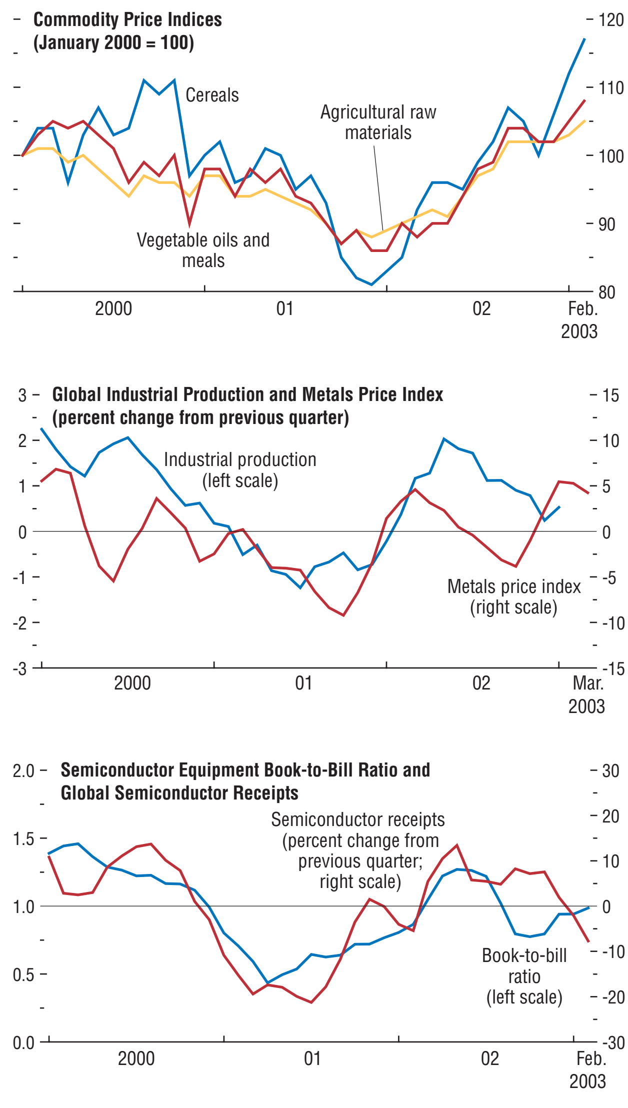
[15]The loss of Venezuelan production in December and January and increased oil consumption in the United States and Japan have put downward pressure on petroleum inventories. In the United States, where imports from Venezuela account for 15 percent of domestic oil consumption, industry inventories in early 2003 were at their lowest levels in almost three decades. Industry inventories in the OECD, excluding the United States, also declined sharply in recent months, but in February 2003 they were at levels comparable to the seasonal lows seen in the mid-1990s.

and pushed up primary commodity prices. While demand should pick up in 2003 with a gradual strengthening of global economic activity, the effect on world market prices for agricultural commodities will likely be dampened by improved production resulting from more normal weather patterns and the passage of the 2002 U.S. Farm Bill, which increased price support and expanded support facilities to new crops. Nevertheless, even if prices stay near end-2002 levels, the average level in 2003 will be significantly higher than last year's average. If, however, risks to the global economic recovery materialize, the outlook for nonfuel commodity prices would clearly be weaker, especially for the more cyclical commodities such as industrial metals.

Severe drought conditions in the United States, Canada, and Australia led to a sharp rise in grain prices over the summer (Figure 1.17). Wheat prices climbed by over 50 percent between May and October, before softening slightly toward the end of the year as increased production from Argentina, Brazil, the European Union, and several CIS countries came to the market. Prices of vegetable oils and meals continued to rise sharply in the second half of the year. Palm oil prices had, by late 2002, recovered to their highest level since 1998 owing to reduced production growth in Malaysia accompanied by a pickup in demand from India and Pakistan. Prices of soybean oil, a substitute for palm oil, also increased sharply late in the year, affected by prospects of a reduced U.S. crop and adverse weather conditions in Brazil and Argentina, major soybean producers. Beverages prices increased as well, particularly in the last quarter of 2002. Prices of cocoa beans surged as political developments in Côte d'Ivoire, the world's largest producer, disrupted production and exports. Coffee prices, particularly for Robusta coffee, recovered in the fourth quarter on account of weather-related damage to the Brazilian crop and sharp downward revisions to estimates for Vietnam's current crop owing to drought and some crop substitution.

Among industrial inputs, prices of agricultural raw materials also strengthened markedly, espe-

Figure 1.17. Nonfuel Commodity Markets



Sources: Semiconductor Equipment and Materials International; Semiconductor Industry Association; and IMF staff estimates.

cially in the second half of the year, mainly reflecting supply factors. Wool prices surged in the last quarter as herds in Australia, the world's largest producer, were cut back sharply owing to the severe drought. Cotton prices climbed late in the year as floods wrought damage to the U.S. crop and demand in China strengthened. Timber prices were boosted by stronger demand by the U.S. and Chinese housing sectors and by continuing lumber trade tensions between the United States and Canada.

Industrial metals prices broadly tracked changes in prospects for global economic activity during the course of last year. In early 2002, as the global economic outlook strengthened, metals prices staged a recovery. When the pace of the global recovery weakened in the second and third quarters, metals prices stabilized and then edged down. In late 2002, however, metals prices again recovered to levels seen in the spring. Nevertheless, with the exception of nickel, metals inventories remain at relatively high levels and are likely to restrain price increases in the near term. Geopolitical tensions, the slower pace of global recovery, and continuing weakness in financial markets have been reflected in increased demand for precious metals. Gold prices have risen by over 25 percent over the past year to six-year highs in early 2003, before easing somewhat in February and March.

Semiconductor Markets

The recovery seen in early 2002 in semiconductor markets weakened markedly in the second half of the year as the pace of global economic activity slowed. Global semiconductor sales growth, which had picked up sharply in the first quarter of 2002, fell back during the rest of the year. The book to bill ratio for North American semiconductor manufacturing equipment—widely regarded as a leading indicator of activity in the semiconductor industry—declined sharply in the third quarter before recovering to near unity at end-2002 as shipments fell.[16] The near-term outlook for the sector may be affected by lingering idle capacity, which, according to market analysts, remains relatively high, both for new technologies and for the broader semiconductor industry.

The pace of shipments and new orders of computers and electronic equipment in the United States also slowed markedly during the course of last year. Indeed, orders and shipments contracted in the latter half of the year. Slower external demand growth was reflected in weaker export performance, especially of electronics exports, in many of the emerging economies in Asia, where the IT sector comprises a relatively large share of industrial activity. An important exception, however, was China, where the performance of electronics exports weakened in the second quarter of 2002—as in other Asian economies—but subsequently witnessed a steady improvement in the latter half of the year, likely owing to increased outsourcing of production by firms in North American and other Asian economies to Chinese firms.

Appendix 1.2. How Will the War in Iraq Affect the Global Economy?[17]

The human and social consequences of the war in Iraq are obviously of paramount importance, but the economic impact of the conflict could also be significant, although given the current uncertainties—including about the duration and intensity of the war—it is impossible to forecast the economic consequences with any precision.[18] This appendix discusses the key

[16]The book to bill ratio is the ratio of orders to shipments. A reading below unity signals near-term contraction in billings. The ratio fell to about 0.8 during September–November 2002 before recovering to over 0.9 in December–January mainly on account of a decline in billings.

[17]The main authors of this appendix are Tim Callen and James Morsink.

[18]A number of potential scenarios for a war in Iraq are discussed in the papers prepared for the conference on "After the Attack on Iraq: Economic Consequences," held by the Center for Strategic and International Studies in Washington D.C. on November 12, 2002. Nordhaus (2002) provides a discussion on the possible impact of a war on the U.S. economy.

Table 1.12. Impact of a Permanent $5 a Barrel Increase in Oil Prices After One Year
(Percent of GDP)

	Real GDP	Trade Balance
World GDP	–0.3	0.0
Industrial countries	–0.3	–0.2
United States	–0.4	–0.1
Euro area	–0.4	–0.1
Japan	–0.2	–0.2
Other	–0.2	0.2
Developing countries	–0.2	0.2
Of which:		
Latin America	–0.1	0.0
Asia	–0.4	–0.5
Emerging Europe and Africa	0.1	0.2

Source: IMF staff estimates based on IMF (2000).

transmission channels through which the war could affect economic activity, assesses in qualitative terms the possible impact of the war on the global economy and on the main regions of the world, and finally discusses possible macroeconomic policy responses.

Key Transmission Channels

The war in Iraq will affect the global economy through a number of channels.

- *Oil prices.* As Iraq is a major producer and exporter of oil, the disruption of its shipments will lead to higher oil prices, although the extent of the increase will depend on the production response from OPEC countries (see Appendix 1.1). Oil prices affect global economic activity through shifts in the terms of trade (the beneficiaries of higher oil prices spend less than the losers), aggregate supply (oil is an important input in production), and inflation (depending on wage, price, and monetary policy responses). A sustained $5 a barrel increase in oil prices is estimated to lower global growth by about 0.3 percent after one year (Table 1.12).
- *Confidence effects.* The war could further depress consumer and business confidence, with negative implications for consumption and investment spending. The impact would likely be heightened if hostilities are accompanied by terrorist attacks in other regions of the world. While it is extremely difficult to quantify the size of the potential impact, the effects could be significant. For example, a sustained shock to confidence of the size that followed the September 11, 2001 terrorist attacks would reduce growth in the United States by about 1 percent and in other countries by somewhat less (Table 1.13).
- *Uncertainty in financial markets.* Increased geopolitical uncertainty would likely result in higher risk premia in financial markets and lower equity valuations. A sustained 10 percent drop in equity prices could have a significant effect on activity, through wealth effects on consumption and investment, particularly in countries where equities are widely held (Table 1.14). In countries where banks have large equity holdings, a decline in equity prices would weaken bank capital and increase the risk of a credit crunch, particularly where banking systems are already under pressure.

Table 1.13. Effects of Business Confidence on Economic Activity in Selected Industrial Countries
(Percent of GDP, unless otherwise indicated)

	Impact of a One Standard Deviation Fall in the Monthly Change in Confidence on Real GDP	Drop in Confidence Between August and October 2001 (Number of standard deviations)	Cumulative Impact on Activity if Decline in Confidence Were Sustained
United States	–0.23	4.2	–1.0
Germany	–0.20	3.7	–0.7
France	–0.15	1.9	–0.3
Italy	–0.22	3.0	–0.7
United Kingdom	–0.23	0.5	–0.1

Source: Table 2.2 in the December 2001 *World Economic Outlook.*

Table 1.14. Stock Market Effects on Economic Activity in Selected Industrial Countries

	Effect of a 10 Percent Decline in Stock Market Capitalization[1] (percent)	
	Retail sales	Investment
United States	–1.3	–1.5
Japan	–2.4	–2.4
Germany	. . .	. . .
France	–0.5	. . .
United Kingdom	–1.5	–3.0
Canada	–1.5	–2.9
Netherlands	–0.7	–0.8
North America and United Kingdom[2]	–1.4	–2.5
Continental Europe[2]	–0.4	. . .

Source: Edison and Sløk (2001, 2002).
[1]Effect after two years of a fall in stock market capitalization (excluding the telecommunications, media, and information technology sectors). Estimates are only shown when statistically significant.
[2]Simple average.

Capital flows to emerging markets would also likely decline, putting particular pressure on countries with large external financing requirements.

- *Travel, tourism, and remittance income.* Geopolitical uncertainties have made people less willing to travel, particularly internationally. This will adversely affect countries that are dependent on tourism-related revenues, and will have a negative impact on certain industries, particularly airlines. Some countries may also be affected by a decline in remittance income from expatriate workers in the Middle East.

Global and Regional Economic Impact

Clearly, it is very difficult to quantify the impact of the war in Iraq on the global economy, although the longer and more severe the conflict, the larger will be the likely economic cost. The situation in Iraq has already affected the world economy in recent months through its impact on oil prices, financial markets, and confidence. Given that these developments are already built into the World Economic Outlook baseline, if the uncertainties surrounding the conflict in Iraq are resolved in the near term with little spillover outside the region, the additional impact on the global economy will likely be quite small and not obviously outside the usual error ranges that accompany the baseline projections in the World Economic Outlook. Indeed, it is possible that a relatively rapid resolution of the current uncertainties could provide a larger boost to global growth in the remainder of 2003 and beyond than currently assumed in the baseline projections. In this context, oil prices have generally fallen back, and equity markets risen, since just before the war started, though markets have remained very volatile.

A protracted war would have more significant adverse effects on global growth. Were Iraqi oil production to be affected for a long time, and if other OPEC countries did not make up for the lost production, oil prices could rise significantly above the prewar baseline and remain at a higher level for a number of months. There would likely be a more sustained decline in consumer and business confidence—particularly if the war were accompanied by terrorist attacks in other regions of the world—while increased geopolitical uncertainty could lead to falls in global equity prices, and non-investment-grade borrowers, including many emerging market sovereigns, could see a sharp increase in risk premia and difficulty accessing capital markets. While the quantification of the impact of these shocks on growth is very difficult, it is possible that in the event of a long drawn-out conflict, real per capita global GDP growth could drop close to zero, from 2 percent in the baseline scenario, and a global recession could not be excluded (defined by the IMF as negative real per capita GDP growth).

Industrial countries would be affected through all of the three channels described previously. As a group, industrial countries would be hit by higher oil prices as most are oil importers—the United States and the euro area would be the most affected. Consumer and business confidence would also be hurt, while declines in equity markets would affect all countries, but particularly those where equities comprise a relatively large part of household wealth. Financial systems in a number of countries could also come under significant pressure—including from declining equity prices, increases in non-performing loans, and exposures to emerging markets—which may reduce their willingness to lend. In some countries, increased defense expenditures would provide some offsetting demand boost, although this could also make medium-term budgetary goals more difficult to attain.

In developing countries, adverse effects from a longer war would be greatest in those regions that rely more on imported oil, depend on external financial flows, are more sensitive to the global economic cycle, and are close to the fighting.

- In the *Middle East*, the economic impact of the conflict is likely to vary significantly between countries. Oil-exporting countries are already gaining from higher oil prices, but the uncertainty associated with the war is depressing investment spending and tourism in the region and diverting resources to military activities. Countries in close proximity to, or that have close economic relations with, Iraq will suffer through lost grants and trade, and possibly the cost of accommodating refugees. Countries that are already under economic stress could be severely affected by the war.
- In *Latin America*, higher oil prices will benefit oil exporters in the region, but would hurt other countries. Countries that are dependent on non-oil exports to the United States and other industrial nations would be hurt by any weakening of demand in advanced countries, while reduced investor appetite for emerging market debt would have a negative affect on countries that have significant external financing needs. Tourism could also be depressed if travel from industrial countries declines. Overall, a longer conflict would negatively affect most countries in the region, and external shocks could be amplified by vulnerabilities in financial sectors in some countries.
- Most emerging markets in *Asia* are oil importers, while their high degree of trade openness also makes them very sensitive to the global business cycle. Some countries could also be affected by a decline in equity prices, lower remittance income from workers in the Middle East countries and from tourism revenues, and reduced access to international capital markets. Consequently, a longer war could have a considerable negative impact on growth in Asia, although it is unlikely to create major external difficulties in most countries given the generally high level of reserves and low external debt in the region.
- Many oil-importing poor countries, including in sub-Saharan Africa and the CIS, would face a double blow from higher oil prices and lower nonfuel commodity prices, and in some cases a decline in tourism. As well as reducing growth, this would seriously affect the external current account positions of these countries. However, given their relatively low exposure to the global economic cycle and lack of access to international capital markets, they would be less affected through other transmission channels.

Policy Responses

The appropriate policy response to the economic consequences of the war in Iraq will depend on both the severity and the relative importance of the resulting demand and supply shocks. If the uncertainties surrounding the situation in Iraq are resolved in the near term, the demand and supply shocks will likely be small, and the appropriate policies will probably be similar to those in the baseline scenario. Were the conflict to be more protracted, some additional policy action would in all probability be needed. While higher oil prices would increase inflationary pressures—the pass-through from oil prices to inflation differs, however, among countries—this would probably be more than offset by the deflationary effects of a decline in confidence and increased risk aversion in financial markets. Indeed, if global activity were significantly affected by the war, there could be a risk that deflation would emerge in those countries where inflation was already low.

- The *first line of defense* should be monetary policy, which can be modified most rapidly in response to changes in macroeconomic prospects. Advanced economies would need to cut interest rates, while in Japan the case for more aggressive quantitative easing, backed by a public commitment to end deflation, would become even stronger.[19] Were deflation to become a threat elsewhere, aggressive monetary action would be essential.
- The appropriate *role of fiscal policy* would depend on the severity of the slowdown and the existing budget situation in individual countries. If activity is significantly affected by the war, then the automatic stabilizers should be allowed to operate in most countries, and the appropriate pace of fiscal consolidation in the euro area and Japan might need to be revisited. If the downturn is sufficiently steep, a discretionary fiscal response might need to be considered.
- *Financial sector* policies would need to focus on maintaining systemic stability. Central banks would need to stand ready to provide liquidity to ensure orderly and well-functioning financial markets. In the absence of threats to systemic stability, distress in individual financial institutions should be addressed through market-based mechanisms for orderly resolutions and exits. In cases where systemic risks emerge, aggressive action to strengthen the banking system would be required, including, if necessary, the injection of public funds to bolster bank capital subject to strict conditionality. Further measures to restore investor confidence in accounting and corporate governance would also help.
- *Structural reforms* would be difficult to implement in an environment of slowing growth, but if progress could be made this would boost confidence. Priority should be given to pension and health care reform (to assuage concerns about the medium-term effects of higher fiscal deficits) and multilateral trade liberalization under the Doha Round.
- In the event of a significant deterioration in global economic conditions, the *international community* might be called upon to provide additional aid to low-income countries and short-term financial support to those countries experiencing temporary financing difficulties.

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