CHAPTER 2

COUNTRY AND REGIONAL PERSPECTIVES

Against the background of the global outlook outlined in Chapter 1, this chapter analyzes prospects and policy issues in the major advanced economies and in the main regional groupings of emerging market and developing countries. A consistent theme is that policymakers around the world face the immediate challenge of maintaining strong noninflationary growth in the face of recent turbulent global financial conditions. They also need to continue to push forward with reforms necessary to ensure continued strong growth in the future.

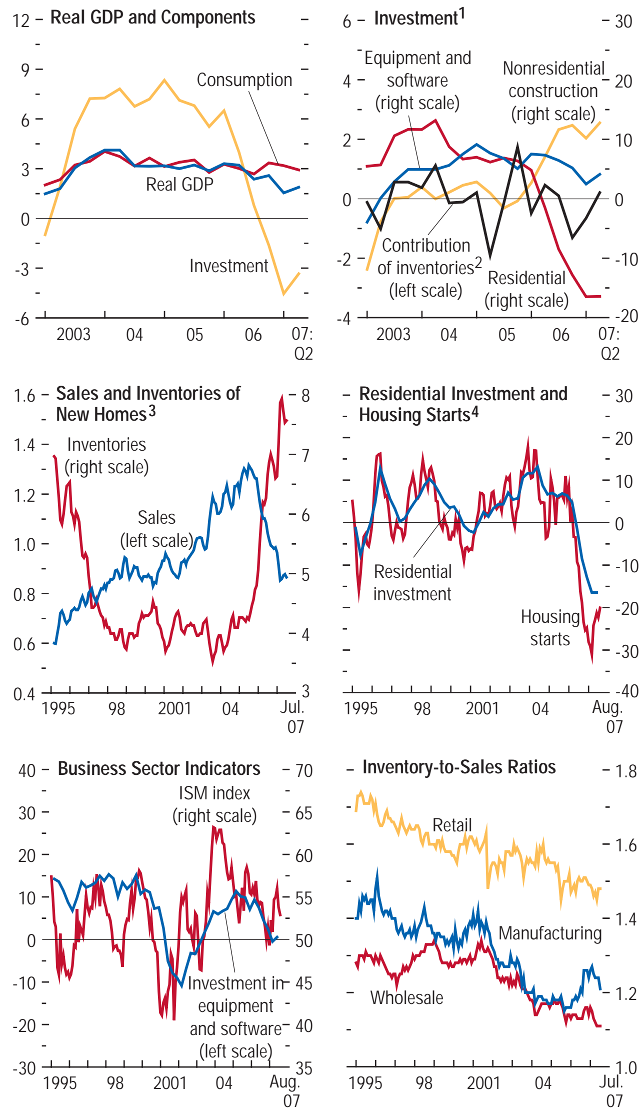
United States and Canada: Uncertainties About the U.S. Outlook Have Risen

Following a weak start to 2007, the U.S. economy rebounded strongly in the second quarter, growing by 3.8 percent (annualized rate). Net exports and business investment provided a significant boost to growth, although private consumption growth slowed markedly in the face of rising gasoline prices, and residential investment continued to exert a significant drag on growth (Figure 2.1). Recent data, however, have painted a weaker picture of the U.S. economy going forward, reflecting in part the impact of the recent turmoil in financial markets. While personal consumption spending, employment, and nonresidential construction data have been solid, housing market indicators have been very weak, and consumer sentiment, the ISM business surveys, and durable goods orders all declined in the most recent readings.

Against this background, the projection for U.S. growth in 2007 as a whole is unchanged at 1.9 percent, but has been lowered by 0.9 percentage point (relative to the July *World Economic Outlook Update*) to 1.9 percent in 2008 (Table 2.1). Ongoing difficulties in the mortgage market are expected to extend the decline in residential investment, while house price declines are likely to encourage households to

Figure 2.1. United States: Indicators of Investment
(Percent change from a year earlier unless otherwise stated)

Weak investment spending, particularly in the residential sector, has been at the heart of the U.S. economic slowdown. Against the background of recent financial market turbulence, the investment outlook remains very uncertain.



Sources: Bloomberg Financial Markets, LP; Haver Analytics; and IMF staff calculations.
[1]Investment in equipment and software, residential investment, and nonresidential construction measured as percent change from four quarters earlier.
[2]Contribution of change in real private inventories to GDP growth.
[3]Three-month moving averages of million units of sales, and months of supplies of inventories.
[4]Private housing starts measured as three-month moving averages of percent change from a year earlier.

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

	Real GDP				Consumer Prices				Unemployment			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Advanced economies	**2.5**	**2.9**	**2.5**	**2.2**	**2.3**	**2.3**	**2.1**	**2.0**	**6.0**	**5.6**	**5.3**	**5.5**
United States	3.1	2.9	1.9	1.9	3.4	3.2	2.7	2.3	5.1	4.6	4.7	5.7
Euro area[1]	1.5	2.8	2.5	2.1	2.2	2.2	2.0	2.0	8.6	7.8	6.9	6.8
Germany	0.8	2.9	2.4	2.0	1.9	1.8	2.1	1.8	9.1	8.1	6.5	6.3
France	1.7	2.0	1.9	2.0	1.9	1.9	1.6	1.8	9.7	9.5	8.6	8.0
Italy	0.1	1.9	1.7	1.3	2.2	2.2	1.9	1.9	7.7	6.8	6.5	6.5
Spain	3.6	3.9	3.7	2.7	3.4	3.6	2.5	2.8	9.2	8.5	8.1	8.2
Netherlands	1.5	3.0	2.6	2.5	1.5	1.7	2.0	2.2	4.7	3.9	3.2	3.1
Belgium	1.4	3.0	2.6	1.9	2.5	2.3	1.8	1.8	8.4	8.2	7.6	7.6
Austria	2.0	3.3	3.3	2.5	2.1	1.7	1.9	1.9	5.2	4.8	4.3	4.2
Finland	2.9	5.0	4.3	3.0	0.8	1.3	1.5	1.8	8.4	7.7	6.7	6.5
Greece	3.7	4.3	3.9	3.6	3.5	3.3	3.0	3.2	9.9	8.9	8.5	8.5
Portugal	0.5	1.3	1.8	1.8	2.1	3.0	2.5	2.4	7.6	7.7	7.4	7.1
Ireland	5.9	5.7	4.6	3.0	2.2	2.7	2.5	2.1	4.4	4.4	4.7	5.5
Luxembourg	4.0	6.2	5.4	4.2	2.5	2.7	2.2	2.2	4.2	4.4	4.4	4.6
Slovenia	4.1	5.7	5.4	3.8	2.5	2.5	3.2	3.1	6.5	6.0	6.0	6.0
Japan	1.9	2.2	2.0	1.7	–0.3	0.3	—	0.5	4.4	4.1	4.0	4.0
United Kingdom[1]	1.8	2.8	3.1	2.3	2.0	2.3	2.4	2.0	4.8	5.4	5.4	5.4
Canada	3.1	2.8	2.5	2.3	2.2	2.0	2.2	1.9	6.8	6.3	6.1	6.2
Korea	4.2	5.0	4.8	4.6	2.8	2.2	2.6	2.7	3.7	3.5	3.3	3.1
Australia	2.8	2.7	4.4	3.8	2.7	3.5	2.3	2.8	5.1	4.8	4.4	4.3
Taiwan Province of China	4.1	4.7	4.1	3.8	2.3	0.6	1.2	1.5	4.1	3.9	3.9	4.0
Sweden	2.9	4.2	3.6	2.8	0.8	1.5	1.9	2.0	5.8	4.8	5.5	5.0
Switzerland	2.4	3.2	2.4	1.6	1.2	1.0	1.0	1.0	3.4	3.3	2.4	2.7
Hong Kong SAR	7.5	6.9	5.7	4.7	0.9	2.0	2.0	3.2	5.7	4.8	4.2	4.0
Denmark	3.1	3.5	1.9	1.5	1.8	1.9	1.9	2.0	5.7	4.5	3.6	3.9
Norway	2.7	2.8	3.5	3.8	1.6	2.3	0.8	2.5	4.6	3.4	2.8	2.9
Israel	5.3	5.2	5.1	3.8	1.3	2.1	0.5	2.5	9.0	8.4	7.5	7.2
Singapore	6.6	7.9	7.5	5.8	0.5	1.0	1.7	1.7	3.1	2.7	2.6	2.6
New Zealand[2]	2.7	1.6	2.8	2.3	3.0	3.4	2.4	2.7	3.7	3.8	3.8	4.3
Cyprus	3.9	3.8	3.8	3.7	2.6	2.5	2.0	2.4	5.3	4.5	4.0	4.0
Iceland	7.2	2.6	2.1	–0.1	4.0	6.8	4.8	3.3	2.1	1.3	2.0	3.2
Memorandum												
Major advanced economies	2.3	2.6	2.1	1.9	2.3	2.3	2.1	1.9	6.0	5.6	5.3	5.7
Newly industrialized Asian economies	4.7	5.3	4.9	4.4	2.3	1.6	2.0	2.3	4.0	3.7	3.5	3.4

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

raise their saving rate out of current incomes and thereby dampen consumption spending. Exports, however, are expected to grow robustly, benefiting from the continued decline in the dollar and solid growth in partner countries, and healthy corporate balance sheets should support business investment.

Risks to this outlook, however, are on the downside. While the recent further weakening of the U.S. dollar could lead to more vigorous export growth than in the baseline forecast, three downside risks are particularly apparent.

- First, while the turmoil in the financial markets appears to have eased, at this stage it is unclear to what extent the cost and availability of credit across the broader economy will be affected. The reintermediation of credit onto the balance sheets of banks as they absorb off-balance-sheet entities that are experiencing financial difficulties could curtail new lending, while difficulties among specialized mortgage lenders will reduce the availability of housing finance. Spreads in high-yield markets are also likely to remain elevated, affecting the investment outlook. A significant pullback in lending by financial institutions would clearly have negative implications for the growth outlook.
- Second, there are significant downside risks from the housing market. With inventories of unsold homes high, rising delinquencies

and tighter credit conditions in the subprime mortgage market, and the cost of some other types of higher-quality mortgages rising, a deeper and more protracted housing downturn than assumed in the current baseline is a risk. Not only would this extend the decline in residential investment, but deeper falls in house prices would put additional pressure on household finances and consumption, particularly if the labor market were to continue to weaken (see Box 2.1 for a discussion of the effects of house prices on growth).

- Third, at this stage it is unclear to what extent the recent sharp slowdown in productivity growth is attributable to structural, as opposed to cyclical, factors. Reflecting the view that the slowdown is indeed partly structural, IMF staff estimates of medium-term potential growth have been marked down to 2¾ percent. But, if underlying productivity growth is weaker than now estimated, this would feed through into expectations of future incomes, thus reducing consumption and investment spending.

With the economy weakening, inflation pressures have moderated. As measured by the core personal consumption expenditure deflator, 12-month inflation has come down below 2 percent. Pressures on core inflation are expected to continue to ease in the coming months against the backdrop of slowing growth in shelter costs (which have been an important driver of core inflation over the past year) and modest growth, although the depreciation of the dollar could add to import prices.

Against the background of the changing balance of risks to growth and inflation, the Federal Reserve cut the federal funds rate by 50 basis points to 4.75 percent at its September meeting. Looking forward, signs that growth was likely to continue below trend would justify further interest rate reductions, provided that inflation remains contained. At this stage, markets expect the Fed to cut rates by a further 50 basis points in the coming months.

The current account deficit is projected to narrow, reaching 5.5 percent of GDP in 2008 compared with 6.2 percent of GDP in 2006, assuming that the real effective value of the U.S. dollar remains at its current level (Table 2.2). Strong export growth and weaker import demand are expected to more than offset the impact of higher oil prices and lower net investment income. Despite the large external borrowing needed to finance the deficit, valuation gains from the depreciating U.S. dollar in recent years and the underperformance of the U.S. equity markets relative to those overseas have meant that the net foreign liability position of the United States actually

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

	2005	2006	2007	2008
Advanced economies	**–1.3**	**–1.4**	**–1.3**	**–1.4**
United States	–6.1	–6.2	–5.7	–5.5
Euro area[1]	0.3	—	–0.2	–0.4
Germany	4.6	5.0	5.4	5.1
France	–1.1	–1.2	–1.6	–1.8
Italy	–1.5	–2.4	–2.3	–2.2
Spain	–7.4	–8.6	–9.8	–10.2
Netherlands	7.7	8.6	7.4	6.7
Belgium	2.6	2.0	2.5	2.5
Austria	2.1	3.2	3.7	3.7
Finland	4.9	5.2	5.0	5.0
Greece	–6.4	–9.6	–9.7	–9.6
Portugal	–9.7	–9.4	–9.2	–9.2
Ireland	–3.5	–4.2	–4.4	–3.3
Luxembourg	11.1	10.6	10.5	10.3
Slovenia	–1.9	–2.5	–3.4	–3.1
Japan	3.6	3.9	4.5	4.3
United Kingdom	–2.5	–3.2	–3.5	–3.6
Canada	2.0	1.6	1.8	1.2
Korea	1.9	0.7	0.1	–0.4
Australia	–5.8	–5.5	–5.7	–5.6
Taiwan Province of China	4.5	6.8	6.8	7.1
Sweden	7.0	7.2	6.0	5.7
Switzerland	13.5	15.1	15.8	15.0
Hong Kong SAR	11.4	10.8	11.2	9.5
Denmark	3.8	2.4	1.3	1.3
Norway	15.5	16.4	14.6	15.1
Israel	3.3	5.6	3.7	3.2
Singapore	24.5	27.5	27.0	25.4
New Zealand	–8.6	–8.7	–8.5	–8.6
Cyprus	–5.6	–5.9	–5.5	–5.6
Iceland	–16.1	–27.3	–11.6	–6.0
Memorandum				
Major advanced economies	–2.0	–2.2	–1.9	–1.9
Euro area[2]	—	–0.2	–0.1	–0.3
Newly industrialized Asian economies	5.5	5.6	5.4	4.9

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

Box 2.1. What Risks Do Housing Markets Pose for Global Growth?

Following a long run-up, house prices in the United States have decelerated sharply since mid-2005, and the subsequent drop in residential investment has been a substantial drag on the economy over the past year. Housing markets in many other countries—in both advanced and emerging market economies—have experienced boom conditions in recent years, and some of these have also recently shown signs of softening. So far, these moderations have occurred without the deep correction seen in the United States, but there remains the concern that the U.S. experience might presage steep housing downturns in other countries that have also experienced a rapid rise in house prices, with associated risks for output growth.

Recent financial turbulence has raised the risk of more drawn-out difficulties in the U.S. housing sector that could have a deeper impact on the broader economy. Tightening credit conditions could affect a broader range of households and further curtail effective demand for housing. And house prices could decline more sharply than currently expected with implications for residential investment and consumer spending. At the same time, credit conditions may also tighten in some of the western European countries—because of their large exposures to asset-backed commercial paper and continuing strains in short-term funding markets—and this could have a significant bearing on the housing market in these countries.

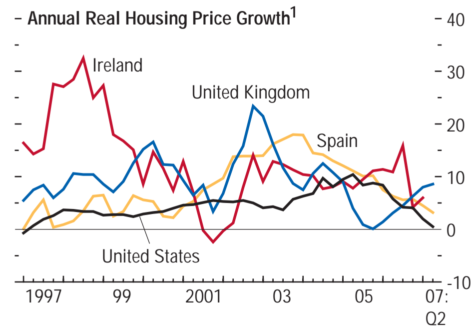
The Run-Up in House Prices

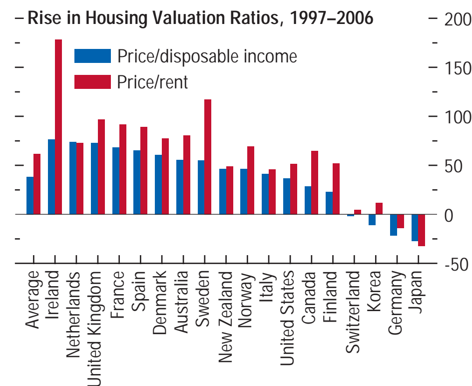
Traditional valuation measures, ratios of both house price to income and house price to rent, have risen steeply in several Organization for Economic Cooperation and Development (OECD) and emerging market countries in recent years (first figure). Specifically,

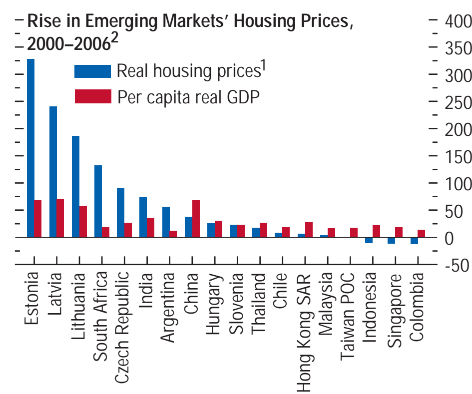
- Relative to incomes and rents, many industrial economies have witnessed even larger run-ups

Note: The main author of this box is Andrew Benito. Sergei Antoshin provided research assistance.

Housing Price Developments
(Percent change)







Sources: OECD; and IMF staff calculations.
[1]Deflated by CPI.
[2]Data for India cover 2000–05.

in house prices than the United States. For the OECD countries on average, the ratio of house price to income has risen by more than one-third, and the ratio of house price to rent by almost two-thirds, since 1997. The largest increases in house prices relative to incomes have been experienced by France, Ireland, the Netherlands, Spain, and the United Kingdom. By contrast, Germany and Japan have experienced falling house price valuation ratios over the past 10 years.

- Based on limited data, many emerging market economies have also experienced substantial house price run-ups since 2000, exceeding growth in per capita incomes. The largest increases were recorded in Estonia and Latvia (although data are only for the capital cities and are therefore likely to overestimate countrywide growth). Other large price rises, with real house prices almost doubling or more, were recorded in the Czech Republic, Lithuania, and South Africa. However, real house prices have declined in Colombia, Indonesia, and Singapore.
- In China, the increase in real house prices was less than real income growth over the same period, although there have been localized booms in fast-growing cities such as Beijing and Shanghai.

Risk of Weakening Housing Markets

The risk of a broader weakening in housing markets depends partly on how much of the previous price rise can be justified by changes in fundamental determinants of house prices, including interest rates, availability of financing, income growth, and demographics. It also depends on how those fundamentals, including long-term interest rates, evolve in the future. The assessment is likely to differ across countries, as will the time horizon over which the risk applies.[1]

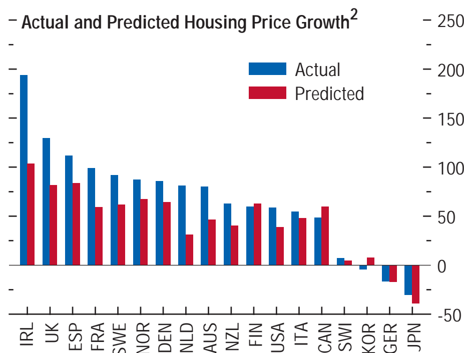
[1]See, for example, Girouard and others (2006) and the collection of papers presented at the Jackson Hole Symposium on Housing, Housing Finance, and Monetary Policy, August 30–September 1, 2007.

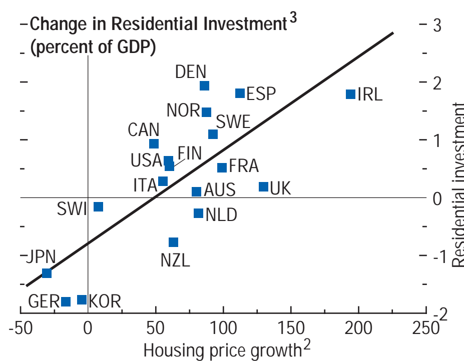
The following analysis extends and updates an earlier IMF study that modeled house price inflation as a function of an affordability ratio (the lagged ratio of house prices to disposable incomes), the growth in disposable income per capita, short-term interest rates, credit growth, growth in the country's equity market index, and growth in the working-age population (see Terrones, 2004). The previous study is extended in two ways. First, long-term interest rates are included in addition to the variables considered in the previous study. This is generally found to be significant. Second, separate equations are estimated for each country, so that the role assigned to each factor is allowed to vary across countries, although the same variables are included for all countries. The equation is estimated for a group of 18 OECD countries for which adequate data are available, using quarterly data for the period 1970–2006.

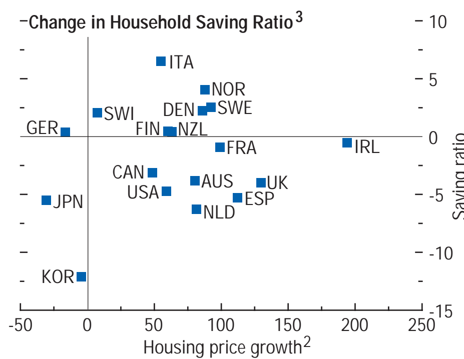
The results indicate that almost three-quarters of the rise in real house prices over the period 1997–2006 can be explained on average by the estimated model, although this still leaves a significant unexplained component. For the United States, real house prices are assessed to have risen by about one-third more than explained by fundamentals (second figure). The unexplained share of house price increases is assessed to be still larger in a number of other countries, including Ireland, the Netherlands, and the United Kingdom. However, there is considerable uncertainty about these estimates, because local conditions that are not captured in the econometric analysis could play an important role. For example, migration patterns, supply constraints, and changes in the availability of mortgage financing—including to the subprime sector—could all be relevant. On the other hand, some of the increase in house prices that is explained by the model, such as through the role for credit growth, may not reflect solely economic fundamentals. Nevertheless, taken at face value, the estimates suggest that a number of advanced economies' housing markets outside the United States could be vulnerable to a correction.

Box 2.1 *(concluded)*

Risks to Output Growth, 1997–2006[1]







Source: IMF staff calculations.
[1]AUS: Australia; CAN: Canada; DEN: Denmark; ESP: Spain; FIN: Finland; FRA: France; GER: Germany; IRL: Ireland; ITA: Italy; JPN: Japan; KOR: Korea; NLD: Netherlands; NOR: Norway; NZL: New Zealand; SWE: Sweden; SWI: Switzerland; UK: United Kingdom; and USA: United States.
[2]Cumulative growth rate at constant prices.
[3]Difference over 1997–2006.

House Prices and the Broader Economy

The countries most at risk from a weakening housing sector are likely to be those that have experienced the largest increases in house-price-sensitive components of aggregate demand as well as those where the run-up in prices seems less easily explained by changes in fundamentals. Over the past decade, growth has been boosted across many OECD economies by strong residential investment, with the countries that experienced the largest run-up in house prices generally witnessing the strongest additional residential investment (see second figure). For example, in Ireland and Spain, the ratio of real residential investment to GDP rose by 1.8 percentage points compared with an increase of 0.6 percentage point in the United States over the same period, although part of the difference is accounted for by weakening U.S. residential investment in 2006.[2] Home builders' ability to respond to higher prices is, however, constrained in some countries, such as the Netherlands and the United Kingdom, by planning restrictions and land limits (Barker, 2004). This may help explain why housing demand pressures have raised prices more than has residential investment in these countries.

When home builders perceive the profitability of new housing investment to moderate, residential investment can decline rapidly, reversing some of the boost to output growth from housing investment. This has already been a significant feature of the housing correction in the United States. A number of other countries, such as Denmark, Ireland, and Spain, could also be subject to such a correction. However, the pace and depth of the corrections would depend on country-specific factors. In the United States, the correction has been exacerbated by the sharp reversal in the subprime mortgage market, a factor less relevant else-

[2]The spread of increases in residential investment is even larger in terms of nominal ratios of residential investment to GDP, reflecting the variation in the relative price of housing.

where, because subprime mortgages represent a much smaller share of lending.

A decline in house prices could also affect the broader economy through its impact on consumer spending. The strength of this link would again vary across countries and also depend on why house prices have changed. Weakening house prices would be expected to dampen spending of some households through a negative "wealth effect," although other households (such as renters planning to buy a home) are made better off by lower prices. Spending can also be affected through a collateral channel, because house price movements affect the value of home equity and the terms under which households can borrow from banks. This latter effect tends to be stronger in economies such as the United Kingdom and the United States, where financing of home equity withdrawal is more easily available.[3] The figure shows that the cross-country correlation between the household saving ratio and house prices is weak. Research also suggests that these links vary over time within a given country, depending on why house prices have varied.[4] For example, in the United Kingdom, house price rises were more strongly associated with rising income expectations in the mid- to late 1980s than during the recent run-up. This may help explain why the earlier period was associated with a more pronounced consumption boom.

Consumer spending is also influenced by many factors other than house prices. Relevant factors include current and expected incomes, financial market wealth, and retail lending conditions. During the recent U.S. housing correction, robust employment growth and solid equity market performance have supported consumption. The extent to which a weakening housing market is associated with weaker spending in other economies will also depend on the evolution of these factors.

In sum, after a period of remarkable house price growth, conditions have eased back in a number of advanced economies' housing markets. There is some risk to global output growth from these developments: economies that have experienced a larger unexplained increase in house prices than the United States account for almost 20 percent of the total output of advanced economies. These risks may have been exacerbated by recent market turmoil and by an associated repricing of risk. Furthermore, western European banks are exposed to the U.S. housing sector, and strains in short-term funding markets could restrain their lending activity and have an adverse impact on the housing market in these countries. The extent of these risks is, as yet, unclear. In general, residential investment is the component of demand most at risk to weaker housing market conditions, although consumption could also come under pressure in some countries. Spillovers from the U.S. housing market have also occurred through financial channels, and such links need to be carefully monitored.

[3]See the April 2002 *World Economic Outlook*, pp. 74–85; Klyuev and Mills (2006); and Carroll, Otsuka, and Slacalek (2006).

[4]See Benito and others (2006), pp. 142–54. Housing transactions also tend to be linked with spending durables, reflecting the number of households purchasing durable goods for their new homes.

improved slightly in 2006 for the third year running. Nevertheless, although the real effective U.S. dollar is still estimated to be above its medium-term fundamental value, valuation gains cannot be relied on to stabilize the liability stock going forward. It is therefore important that national savings increase in the coming years to support a reduction in the current account deficit.

Fiscal developments have remained favorable, with the federal government deficit now expected to come in at 1.2 percent of GDP in FY2007, less than half of that budgeted. This overperformance reflects both revenue buoy-

ancy and lower-than-budgeted expenditures.[1] Going forward, the U.S. administration aims to balance the budget by FY2012 (a target also adopted by the U.S. Congress in its own budget resolution). Official projections, however, do not fully account for the alternative minimum tax relief or war costs in future years. The projections also assume spending restraint that may be difficult to achieve. Adjusting for these items, the IMF staff projects that the deficit will likely remain above 1 percent of GDP through FY2012. In the IMF staff's view, a more ambitious fiscal consolidation strategy than currently envisaged, combined with reforms to Social Security and Medicare, would better help ensure long-term fiscal sustainability, although automatic fiscal stabilizers should be allowed to operate in the event of a protracted downturn. Such a fiscal strategy should aim at achieving budget balance, excluding the Social Security surplus. Spending restraint is essential in this regard, but steps to increase revenues also may be considered.

The recent turmoil in financial markets has underscored the need for regulators and supervisors to increase their focus on several aspects of the U.S. financial system (see also the October 2007 *Global Financial Stability Report,* or GFSR). For example, greater transparency and disclosure by systemically important financial institutions, including of their links with off-balance-sheet vehicles, would help reduce uncertainties about counterparty risk that were at the center of the drying up of liquidity in some parts of the financial markets. It is also important to consider how securitization and financial innovation more generally have affected the incentive structure in financial markets. This would include looking at whether the incentives for loan originators to accurately assess risk have been diluted, and whether investors put excessive reliance on rating agencies in assessing risks rather than conducting their own due diligence.

[1]Estimates suggest that 40 percent of the revenue increase during 2004–06 can be explained by corporate profits growing faster than GDP, 40 percent by the growth of capital gains, and much of the remaining 20 percent by stronger income growth at the upper end of the income distribution (which, given the progressive tax system, implies higher average tax rates). See Swiston, Mühleisen, and Mathai (2007).

In Canada, real GDP growth accelerated to over 3 percent in the first half of 2007. Strong domestic demand remained the main driver of growth, boosted by continuing gains in the terms of trade and strong credit and employment growth, while the inventory correction, which had been a significant drag on growth in late 2006, reversed. Nevertheless, the short-term outlook is clouded by weaker prospects in the United States and the recent global financial market turmoil, which has affected parts of the Canadian markets, and the growth forecast for 2008 has been marked down to 2.3 percent (0.5 percentage point lower than in the July *World Economic Outlook Update*). With core CPI inflation above the midpoint of the Bank of Canada's 1–3 percent target range despite the substantial appreciation of the Canadian dollar, the central bank raised its policy rate to 4½ percent in July (the first increase since May 2006), but has remained on hold since. The fiscal position remains strong, with the budget in surplus and the public debt ratio on a firm downward path.

Western Europe: How Resilient Is the Recovery?

The financial market turbulence has come at a time when western Europe has been enjoying its best economic performance for a decade. A long spell of robust global growth, healthy corporate balance sheets, accommodative financing conditions, and past reforms have laid the foundation for a strong upswing. The euro area economy has been expanding at about 3 percent (year on year) since the middle of 2006, although growth eased in the second quarter of 2007, partly owing to weather and holiday effects. Growth has been driven by a broad-based acceleration in investment spending, especially in Germany, in response to high regional and global demand for machinery and equipment, a pickup in construction, and robust exports. Private consumption softened in the first half of 2007, reflecting the

German value-added tax (VAT) hike and pre-election uncertainty in France, but consumer confidence remained fairly robust until June, when it began to weaken. In the United Kingdom, the expansion has continued at a strong and steady pace, with growth of 3 percent (year on year) in the second quarter of 2007, led by consumption. In Norway, Sweden, and Switzerland, growth was also sustained above potential rates in the second quarter.

Recent data provide mixed signals about the likely growth performance of western European economies in the coming quarters, although the recent financial market turbulence and weaker growth in the United States are pointing to a likely slowdown. Euro area growth is now forecast to slow to about 2.5 percent in 2007 and 2.1 percent in 2008, while growth in the United Kingdom is now expected to ease from 3.1 percent in 2007 to 2.3 percent in 2008. Exports will be affected by weakening external demand, and the strength of the euro is likely to weigh on export prospects of countries lacking a sufficient cushion in competitiveness, including France, Portugal, and Spain. The tightening of global credit conditions is likely to lead to some cooling of European housing markets and dampening prospects for residential investment and household consumption. Growth is also likely to be affected by tighter availability of bank credit. A number of European banks have significant exposure to the U.S. housing market, particularly through off-balance-sheet vehicles supported by backup lines of credit, and the sector as a whole has been affected by the higher cost of funding and liquidity shortages. Responding to pressures in short-term interbank markets, the European Central Bank (ECB) and the Bank of England (BoE) stepped in to provide liquidity. On a more positive note, high capacity utilization and strong corporate profitability are projected to support investment, while recent improvements in the labor market should help to hold up consumer spending.[2]

[2]Recently approved tax cuts in France will also support activity in 2008.

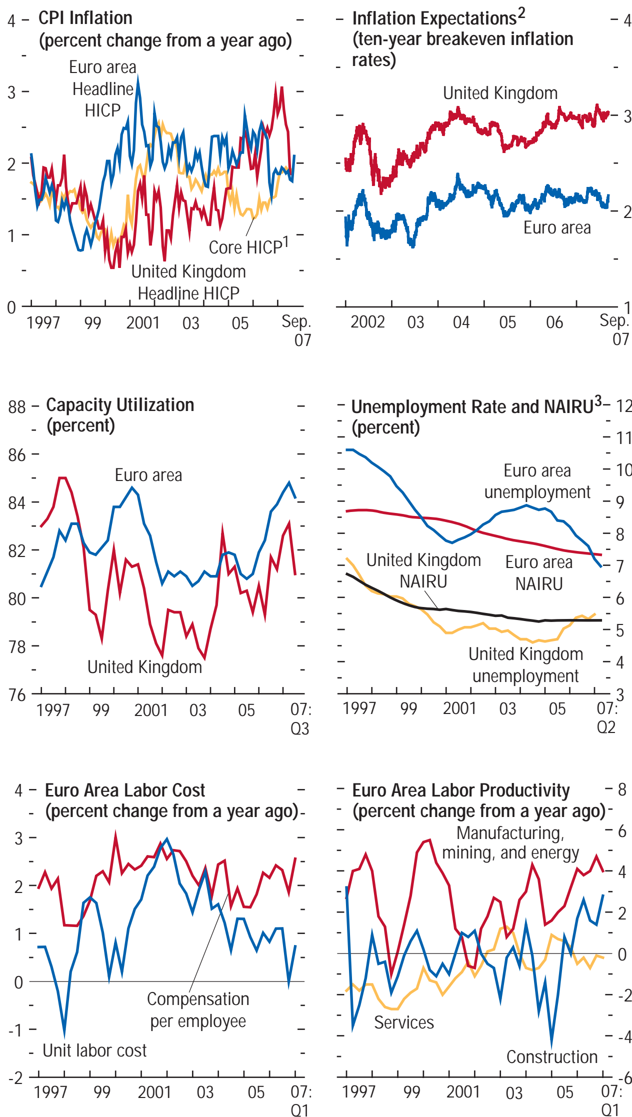
The balance of risks to the outlook are to the downside. Deteriorating conditions in credit markets could further slow consumption and investment, particularly if banks sharply curtail lending in the coming quarters as they seek to improve their balance sheets in what still remains a volatile and uncertain environment. In countries where housing prices still seem elevated—France, Ireland, Spain, and the United Kingdom—growth dynamics will depend on the pace of adjustment in the housing sector in response to tightening credit conditions and, in some cases, changes in the fiscal treatment of housing investment. Other risks—mainly relating to volatile oil prices, a more protracted slowdown in the U.S. economy, and a disorderly unwinding of global imbalances—are also to the downside.

The euro area headline CPI has remained below 2 percent this year, but ticked up in September and is expected to temporarily exceed this threshold during the remainder of the year on account of higher energy and food prices (Figure 2.2). It is projected to hover around 2 percent in 2008 as tighter credit conditions, lower pressures of resources, as well as the unwinding of the German VAT increase are expected to offset rising energy costs. Despite continuing tightening in the labor markets, wage growth in the euro area is expected to remain moderate in the coming quarters, as the slowdown in activity, appreciation of the euro, and structural changes in the labor supply, including increased competition (partly due to the enlargement of the European Union) and large migration inflows, should continue to keep inflation in check (Box 2.2). In the United Kingdom, inflation temporarily overshot the BoE's 2 percent target, in part owing to the pass-through of energy price increases, but has recently fallen below the target.

The ECB and the BoE tightened monetary policy through June in the face of rising resource utilization and firming inflation, but have remained appropriately on hold since the onset of the financial market turmoil. In the euro area, considering the downside risks to growth and inflation from financial market turmoil,

Figure 2.2. Western Europe: What Is the Outlook for Inflation?

Inflation has been firming up in the euro area in tandem with rising resource utilization. Wages are not yet outpacing productivity, but structural changes in the labor supply are moderating the pickup in wages. Productivity improvements seem to have been concentrated in cyclical industries so far.



Sources: Haver Analytics; and IMF staff calculations.
[1]Core defined as headline, excluding energy, food, alcohol, and tobacco.
[2]Differences between inflation expectations from 10-year breakeven rates in the United Kingdom and the Bank of England's inflation target are, in part, because bonds are indexed to retail price inflation (RPI). The latter has tended to exceed the CPI in recent years, mainly because, in contrast to the CPI, the RPI includes interest rate payments on mortgages.
[3]NAIRU defined as nonaccelerating inflation rate of unemployment.

monetary policy can afford to stay on hold over the near term. However, as these downside risks dissipate, some further tightening may well be required. Conversely, in the event of a more protracted slowdown, an easing of monetary policy would need to be considered. In the United Kingdom, the monetary authorities will need to consider similar factors—with inflation, the exchange rate, the possible softening in domestic credit supply, and the U.S. outlook to be weighed against the strength of domestic demand.

Many, although not all, euro area countries took advantage of buoyant revenue growth in 2006 to advance fiscal consolidation. The euro area's cyclically adjusted fiscal deficit declined by almost 1 percentage point of GDP in 2006, led by reductions in Germany, France, and Italy (adjusting for one-off measures), and public debt declined relative to GDP. The challenge is to continue the progress on fiscal consolidation. Besides preparing for population aging, lower fiscal deficits would help create room for cutting distortionary taxes, laying the ground for a long-lasting improvement in economic performance. Under the reformed Stability and Growth Pact, most countries in the euro area are aiming for budget balance or even a small surplus over the medium term, and countries that have not yet reached their medium-term objectives are required to adjust by at least ½ percent of GDP a year. However, this goal seems unlikely to be met in a number of countries, including France (which has recently approved a package of tax cuts) and Italy (where the government has scaled back its fiscal adjustment in 2007–08, despite significant revenue overperformance).

The euro area's long-term prospects hinge on its ability to accelerate productivity and employment growth, as well as improve structural flexibility of member countries' economies. Employment performance has strengthened recently owing to past reforms and cyclical factors, but productivity performance remains lackluster. Although the euro area fares well on international comparisons of productivity in tradable goods sectors, its productivity in services, which tend to be more sheltered from competi-

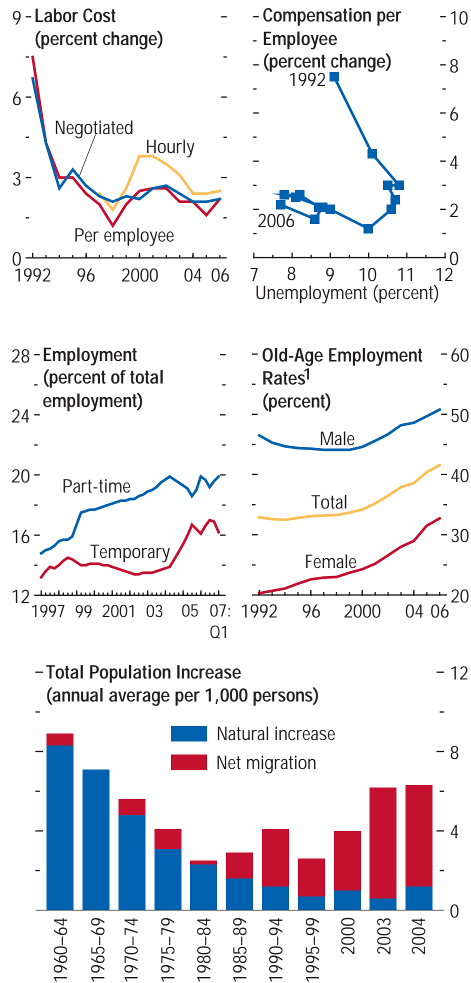
Box 2.2. Labor Market Reforms in the Euro Area and the Wage-Unemployment Trade-Off

Labor market performance in the euro area appears to have improved significantly over the past decade. During the 1970s, against the background of expanding welfare states, growing union assertiveness, and macroeconomic policy misjudgments, oil price and other shocks led to a sharp increase in unemployment and inflation and a decline in labor force participation. Experiences over the past few years could not have been more different: whereas oil and administrative prices grew rapidly, wages remained subdued and unemployment fell to a quarter-century low of 7 percent in mid-2007. This box examines the factors underlying the improved trade-off between wages and unemployment and concludes that labor market reforms have made an important contribution in this regard. Nonetheless, more work remains to be done to continue reducing unemployment on a sustainable basis and to boost the still relatively low labor force participation.

Background

Although unemployment has declined significantly over the past several years in the euro area, labor costs have not accelerated. Labor costs decelerated during 1992–97 and have moved sideways thereafter. Specifically, the rate of increase of compensation per employee and negotiated wages declined from about 7 percent in 1992 to about 2 percent in 1997 and has hovered between 1½ percent and 2½ percent a year since then, and real wage growth has also been declining (figure). Changes in national policies and union behavior as well as increased competition from emerging market countries were the key factors underlying these developments. Measures such as the exemption of small and medium-size enterprises from the 35-hour workweek in France increased scope for fixed-term and part-time contracts in Italy (under the so-called Biagi reforms), and flexible working-time agreements between employers and unions in various sectors in Germany have facilitated increased flexibility and have helped contain the growth of labor costs.

Note: The main author of this box is Emil Stavrev.



Sources: European Commission; Eurostat; and Haver Analytics.
[1]Ages 55 to 64 years.

Analytical Framework

The labor supply (wage) curve proposed in Blanchflower and Oswald (1990) provides a framework for estimating the effect of labor market reforms on the supply of labor. In this

Box 2.2 *(concluded)*

framework, real wages adjusted for productivity changes are modeled as a function of the unemployment rate and supply-side factors:

$$ln\frac{W_t}{C_t A_t} = \alpha_t - \theta\ ln(u_t),$$

where W_t denotes wages, C_t is the consumer price index, A_t is the total factor productivity (scaled by the labor share), u_t is the unemployment rate, and α_t denotes the cumulative effect of factors that affect wage-setting behavior and thus shift the wage curve. These factors include changes in unemployment benefits, the tax wedge between earned wages and workers' purchasing power, and employment preferences of workers.

The cumulative effect of labor market reforms and changes in preferences toward employment, α_t, can be obtained as a residual from the above equation. Estimation of this equation for euro area data from 1992 to 2006 shows that α_t declined gradually by about 6 percent over this period, suggesting an improved trade-off between wages and unemployment, that is, lower unemployment for a given level of real wages.

Factors Behind Wage and Employment Developments

What are the factors that contributed to this improved trade-off between wages and unemployment in the euro area since the early 1990s?

- Structural reforms have helped increase the labor supply for any given real wage. Examples of such policies include the deregulation of part-time and "temp" work in Spain and France in the 1990s. As a result of such deregulation, the share of temporary employment in total employment increased significantly (see figure).[1]
- Participation rates of older workers have risen as a result of the phasing out of early retirement schemes. Similarly, female participation has continued to increase (see figure).
- Labor taxation has been reduced. Effective social security contribution rates declined in France, Germany, and Italy, and the tax wedge (the difference between wages and take-home pay) narrowed in France, Italy, and Spain in the second half of the 1990s.
- Greater emphasis has been given to employment by both unions and workers as their preferences have shifted toward job preservation and job creation, possibly in response to increased external competition, particularly from Asian emerging market countries.
- Higher net immigration has contributed to moderate wage growth (see figure). The employment of lower-cost immigrants in agriculture and other sectors has reduced overall inflation, allowing workers to have the same real wage growth for lower nominal wage increases. Also, by reducing skill mismatches and taking jobs that are difficult to fill, immigrants raise growth and welfare, increasing overall employment.

[1]European Central Bank (2007).

tion, is subpar. Improving contestability of services markets (particularly wholesale and retail trade and financial services) through deregulation and opening to foreign competition is critical for boosting long-term growth prospects. The Services Directive goes a long way in this direction, and the challenge now is to implement it in a meaningful way and possibly broaden it to additional sectors. Continued labor and product market reforms need to focus on strengthening incentives to work and on improving wage flexibility. The Lisbon Strategy holds promise in this regard, provided its full potential is unleashed. Further financial integration can facilitate sharing of risks relating to country-specific demand or supply shocks (Stavrev, 2007).

Industrial Asia: Deflation Is Not Yet Decisively Beaten in Japan

The Japanese economy contracted slightly in the second quarter of 2007, following two quar-

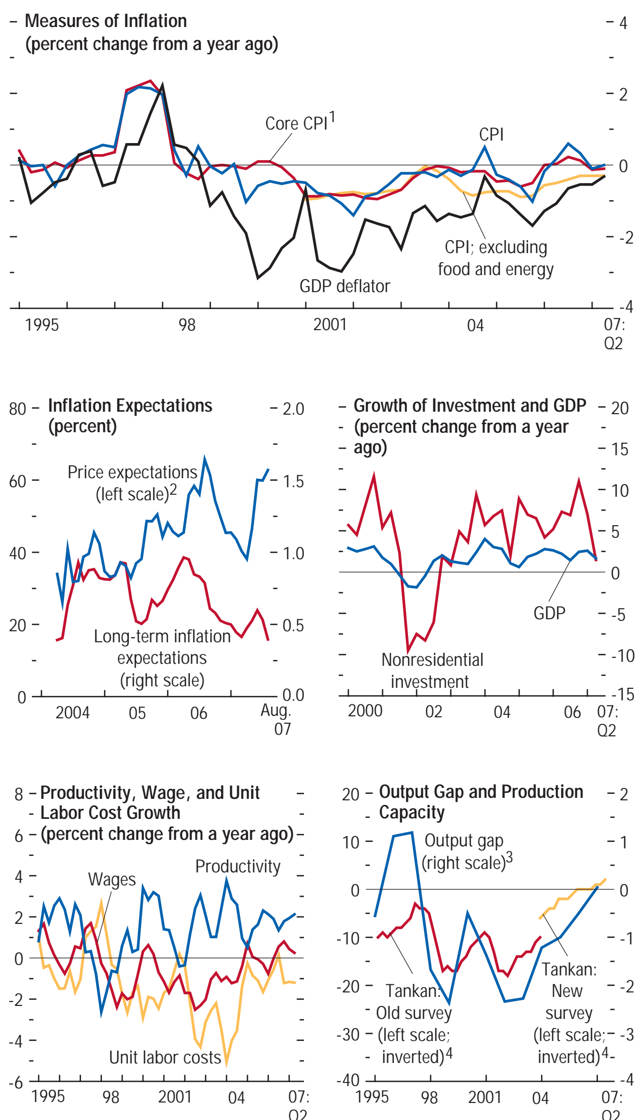
ters of strong gains. The decline in real GDP in the quarter was driven largely by declines in investment and weaker consumption growth. Looking ahead, the September Tankan survey showed that business confidence remains solid, consistent with continued strong performance by large exporters, but some recent data on domestic demand, such as for household consumption, have been more mixed. Further, heightened global financial market volatility has clouded the near-term outlook, although the direct exposure of the Japanese financial system to the U.S. subprime mortgage market is limited.

Reflecting the weak second quarter outcome and other incoming information, the projection for real GDP growth has been marked down to 2 percent in 2007 and 1.7 percent in 2008 (0.6 and 0.3 percentage point lower than in the July *World Economic Outlook Update*). The tight labor market—the unemployment rate stood at 3.8 percent in August—is expected to underpin stronger income and consumption growth going forward, and robust profits and healthy balance sheets should provide support to corporate investment. Risks to the outlook appear tilted somewhat to the downside at this stage. While faster wage growth could boost consumption spending, growth would be dampened by a more significant downturn in the global economy, higher oil prices, or a further appreciation of the yen.

Despite four years of robust growth, deflation has yet to be decisively beaten (Figure 2.3). Indeed, after a period of rising consumer prices, the year-on-year changes in the headline and core CPI have once again turned modestly negative in recent months, although land prices are now rising. While the decline in consumer prices is likely to be reversed in the period ahead as higher energy prices feed into the CPI, prospects for a decisive move to positive inflation remain elusive. A number of factors seem to be limiting inflation. Corporate investment has been strong in recent years and, combined with structural reforms that have boosted productivity, this has likely increased the growth potential

Figure 2.3. Japan: Deflation Still Not Decisively Beaten

Sustained growth in recent years has not yet resulted in a decisive exit from deflation. With strong investment spending and improved productivity-boosting capacity, and inflation expectations remaining low, price increases are likely to remain limited in the near term.



Sources: Cabinet Office, Government of Japan; CEIC Data Company Limited; Haver Analytics; OECD, *Economic Outlook;* and IMF staff calculations.

[1]All items, excluding fresh food.

[2]Respondents expecting prices to increase minus those expecting prices to decrease.

[3]Output gap expressed as a percent of potential GDP.

[4]Tankan, actual production capacity in diffusion index for all industries.

of the economy. Indeed, measures of capacity utilization have only recently begun to suggest that the economy is working at full capacity. In addition, wages have been held down by demographic changes that are seeing retiring older workers with high wages replaced by younger, lower-paid ones, and an increasing prevalence of new hires under temporary employment contracts who tend to have lower wages. Last, inflation expectations are anchored at low levels after many years of deflation. Although on some measures expectations have risen in recent months, consumers and investors are still apparently less certain about prospects for higher inflation than they were a year ago.

Against this background, the Bank of Japan has maintained an accommodative monetary stance, keeping its policy rate steady at about 0.5 percent since February. Although interest rates will eventually need to return to more normal levels, such increases should await clear signs that prospective inflation is moving decisively higher and that concerns over recent market volatility have waned. There is also scope for the Bank of Japan to help guide inflation expectations higher. A clearer indication from the Bank of Japan of its desired inflation rate and more forward-looking statements that inform financial markets about the central bank's views of the likely evolution of risks to growth and inflation and the likely future course of monetary policy would help.

With central banks in many other countries tightening monetary policy over the past year, interest rate differentials with Japan have widened. Until the recent increase in financial market volatility, this interest rate differential had contributed to strong capital outflows from Japan and a weaker yen. The yen carry trade—the practice of borrowing in yen to purchase higher-yielding assets in other currencies—was only one factor behind these outflows. Japanese investors have also increasingly turned to foreign investments to diversify their portfolios and earn higher returns, with retail investors (through mutual funds) and pension and life insurance companies being the main sources. Indeed, with the share of household financial assets held overseas still small, such outflows could be expected to continue going forward even if interest rate differentials narrow.

The yen depreciated on a real effective basis in the first half of 2007 to its weakest level in more than two decades, but it has regained ground recently as heightened financial market volatility has prompted some unwinding of yen carry trade capital outflows. Although the yen is undervalued relative to its medium-term fundamentals, it is appropriate for monetary policy to continue to focus on overcoming deflation and sustaining growth rather than on the level of the exchange rate. Indeed, a premature increase in policy rates could ultimately prove counterproductive by undermining growth, aggravating deflation, and working against the resolution of global imbalances. Nevertheless, as domestic economic fundamentals continue to improve and/or ongoing financial market volatility further discourages carry trade capital outflows, it would be expected that the yen will appreciate, and such upward pressures should not be resisted.

Considerable progress has been made in reducing the fiscal deficit in recent years on the back of buoyant corporate tax revenues and reduced outlays on public investment. Going forward, however, the pace of adjustment is set to slow. The IMF staff's assessment is that the structural budget deficit will decline by only about ¼ percent of GDP a year compared with about 1 percent of GDP a year over the past three years. Given the continued favorable outlook, a stronger fiscal adjustment would be desirable to help put the public debt ratio on a firmly declining path. In terms of specific measures, although there remains some scope for further reductions in public investment spending, a broad reform of the tax system that includes steps to widen the income tax base, raise the consumption tax rate, and strengthen tax administration would provide the basis for higher revenues. Fiscal consolidation would also be supported by further structural reforms to improve growth potential, particularly to

increase labor utilization and promote greater market opening and deregulation in sheltered sectors of the economy.

The Australian and New Zealand economies are expanding strongly, although the global financial market turmoil could act to modestly dampen growth in the near term. While the impact has been more limited than in some other countries, financial markets in Australia and New Zealand have been affected by recent developments, with interbank interest rates and credit spreads increasing, and reduced liquidity among nonbank institutions. Nevertheless, at this juncture, the main short-term policy challenge in both countries continues to be to keep firm control on inflation in the face of strong domestic demand and tight labor markets. To this end, both central banks have recently raised their policy rates—to 6½ percent in Australia and to 8¼ percent in New Zealand. Flexible exchange rates and prudent fiscal policies have played central roles in managing the domestic impact of strong capital inflows and the improving terms of trade. Against this background, it is important that both governments continue to exercise fiscal restraint in the period ahead.

Emerging Asia: Successfully Managing Strong Foreign Exchange Inflows

Growth in emerging Asia remained exceptionally rapid in the first half of 2007. The regional expansion was led by China, where real GDP grew by 11½ percent (year on year) in the first half of 2007 as exports and investment accelerated, and by India, where gains in domestic demand, particularly investment, underpinned 9¼ percent (year on year) growth in the first half. Growth also accelerated in Singapore (where consumption and investment both strengthened), the Philippines (where record remittance inflows boosted consumption and government spending grew strongly), Korea (where the industrial sector rebounded), and Indonesia (where lower interest rates boosted domestic demand). In Thailand, political uncertainties continued to undermine confidence and domestic demand. Growth appears to have remained buoyant in the third quarter, with global financial market volatility having a limited impact on the region to date, although the weaker outlook for the advanced economies is likely to slow export growth going forward.

Against this background, growth projections have been revised downward modestly since the July *World Economic Outlook Update*. The regional economy is now expected to expand by 9.2 percent this year and 8.3 percent in 2008 (Table 2.3). Growth in China is projected at 11.5 percent in 2007, before slowing to 10 percent in 2008, while the Indian economy is expected to expand by 8.9 percent this year and 8.4 percent in 2008. The newly industrialized Asian economies are expected to be most affected by the weaker U.S. outlook, and growth for 2008 has been revised down to 4.4 percent (0.4 percentage point lower than in the July *World Economic Outlook Update*). Among the ASEAN-4 economies, some rebound in Thailand as confidence recovers is expected to offset modest slowdowns in Malaysia and the Philippines.

Risks to the outlook are broadly balanced at this stage. Slower demand for Asian exports, and electronic goods in particular, and the possibility of further global financial market turbulence are particular downside concerns. On the upside, the projected easing of growth in China may not materialize unless the authorities tighten monetary policy more decisively and allow a faster appreciation of the exchange rate. Faster growth in the near term, however, would come at the cost of increased downside risks related to overinvestment beyond the projection period. Growth in India could also be stronger than projected, particularly if robust corporate profits further boost investment spending.

Foreign exchange inflows to the region have been very strong (Figure 2.4). Current account transactions have accounted for much of the inflow, with the regional current account surplus expected at 6½ percent of GDP this year—the surplus in China is rising rapidly and that in

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

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Emerging Asia[3]	**8.7**	**9.3**	**9.2**	**8.3**	**3.5**	**3.7**	**4.9**	**4.2**	**4.5**	**5.8**	**6.6**	**6.5**
China	10.4	11.1	11.5	10.0	1.8	1.5	4.5	3.9	7.2	9.4	11.7	12.2
South Asia[4]	**8.6**	**9.1**	**8.4**	**8.0**	**5.0**	**6.4**	**6.6**	**4.9**	**–1.0**	**–1.4**	**–2.3**	**–2.7**
India	9.0	9.7	8.9	8.4	4.2	6.1	6.2	4.4	–1.0	–1.1	–2.1	–2.6
Pakistan	7.7	6.9	6.4	6.5	9.3	7.9	7.8	7.0	–1.4	–3.9	–4.9	–4.9
Bangladesh	6.3	6.4	5.8	6.0	7.0	6.5	7.2	6.3	—	1.2	1.3	0.8
ASEAN-4	**5.1**	**5.4**	**5.6**	**5.6**	**7.3**	**8.2**	**4.0**	**4.2**	**2.1**	**5.2**	**4.7**	**3.7**
Indonesia	5.7	5.5	6.2	6.1	10.5	13.1	6.3	6.2	0.1	2.7	1.6	1.2
Thailand	4.5	5.0	4.0	4.5	4.5	4.6	2.0	2.0	–4.5	1.6	3.7	2.2
Philippines	4.9	5.4	6.3	5.8	7.6	6.2	3.0	4.0	2.0	4.3	3.8	2.6
Malaysia	5.2	5.9	5.8	5.6	3.0	3.6	2.1	2.4	15.3	17.2	14.4	13.3
Newly industrialized Asian economies	**4.7**	**5.3**	**4.9**	**4.4**	**2.3**	**1.6**	**2.0**	**2.3**	**5.5**	**5.6**	**5.4**	**4.9**
Korea	4.2	5.0	4.8	4.6	2.8	2.2	2.6	2.7	1.9	0.7	0.1	–0.4
Taiwan Province of China	4.1	4.7	4.1	3.8	2.3	0.6	1.2	1.5	4.5	6.8	6.8	7.1
Hong Kong SAR	7.5	6.9	5.7	4.7	0.9	2.0	2.0	3.2	11.4	10.8	11.2	9.5
Singapore	6.6	7.9	7.5	5.8	0.5	1.0	1.7	1.7	24.5	27.5	27.0	25.4

[1]Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.
[2]Percent of GDP.
[3]Consists of developing Asia, the newly industrialized Asian economies, and Mongolia.
[4]Includes Maldives, Nepal, and Sri Lanka.

Hong Kong SAR, Malaysia, Singapore, and Taiwan Province of China remains large. Net capital flows to the region, which in aggregate are dominated by foreign direct investment, have also picked up this year, although they remain below the 2004 level. Nevertheless, they are the predominant source of foreign exchange inflows for India, Korea, and Vietnam.

Large foreign exchange inflows present opportunities to boost investment and growth, but they also create short-term challenges. Policies have, however, generally steered a path between maintaining external competitiveness—regional exports continue to grow rapidly—limiting risks of overheating, and preparing for their possible reversals. In most countries, inflation remains low or has eased considerably following earlier upward pressures (Indonesia and the Philippines), while the pace of credit growth has slowed (Korea and Singapore are exceptions). In India, inflation has eased in recent months, but upside risks remain—core inflation is still elevated, credit growth remains rapid, and equity prices have risen sharply over the past 12 months. In China, surging food prices drove CPI inflation up to 6.5 percent in August (even though nonfood price inflation remains subdued), credit is expanding strongly, and there are concerns about overvaluation in equity prices.

The successful management of foreign exchange inflows into the region has been achieved through a pragmatic range of policy responses tailored to suit individual country circumstances.

- Exchange rate reforms have been introduced in some countries (China and Malaysia), and most currencies have appreciated in nominal and real effective terms over the past couple of years. Nevertheless, rapid reserve accumulation has continued.
- Restrictions on capital outflows have been eased. Regulatory reform has made it easier for private investors to acquire and hold foreign assets (China, Korea, Malaysia, and Thailand), and national pension funds have been permitted to invest an increasing share of their assets in foreign investments (Thai-

land). Foreign direct investment outflows from the region have also increased, as Asian firms have sought to increase their global presence and acquire natural resources overseas. In the case of Thailand, wide-ranging controls on capital inflows were introduced in December 2006, although most of these have now been removed, while in India restrictions on external commercial borrowing have been tightened.

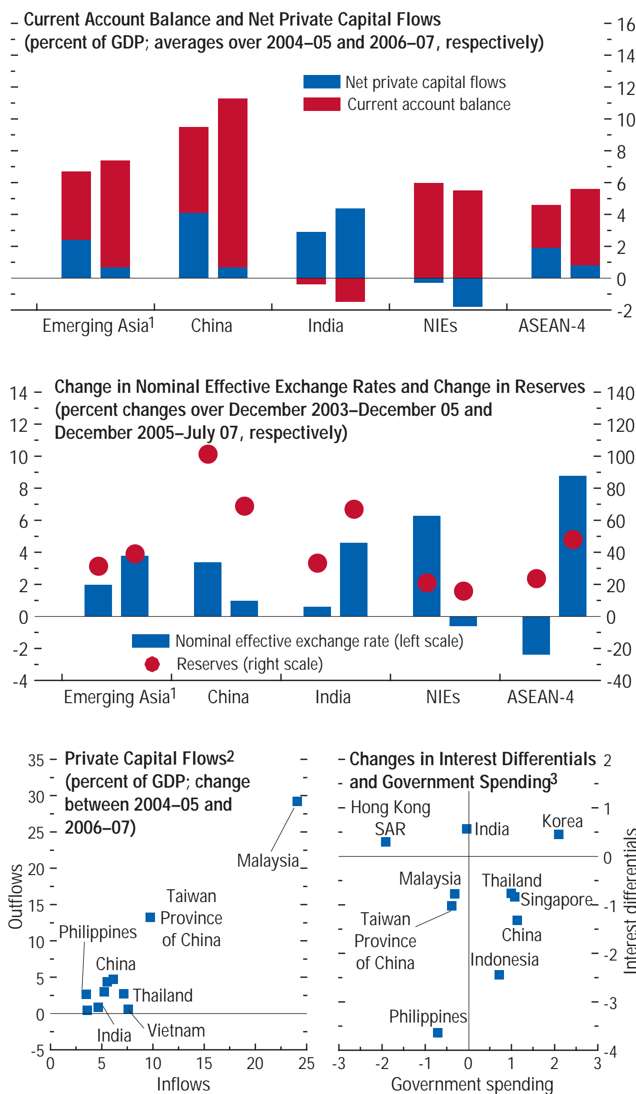
- Declining inflation has allowed some central banks to cut interest rates (Indonesia, the Philippines, and Thailand), whereas others have recently tightened monetary policy (including China, India, and Korea). The restraint of government expenditures has also played a role in a number of countries, notably Hong Kong SAR, India, Malaysia, and Taiwan Province of China.

Looking forward, policymakers will need to respond flexibly to future foreign exchange flows. The continued liberalization of restrictions on capital outflows would be helpful, not only from a short-term demand management perspective if strong foreign exchange inflows continue, but also because of the broader diversification benefits that investors will gain. As discussed in Chapter 3, fiscal expenditure restraint can be an effective tool for managing large capital inflows and will need to play a role in the policy response. This is particularly the case in countries such as India and Pakistan, where further consolidation is still needed despite recent progress in reducing government deficits and debt levels. Strong financial sector supervision and the continued development of domestic financial markets will also be important (see the October 2007 GFSR). One concern in this respect is that corporates in some countries have increased their foreign currency borrowing, raising their exposure to any future exchange rate correction.

Greater exchange rate flexibility in some countries would also be helpful. In China, the large increase in reserves has been only partially sterilized and has added to already substantial liquidity in the banking system, threatening to

Figure 2.4. Emerging Asia: Managing Strong Foreign Exchange Inflows

Foreign exchange inflows into emerging Asia have been very strong, driven largely by current account surpluses. Policymakers have responded by letting exchange rates appreciate to some extent and liberalizing capital outflows, while continuing to accumulate reserves.



Source: IMF staff calculations.
[1]China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, and Thailand.
[2]Excludes Hong Kong SAR and Singapore, which are regional financial centers.
[3]Interest rate differential calculated as difference between country interest rate and U.S. interest rate. Change is measured as difference between the latest observation and the average of 2005. Changes in government spending, in percent of GDP, measured as difference between 2006–07 average and 2004–05 average.

Table 2.4. Selected Western Hemisphere Countries: Real GDP, Consumer Prices, and Current Account Balance

(Annual percent change unless noted otherwise)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Western Hemisphere	**4.6**	**5.5**	**5.0**	**4.3**	**6.3**	**5.4**	**5.3**	**5.8**	**1.4**	**1.5**	**0.6**	**—**
South America and Mexico[3]	**4.5**	**5.4**	**4.9**	**4.2**	**6.2**	**5.2**	**5.2**	**5.8**	**1.7**	**1.8**	**0.8**	**0.2**
Argentina	9.2	8.5	7.5	5.5	9.6	10.9	9.5	12.6	1.9	2.5	0.9	0.4
Brazil	2.9	3.7	4.4	4.0	6.9	4.2	3.6	3.9	1.6	1.2	0.8	0.3
Chile	5.7	4.0	5.9	5.0	3.1	3.4	3.9	4.1	1.1	3.6	3.7	2.3
Colombia	4.7	6.8	6.6	4.8	5.0	4.3	5.5	4.6	–1.5	–2.1	–3.9	–3.5
Ecuador	6.0	3.9	2.7	3.4	2.1	3.3	2.1	2.3	0.8	3.6	2.4	2.5
Mexico	2.8	4.8	2.9	3.0	4.0	3.6	3.9	4.2	–0.6	–0.3	–0.7	–1.1
Peru	6.7	7.6	7.0	6.0	1.6	2.0	1.5	2.3	1.4	2.8	1.3	1.1
Uruguay	6.6	7.0	5.2	3.8	4.7	6.4	8.0	6.8	—	–2.4	–2.8	–2.8
Venezuela	10.3	10.3	8.0	6.0	16.0	13.7	18.0	19.0	17.8	15.0	7.8	4.1
Central America[4]	**4.5**	**5.9**	**5.4**	**4.9**	**8.4**	**7.0**	**6.5**	**6.0**	**–5.1**	**–5.0**	**–5.6**	**–5.8**
The Caribbean[4]	**6.5**	**8.4**	**6.0**	**4.4**	**6.7**	**8.0**	**6.4**	**5.3**	**–0.3**	**–0.4**	**–1.0**	**–0.6**

[1]Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.
[2]Percent of GDP.
[3]Includes Bolivia and Paraguay.
[4]The country composition of these regional groups is set out in Table F in the Statistical Appendix.

underpin a further surge in lending and investment growth. A more flexible exchange rate would give monetary policy more scope to focus on domestic objectives, particularly the need to slow lending and investment growth. Along with policies that reduce the need for precautionary savings (including increased spending on health care, pensions, and the social safety net), appreciation of the renminbi—which is undervalued relative to medium-term fundamentals—would also boost consumption by increasing household purchasing power. Together with reduced incentives for investment in the export sector, this would contribute to a narrowing of the very large current account surplus. Elsewhere, flexible exchange rate management will enable countries to adjust to evolving developments in global financial markets, while monetary policy has scope to respond to changes in the balance of risks to growth and inflation.

Latin America—Responding to Surging Foreign Exchange Inflows

Following 5½ percent growth in 2006, the pace of expansion in Western Hemisphere countries is projected to moderate to 5 percent in 2007 as a whole and to 4.3 percent in 2008 (Table 2.4). This easing would reflect in part spillovers from the slowdown of activity in the United States on Mexico and Central America, mainly through trade linkages as well as somewhat slower growth of remittances from migrant workers, and the end of a hotel construction boom in the Caribbean. In a number of commodity-exporting countries in South America—including Argentina, Colombia, Peru, Uruguay, and Venezuela—growth is expected to come down from very high rates in 2006, in part because of increasing supply constraints. Growth is picking up in Brazil in 2007, responding to monetary policy easing after inflation was brought on track with central bank objectives, but is also expected to slow in 2008.

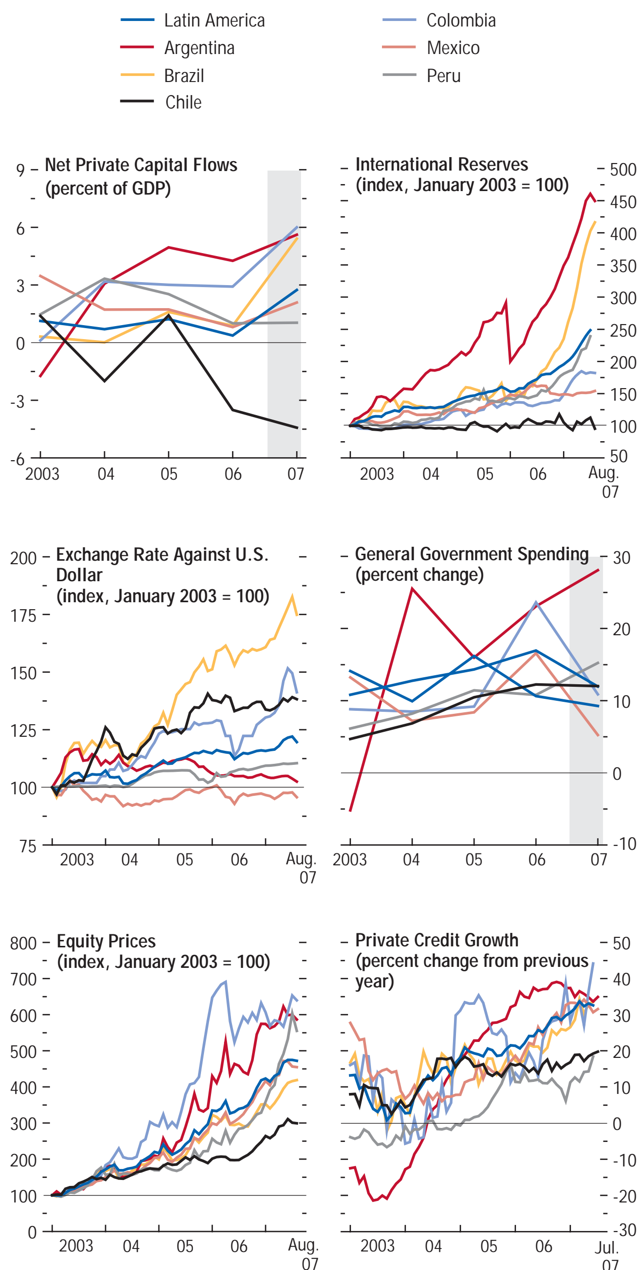
The balance of risks to these projections for the region would seem to be moderately on the downside, arising principally from the possibility of continued turbulent conditions in global financial markets having spillover effects on Latin America through trade and financial channels. So far the impact of recent financial developments on Latin America has been relatively

contained, because the strengthening of macroeconomic policy frameworks and public sector balance sheets has helped to anchor investor confidence. However, a weaker path for the U.S. economy would dampen demand for Latin American exports, with Mexico and Central America being most at risk because of greater trade linkages. Moreover, commodity exporters in South America would be affected by any softening in food, metals, or energy prices as a result of slower global demand growth. The impact through the financial channel would most likely be less dramatic than the "sudden stops" experienced in the past, given Latin America's stronger fundamentals, but nevertheless there would be a cooling influence from less-buoyant equity prices and from increases in borrowing spreads. On the other hand, there are also upside risks. Surging capital inflows in the first half of 2007 boosted local asset prices and credit growth, and further measures may still be needed to rein in growth of domestic demand in a number of countries in response to overheating concerns (Figure 2.5).

A key macroeconomic challenge for Latin America is how to handle foreign exchange inflows. Through 2006, these inflows were largely trade related, as strong foreign demand and high commodity prices boosted export earnings, and the regional current account surplus rose to a record 1.8 percent of GDP. In contrast, net capital inflows were on a declining trend, as governments took advantage of improved fiscal performance to repay foreign borrowing. However, these trends have reversed recently. Current account surpluses are moderating in 2007, as strong domestic demand has boosted import growth. In contrast, net capital inflows have risen rapidly since mid-2006, as portfolio and bank-related flows surged, particularly to Argentina, Brazil, and Colombia.[3] The recent turbulence in global financial markets has taken some of the momentum out of these flows, but the expectation is that Latin America

Figure 2.5. Latin America: Capital Inflows Are Complicating Macroeconomic Management

A number of Latin American countries are experiencing heavy capital inflows that are pushing up international reserves and contributing to rapid credit growth and rising equity prices. The degree of exchange rate movement in the face of foreign exchange inflows has varied across countries. Strong increases in government spending are adding to demand pressures.



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

[3]See Chapter 2 of the IMF's *Regional Economic Outlook: Western Hemisphere* (October 2007).

will continue to receive sizable capital inflows in the period ahead, although countries should be prepared for the possibility of increased volatility.

Latin American economies have allowed exchange rates to move more flexibly than in the past, in response to shifts in exchange market pressures. Faced with strong inflows in the first half of 2007, exchange rates strengthened appreciably in a number of countries, including Brazil, Colombia, Paraguay, and Peru, notwithstanding continued intervention. In Brazil, foreign exchange inflows in the first half of 2007 were double their level in the same period of 2006, driving an appreciation of the real to its strongest level against the dollar in seven years, notwithstanding heavy intervention. The exchange rate appreciation has contributed to containing inflation, giving room to the central bank to continue to lower interest rates, thus reducing the wide interest differential with other countries. In July–August, market pressures turned, in the context of financial turbulence, and exchange rates initially weakened across the region, although they have recovered ground in recent weeks. In Argentina, the peso has fluctuated in a narrow range amid central bank interventions, and in Venezuela, the exchange rate has been kept unchanged for more than two years, and inflation has risen to about 20 percent.

Fiscal policy choices have affected the tradeoffs faced by Latin American countries in handling foreign exchange inflows. In Chile, fiscal policy has played a deliberately countercyclical role, as the budget has aimed at a structural surplus adjusted for variations in copper prices, a key determinant of revenues, and this approach has generated substantial capital outflows that have balanced upward pressure on the currency. Elsewhere, general government balances have mostly been kept in surplus or small deficit, helping to bring down the ratios of public debt to GDP. However, with fiscal revenues being boosted by strong growth and export performance, government spending has also been allowed to accelerate in a number of countries, providing a procyclical fiscal impulse and adding to overheating pressures. Such concerns are particularly salient in Argentina, where recent policy measures have added to fiscal stimulus, and in Venezuela.

Latin American countries have used various financial measures to try to discourage capital inflows, but the impact has been limited. For example, Colombia imposed a 40 percent unremunerated reserve requirement (URR) for six months on portfolio and bank-related inflows in May 2007—Argentina has had a similar mechanism (applying a 30 percent URR for one year) in place since 2005. However, these measures have generally had limited impact on market developments. Of greater long-term significance, countries have liberalized restrictions on capital outflows. For example, Argentina, Brazil, Chile, Colombia, and Peru have eased limits on holdings of foreign assets by local mutual funds and pension funds. Over time, such steps should help raise returns and diversify portfolios, while also easing pressures in the foreign exchange market.

A number of countries have also resorted to other microeconomic measures to contain domestic side effects of strong foreign exchange inflows or to contain the impact of strong growth in domestic demand on inflation. For example, Brazil has raised import tariffs on textiles, clothing, and footwear to protect labor-intensive domestic production from competition from Asian imports; both Brazil and Colombia have introduced cheap credit lines, and Argentina has maintained extensive administrative measures to contain increases in consumer prices, including limiting price adjustments in regulated industries, selective price agreements, and export restraints. Argentina's actions, if sustained, could exacerbate capacity constraints in key sectors and undermine the business climate.

From a longer-term perspective, Latin America's present expansion is its longest since the 1960s, and sustained growth has helped reduce external vulnerabilities. However, the region continues to be at the bottom of the

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

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Emerging Europe	**5.6**	**6.3**	**5.8**	**5.2**	**4.9**	**5.1**	**5.1**	**4.1**	**–5.2**	**–6.6**	**–7.3**	**–7.5**
Turkey	7.4	6.1	5.0	5.3	8.2	9.6	8.2	4.6	–6.2	–7.9	–7.5	–7.0
Excluding Turkey	4.9	6.4	6.1	5.2	3.5	3.2	3.8	4.0	–4.8	–6.0	–7.3	–7.8
Baltics	**9.0**	**9.7**	**8.8**	**6.3**	**4.2**	**4.8**	**6.5**	**6.4**	**–9.4**	**–15.1**	**–18.3**	**–18.3**
Estonia	10.2	11.2	8.0	6.0	4.1	4.4	6.0	7.0	–10.0	–15.5	–16.9	–15.9
Latvia	10.6	11.9	10.5	6.2	6.7	6.5	9.0	8.9	–12.6	–21.1	–25.3	–27.3
Lithuania	7.6	7.5	8.0	6.5	2.7	3.8	5.2	4.6	–7.1	–10.9	–14.0	–12.6
Central Europe	**4.5**	**6.0**	**5.8**	**4.9**	**2.4**	**2.1**	**3.3**	**3.3**	**–3.2**	**–3.7**	**–4.1**	**–4.7**
Czech Republic	6.5	6.4	5.6	4.6	1.8	2.5	2.9	4.4	–1.6	–3.1	–3.4	–3.5
Hungary	4.2	3.9	2.1	2.7	3.6	3.9	7.6	4.5	–6.8	–6.5	–5.6	–5.1
Poland	3.6	6.1	6.6	5.3	2.1	1.0	2.2	2.7	–1.7	–2.3	–3.7	–5.1
Slovak Republic	6.0	8.3	8.8	7.3	2.8	4.4	2.4	2.0	–8.6	–8.3	–5.3	–4.5
Southern and south-eastern Europe	**4.5**	**6.8**	**6.0**	**5.7**	**7.0**	**6.0**	**4.6**	**5.1**	**–8.7**	**–10.5**	**–13.6**	**–13.1**
Bulgaria	6.2	6.1	6.0	5.9	5.0	7.3	8.2	7.9	–12.0	–15.8	–20.3	–19.0
Croatia	4.3	4.8	5.6	4.7	3.3	3.2	2.3	2.8	–6.4	–7.8	–8.4	–8.8
Malta	3.3	3.3	3.2	2.6	2.5	2.6	0.6	2.0	–8.0	–6.1	–9.4	–8.2
Romania	4.1	7.7	6.3	6.0	9.0	6.6	4.3	4.8	–8.7	–10.3	–13.8	–13.2
Memorandum												
Slovenia	4.1	5.7	5.4	3.8	2.5	2.5	3.2	3.1	–1.9	–2.5	–3.4	–3.1

[1]Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.
[2]Percent of GDP.

world growth league, and governments should take advantage of present conditions to advance the reforms that are needed to support more rapid growth in investment and productivity. Impediments to improved performance include inefficient public sectors, limited financial intermediation, weak infrastructure, and high income inequality. One encouraging recent development has been progress with fiscal reforms in Mexico, including measures to contain the costs of civil service pensions and to broaden the tax base to replace declining oil revenues and provide additional funding for infrastructure and social spending.

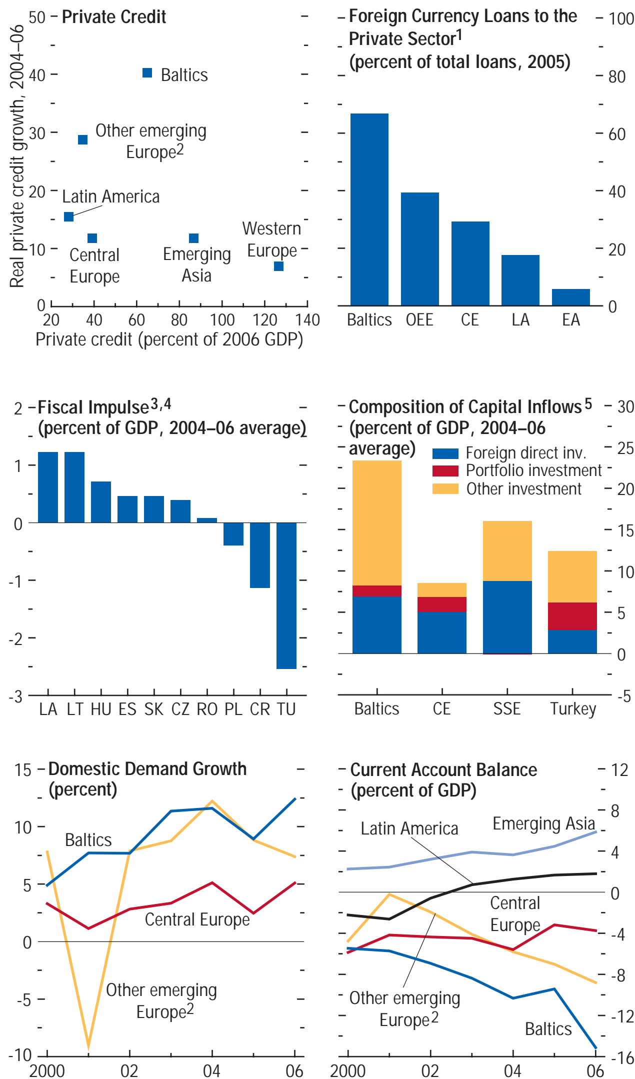
Emerging Europe: Brisk Activity, Rising Imbalances

Growth in emerging Europe accelerated to 6.3 percent in 2006, and the pace moderated only slightly in the first half of 2007 (Table 2.5). Spending on new productive capacity and construction activity bolstered investment, while rising disposable incomes, improving labor markets, and easy access to credit, financed mainly through cross-border interbank loans, continued to buttress consumer spending and investment, especially in the Baltics and in southern and southeastern Europe. Exports benefited from an upswing in western Europe—the main trading partner—as well as increased integration of emerging Europe into regional production chains and the upgrading of the quality of export products. In particular, a pickup in exports helped support Turkey's economy, where domestic demand has slowed in the face of monetary tightening to reduce inflation after it spiked in mid-2006. Growth in Hungary continued to be weaker than in the rest of the region, reflecting in part the short-term impact of fiscal consolidation.

The recent strong performance, however, has been accompanied by rising concerns about widening external imbalances and overheating in the Baltics and southern and southeastern Europe, where booming credit has boosted

Figure 2.6. Emerging Europe: Rapid Credit Growth Is Fueling Domestic Demand

The brisk pace of credit growth in the Baltics and other areas of emerging Europe supports financial deepening, but it raises macroeconomic and prudential concerns. Credit growth bolstered domestic demand in these country groups, leading to a sharp deterioration in the external positions. Procyclical fiscal policies exacerbated imbalances in some cases. Current account deficits were financed largely through bank-to-bank and other borrowing rather than foreign direct investment, as in central Europe.



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

[1]CE: central Europe; OEE: other emerging Europe; EA: emerging Asia; LA: Latin America.

[2]Other emerging Europe includes Bulgaria, Croatia, Malta, Romania, and Turkey.

[3]LA: Latvia; LT: Lithuania; HU: Hungary; ES: Estonia; SK: Slovak Republic; CZ: Czech Republic; RO: Romania; PL: Poland; CR: Croatia; and TU: Turkey.

[4]Fiscal impulse is calculated as the first difference in structural balance, adjusted, where appropriate, to isolate the demand impact of fiscal policy by excluding EU grants and privatization receipts from revenues and excluding payments to the EU from expenditures.

[5]SSE: southern and southeastern Europe.

private domestic demand and elevated inflation and external deficits (Figure 2.6). In Latvia, the current account deficit widened to 21 percent of GDP in 2006, but deficits are also high, at 10–16 percent of GDP, in other Baltic countries, Bulgaria, and Romania. Credit booms in the Baltics and southern and southeastern Europe have been supported by readily available financing through foreign parent banks at low real interest rates and, in some cases, by procyclical fiscal policies (see Figure 2.6). A significant portion of credit in the Baltics and other emerging Europe has been denominated in, or indexed to, foreign currency (more so than in other emerging market regions) and directed to real estate, and the balance sheet mismatches such lending creates raise prudential and macroeconomic concerns. In central Europe, external positions have been stronger, in part because capital inflows there have tended to take the form of foreign direct investment in the tradable goods sectors, with the ensuing exports helping to keep current account deficits under control. Inflation has also been better contained in central Europe, owing in part to monetary policy independence in mostly inflation-targeting countries, past nominal currency appreciation, and the dampening effect of global competition on wages, although expanding demand is now starting to test resource constraints.[4]

Large external imbalances in the Baltics and southern and southeastern Europe are also raising concerns about possible real exchange rate overvaluation, although it is recognized that some part of the real exchange rate appreciation recently experienced by these countries has been consistent with improving fundamentals. Supporting factors include strong productivity growth in the tradables sector (the well-known Balassa-Samuelson effect); EU transfers to the new member states, which are projected to remain sizable in the coming years; and improvements in the quality of services. Moreover, part of the real appreciation is likely to

[4]The sharp increase in inflation projected in Hungary for 2007 reflects large increases in regulated prices.

have been a one-off level adjustment associated with, for example, the adoption of the EU acquis and the increased availability of foreign capital owing to the confluence of unusually benign global financial conditions and structural changes in the investor base for emerging markets. Speculative flows may also have contributed to real appreciation, but such factors are difficult to quantify. Emerging European countries, particularly those with large external financing needs and appreciable currency mismatches in private sector balance sheets, could thus be vulnerable to a change in investor sentiment.

Regional growth is forecast to soften to 5.8 percent in 2007 and further to 5.2 percent in 2008. Domestic demand will slow owing to monetary and fiscal tightening, but should remain strong, supported, among other things, by large inflows of EU transfers and the still significant incentives for outsourcing from western Europe. Tighter global credit conditions are likely to dampen growth of house prices and household consumption, with knock-on effects for construction and business investment.[5] Exports are also likely to slow as a result of weakening external demand from western Europe and, to a lesser extent, strong currencies and rising wage costs. However, the still significant wage differential vis-à-vis western Europe and strong productivity growth will continue to support the competitiveness. The slowdown of activity is expected to be most pronounced in the Baltics, where some cooling of demand would be welcome.

Risks to this outlook are tilted to the downside, largely owing to the possibility of a sharper-than-expected squeeze on credit. In addition, risks of a disorderly unwinding of large external imbalances are concentrated in some countries, with spillovers to the rest of the region mainly through contagion. Countries with large external imbalances—the Baltics, Romania, and Bulgaria—may be significantly affected by the increased cost of external financing and higher risk premiums, following recent financial market turbulence, although the strength of fiscal positions may mitigate the fallout in some cases. There is scope for financial market contagion, whereby a widening of the risk premium for one emerging European country may prompt investors to reassess sovereign risk of other countries in the region. The common-lender problem—a narrow group of predominantly European banks accounting for a significant portion of outstanding claims on emerging European banks and the private sector—is another potential channel for transmission of financial shocks across the region. The potential for spillovers from emerging Europe to western Europe through financial and trade channels exists, but is considerably smaller than within the emerging Europe region (Haas and Tamirisa, 2007).

Macroeconomic policies therefore need to focus on steering economies toward soft landings, while containing vulnerabilities and laying the foundation for sustainable long-term growth. Countries with fixed exchange rate regimes (for example, the Baltics and Bulgaria) or tightly managed floats (for example, Croatia) should rely more on fiscal restraint as they seek to rein in demand pressures. Countries with floating exchange rates (for example, Romania) can also raise interest rates as needed to stem inflationary pressures while reining in procyclical fiscal expansions. Since overall fiscal policy multipliers tend to be small in open emerging European economies, specific fiscal measures aimed at reducing tax and subsidy incentives for real estate borrowing are worth considering. The implementation of fiscal consolidation plans remains a priority in countries with long-term fiscal sustainability concerns, for example, the Czech Republic, Hungary, and Poland. Structural reforms to improve price and wage flexibility also need to be advanced in some countries.

Strong bank supervision, particularly of foreign currency and real estate lending, is critical for maintaining credit quality and bank capital in an environment of rapidly expanding balance sheets. Many countries have been tighten-

[5]The Swedish banks active in the Baltics have announced their intention to tighten the terms of credit, amid heightened concerns about the brisk pace of credit growth in the Baltics.

ing prudential and administrative regulations aimed at encouraging banks to strengthen risk management and/or to reduce the pace of credit growth, but the effectiveness of the latter measures seems to have been limited so far (Hilbers, Ötker-Robe, and Pazarbasioglu, 2007). A stronger prudential policy response is justified in countries where there are concerns about loan quality. In many countries, subsidiaries and branches of banks from advanced economies have been leading credit expansion, and the strength of their parent banks is reassuring, but these banks may have come to rely excessively on the strong profits of their emerging market offshoots (Tamirisa and Igan, 2006). This underscores the need for strong cross-border cooperation with foreign supervisors to ensure that any emerging signs of weaknesses are addressed in a timely and effective manner. Raising borrowers' awareness of risks and improving market infrastructure facilitating banks' risk assessment (for example, credit bureaus) are also a priority.

For the new members of the European Union that are committed to adopting the euro, the key challenge is to meet the necessary entry criteria and to enter the monetary union in positions that allow these countries to continue to perform well in the Economic and Monetary Union (EMU). The sustained real appreciation that accompanies rapid income convergence of the new EU member states, even in cases where the economies are not overheating, makes satisfying the inflation entry precondition particularly challenging (Haas and Tamirisa, 2007). The pursuit of consistent macroeconomic policies and further improvements in the structural flexibility of the economies are thus essential for the new member states to enter the euro area smoothly and to excel in the EMU. Especially in countries that are still far away from "prudent" medium-term fiscal targets, fiscal adjustment would help ease cyclical demand pressures, while putting public finances on a sustainable footing for the longer term and helping satisfy the Maastricht fiscal criteria with a margin. Clear communication of the new member states' euro-adoption prospects is also essential, as it would help households, businesses, and financial markets make appropriate decisions and perhaps facilitate the unwinding of the currency mismatches accumulated on earlier, more optimistic, expectations.

Commonwealth of Independent States: Tensions Between Inflation and Exchange Rate Objectives

The CIS region has not been immune to the recent financial turmoil, but this has come against the backdrop of the longest economic expansion since the beginning of transition. Although easing slightly, growth in the region remained strong in the second quarter of 2007. The Russian economy expanded by about 7¾ percent (year on year), and economic activity in other CIS countries has also remained buoyant. The robust expansion in the region has been underpinned by high commodity prices and strong capital inflows, as well as continuing productivity gains. Consumption has remained the main driver of growth, supported by rising real incomes and easy access to credit, but there are also incipient signs of rebalancing in the composition of demand, with investment picking up recently. Credit to the private sector has been expanding rapidly across the region, fueled by capital inflows, ample domestic liquidity, and structural improvements in the financial sector.

Against the backdrop of the global disruption to liquidity and pullback from risky assets, exchange rates in Kazakhstan and Russia came under some downward pressure in late August. In Kazakhstan, concerns that domestic banks could be vulnerable to global credit retrenchment contributed to depreciation pressures, while in Russia the repatriation of liquid ruble assets by nonresident investors was the primary factor behind the depreciation. As liquidity conditions in interbank markets deteriorated and banks experienced difficulties raising external funds and started to curtail their lending, the central banks of both countries

Table 2.6. Commonwealth of Independent States: Real GDP, Consumer Prices, and Current Account Balance

(Annual percent change unless noted otherwise)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Commonwealth of Independent States (CIS)	**6.6**	**7.7**	**7.8**	**7.0**	**12.1**	**9.4**	**8.9**	**8.3**	**8.8**	**7.6**	**4.8**	**3.1**
Russia	6.4	6.7	7.0	6.5	12.7	9.7	8.1	7.5	11.1	9.7	5.9	3.3
Ukraine	2.7	7.1	6.7	5.4	13.5	9.0	11.5	10.8	2.9	–1.5	–3.5	–6.2
Kazakhstan	9.7	10.7	8.7	7.8	7.6	8.6	8.6	7.8	–1.8	–2.2	–2.2	–1.1
Belarus	9.3	9.9	7.8	6.4	10.3	7.0	8.1	10.0	1.6	–4.1	–7.9	–8.1
Turkmenistan	9.0	9.0	10.0	10.0	10.7	8.2	6.5	9.0	5.1	15.3	13.0	12.5
Low-income CIS countries	**12.0**	**14.6**	**15.7**	**13.4**	**8.4**	**10.0**	**12.1**	**11.7**	**2.2**	**7.5**	**13.7**	**19.1**
Armenia	14.0	13.3	11.1	10.0	0.6	2.9	3.7	4.9	–3.9	–1.4	–4.0	–4.2
Azerbaijan	24.3	31.0	29.3	23.2	9.7	8.4	16.6	17.0	1.3	15.7	31.4	39.9
Georgia	9.6	9.4	11.0	9.0	8.3	9.2	8.5	8.1	–9.8	–13.8	–15.7	–15.2
Kyrgyz Republic	–0.2	2.7	7.5	7.0	4.3	5.6	7.0	7.0	3.2	–6.6	–17.9	–15.1
Moldova	7.5	4.0	5.0	5.0	11.9	12.7	11.2	8.9	–10.3	–12.0	–8.0	–7.3
Tajikistan	6.7	7.0	7.5	8.0	7.3	10.0	9.9	12.6	–2.5	–2.9	–11.6	–12.6
Uzbekistan	7.0	7.3	8.8	7.5	10.0	14.2	12.2	9.8	13.6	18.8	21.1	21.0
Memorandum												
Net energy exporters[3]	7.1	7.7	7.9	7.3	12.1	9.7	8.5	7.9	10.0	9.2	6.3	4.4
Net energy importers[4]	4.5	7.7	7.2	6.0	12.0	8.5	10.4	10.3	1.4	–3.0	–5.4	–7.2

[1]Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.

[2]Percent of GDP.

[3]Includes Azerbaijan, Kazakhstan, Russia, Turkmenistan, and Uzbekistan.

[4]Includes Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Ukraine.

injected liquidity to ensure stability in the banking systems.

Growth momentum is expected to ease from 7¾ percent in 2006–07 to 7 percent in 2008, largely owing to tightening credit conditions and a weakening external environment. High commodity prices and rising fiscal spending would continue to support activity in the net-energy-exporting countries (Azerbaijan, Kazakhstan, Russia, Turkmenistan, and Uzbekistan) (Table 2.6 and Figure 2.7). In the net-energy-importing countries (as a group), growth is expected to slow more rapidly, partly owing to rising oil prices, although growth in these countries will continue to be supported by the ongoing global commodity boom[6] and buoyant regional conditions, as manifested in strong external demand and large inflows of foreign direct investment and private remittances from the net-energy-importing countries.

Nevertheless, risks to growth are tilted to the downside, owing to a possible stronger impact of financial market turbulence on the availability of foreign and domestic financing, as well as the impact of slower global growth on commodity prices and export demand. If growth were to slow down significantly in Russia, demand for imports from smaller countries in the region (Armenia, Georgia, Moldova, the Kyrgyz Republic, and Tajikistan)[7] and flows of private remittances to these countries are likely to be adversely affected.

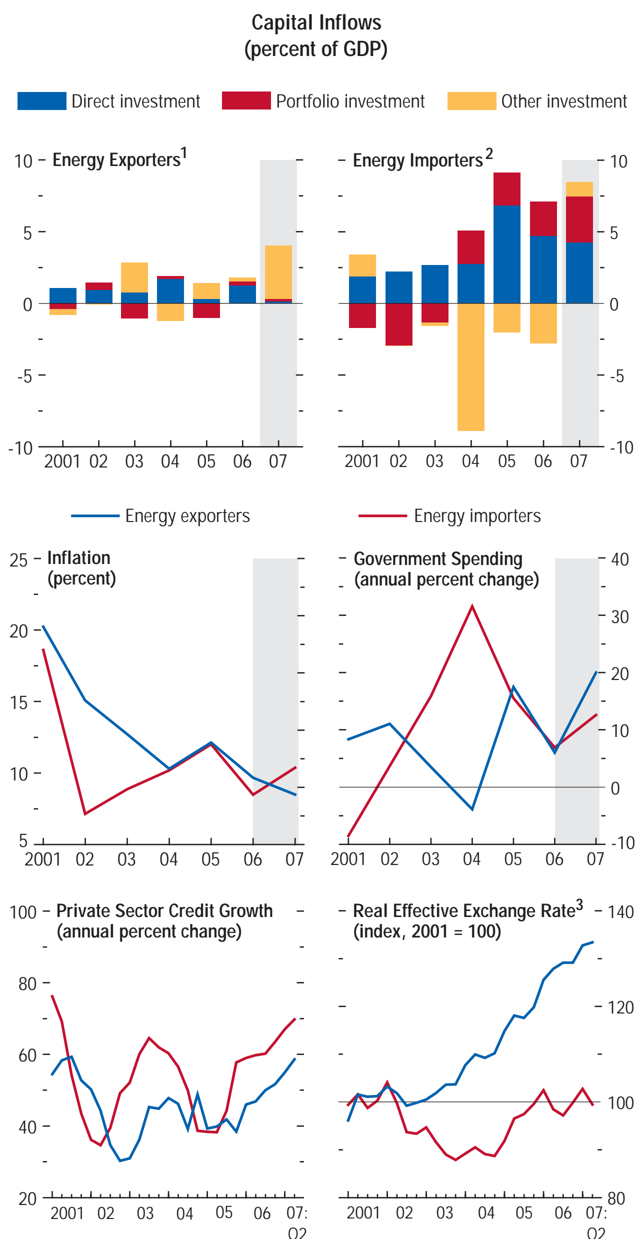
A long spell of robust demand growth in the region has tightened resource constraints, keeping inflation at high levels (9–10 percent). Unit labor costs are rising in some countries, reflecting higher labor utilization rates and tightening labor markets (Ukraine). Equipment shortages

[6]Many countries in the region export commodities: aluminum (Tajikistan), copper (Armenia and Georgia), cotton (Tajikistan and Uzbekistan), and ferrous and scrap metals (Georgia).

[7]These countries receive significant inflows of private remittances (15–35 percent of GDP).

Figure 2.7. Commonwealth of Independent States: Dealing with Capital Inflows

The CIS has benefited from inflows of direct, portfolio, and other investment, which supported financial deepening and economic expansion in the region. Yet large capital inflows have also presented macroeconomic challenges. Countries have to make a choice whether real appreciation should be effected mostly through inflation or nominal appreciation, a choice that is exacerbated by rapid demand growth, expansionary fiscal policies, and limited exchange rate flexibility in most CIS countries.



Sources: IMF, *International Financial Statistics;* and IMF staff estimates.
[1]Includes Azerbaijan, Kazakhstan, Russia, Turkmenistan, and Uzbekistan.
[2]Includes Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Ukraine.
[3]An increase in the index represents a real appreciation whereas a decrease represents a real depreciation of a country's currency relative to that of its trading partners.

are also emerging, as indicated by rising imports of capital goods (Russia). In Azerbaijan, inflation is expected to rise to double digits in 2007 and 2008, as a large fiscal expansion is running up against supply constraints. Besides pushing up prices, robust demand growth in the region is also weakening the external current account positions, which nonetheless remain in a solid surplus in most energy-exporting countries. Competitiveness has suffered from rising prices in some countries, although many currencies in the region (notably, the Russian ruble) are still judged to be undervalued relative to medium-term fundamentals.

The region has attracted large inflows of foreign private capital in recent years. Foreign direct investment—reflecting privatization, mergers and acquisitions, as well as greenfield investment—has supported economic growth, especially in the net-energy-importing countries. Portfolio and other investment inflows have also been increasing over the years, including in the net-energy-exporting countries. This trend has been particularly pronounced in Russia and Kazakhstan, where external bank borrowing soared prior to the onset of the financial market turmoil.[8] High domestic interest rates and expectations of further ruble appreciation have prompted banks to switch to external funding of their domestic loan portfolios. More generally, limited flexibility in exchange rate policy in many CIS countries may have created perceptions of "one-way bets," encouraging speculative inflows. Prospects for continued bank and portfolio capital inflows are more uncertain following the onset of the financial market turmoil, but high oil and other commodity prices are likely to continue to attract capital to the region.

The increased reliance on bank borrowing and portfolio investment inflows for financing growth in the region has brought policy challenges in its wake. In contrast to commodity export revenues, which have been at least partly

[8]In the Kyrgyz Republic, Moldova, and Armenia, official financing has been an important contributor to growth.

sterilized in stabilization funds (for example, in Kazakhstan and Russia), capital inflows have largely fed through to boost domestic credit growth and have generated inflationary pressures. Nominal appreciation in response to capital inflows has been limited, as many countries are targeting nominal exchange rates. A decline in non-oil revenues and/or rapid growth of government spending have added to overheating problems (for example, in Armenia, Azerbaijan, Georgia, Russia, and Ukraine). More recently, concerns about a possible curtailment of external bank financing in the face of global market turmoil have highlighted potential problems that would arise if such flows were to reverse.

Some countries in the CIS region have responded to the large capital inflows and overheating pressures by broadening and tightening reserve requirements, and such approaches have helped mop up liquidity in the system. However, ultimately, greater exchange rate flexibility is required to improve inflation control (for example, in Kazakhstan, Russia, and Ukraine),[9] and preparations for moving to more flexible exchange rates need to be accelerated to prevent high-inflation expectations from becoming entrenched. Supporting this approach, further efforts are needed to develop market-based monetary instruments, deepen the domestic money market, and tighten financial regulations, particularly to ensure that foreign borrowing does not lead to bank or corporate balance sheet vulnerabilities. Growth of government spending should be kept in check, striking a balance between addressing still-significant social and infrastructure needs and excessively fueling inflation and appreciation pressures.

Beyond the near term, boosting savings and investment is critical to strengthening the region's growth outlook. Catch-up productivity gains are likely to diminish over time, while adverse demographic trends are weighing on long-term prospects. The rate of investment (at 21 percent of GDP in 2006 and projected to rise only slightly in 2007) remains lower than in other regions of the world, while the concentration of investment in extractive industries and construction points to the need to diversify the sources of growth. Whether private investment responds to this challenge will depend on further improvements in institutions and the business climate. Financial deepening and the development of arm's-length sources of finance would also strengthen long-term growth prospects. Additional strengthening of prudential regulations (for example, stricter provisioning and higher risk weights for particular categories of loans) and banking supervision would help improve the capacity of banks to manage risks and maintain credit quality in the environment of rapid loan growth.

[9]The central bank let the Russian ruble appreciate by ½ percent vis-à-vis the dollar-euro dual currency basket on June 26 and again by 0.6 percent on August 9.

Sub-Saharan Africa—Benefiting from Globalization

Sub-Saharan Africa (SSA) is enjoying another strong year, with overall growth in the region projected to rise from 5.7 percent in 2006 to 6.1 percent in 2007 and further to 6.8 percent in 2008 (Table 2.7). The growth acceleration reflects largely the coming onstream of new production facilities in oil-exporting countries, such as Angola and Nigeria. But most other countries in the region are projected to maintain relatively high rates of growth, while inflation would generally moderate (excluding Zimbabwe, which is expected to remain an outlier). Risks to the forecast are, however, tilted somewhat to the downside, reflecting mainly the possibility of a weaker global outturn, which would weaken demand for African commodity exports and tighten financial constraints, as well as risks from domestic political developments in individual countries.

Taking a longer-term perspective, SSA is clearly enjoying its best period of sustained growth since independence. While the oil-exporting countries are achieving the most rapid growth, most other countries are also growing strongly and outperforming historic

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

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Africa	**5.6**	**5.6**	**5.7**	**6.5**	**6.6**	**6.3**	**6.6**	**6.0**	**2.0**	**3.1**	**—**	**0.6**
Maghreb	**4.1**	**5.2**	**4.3**	**5.6**	**1.5**	**3.1**	**3.6**	**3.4**	**11.7**	**14.6**	**10.4**	**9.7**
Algeria	5.1	3.6	4.8	5.2	1.6	2.5	4.5	4.3	20.7	25.6	19.4	18.4
Morocco	2.4	8.0	2.5	5.9	1.0	3.3	2.5	2.0	2.4	3.4	0.7	0.2
Tunisia	4.0	5.4	6.0	6.2	2.0	4.5	3.0	3.0	–1.1	–2.3	–2.6	–2.7
Sub-Sahara	**6.0**	**5.7**	**6.1**	**6.8**	**8.2**	**7.3**	**7.6**	**6.7**	**–0.9**	**–0.3**	**–3.0**	**–1.6**
Horn of Africa[3]	**9.3**	**10.5**	**10.9**	**10.2**	**7.7**	**9.3**	**12.0**	**10.3**	**–9.4**	**–13.5**	**–9.5**	**–7.3**
Ethiopia	10.2	9.0	10.5	9.6	6.8	12.3	17.8	15.9	–6.8	–10.4	–5.9	–3.0
Sudan	8.6	11.8	11.2	10.7	8.5	7.2	8.0	6.5	–10.7	–14.7	–10.7	–8.5
Great Lakes[3]	**6.2**	**5.6**	**6.3**	**7.0**	**11.5**	**10.3**	**9.6**	**6.5**	**–3.6**	**–5.2**	**–5.8**	**–7.5**
Congo, Dem. Rep. of	6.5	5.1	6.5	8.4	21.4	13.2	17.5	8.8	–10.6	–7.5	–8.1	–10.9
Kenya	5.8	6.1	6.4	6.5	10.3	14.5	6.9	7.2	–0.8	–2.4	–3.7	–5.1
Tanzania	6.7	6.2	7.1	7.5	4.4	7.3	5.6	5.0	–4.5	–8.6	–10.6	–10.8
Uganda	6.7	5.4	6.2	6.5	8.0	6.6	7.5	5.1	–2.1	–4.1	–2.4	–6.3
Southern Africa[3]	**6.5**	**7.2**	**9.2**	**11.0**	**11.7**	**10.4**	**9.0**	**7.3**	**4.4**	**10.9**	**3.6**	**2.6**
Angola	20.6	18.6	23.1	27.2	23.0	13.3	11.9	8.9	16.8	23.3	7.6	10.7
Zimbabwe[4]	–5.3	–4.8	–6.2	–4.5	237.8	1,016.7	16,170.2	. . .	–11.2	–4.0	–0.9	. . .
West and Central Africa[3]	**5.6**	**4.2**	**4.6**	**6.5**	**11.5**	**7.5**	**5.7**	**5.9**	**2.7**	**5.4**	**–0.4**	**1.8**
Ghana	5.9	6.2	6.3	6.9	15.1	10.9	9.4	8.8	–7.0	–9.7	–9.7	–7.7
Nigeria	7.2	5.6	4.3	8.0	17.8	8.3	5.3	7.4	9.3	12.2	1.8	6.0
CFA franc zone[3]	**4.5**	**2.2**	**4.6**	**5.3**	**4.4**	**3.6**	**3.1**	**3.1**	**–1.5**	**0.5**	**–0.7**	**–0.7**
Cameroon	2.0	3.8	3.8	5.3	2.0	5.1	2.0	2.7	–3.3	–0.7	–1.5	–3.1
Côte d'Ivoire	1.8	0.9	1.7	3.8	3.9	2.5	2.5	3.0	0.2	3.0	2.6	1.3
South Africa	**5.1**	**5.0**	**4.7**	**4.2**	**3.4**	**4.7**	**6.6**	**6.2**	**–4.0**	**–6.5**	**–6.7**	**–6.4**
Memorandum												
Oil importers	4.7	5.3	4.9	5.3	5.6	6.5	6.9	6.0	–3.2	–3.9	–4.5	–4.1
Oil exporters[5]	7.5	6.3	7.5	9.1	8.9	5.9	6.1	6.0	11.5	14.7	7.2	8.9

[1]For consumer price inflation, the composition of the regional groups excludes Zimbabwe. Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.

[2]Percent of GDP.

[3]The country composition of these regional groups is set out in Table F in the Statistical Appendix.

[4]Given recent trends, it is not possible to forecast inflation and nominal GDP with any precision and consequently no projection for 2008 is shown.

[5]Includes Chad and Mauritania in this table.

trends (Figure 2.8). Moreover, faster-growing countries in the region are making substantial progress in reducing poverty rates. This growth success reflects a potent combination of a favorable external environment (particularly, improving terms of trade), sound policy implementation, and the rising openness of SSA economies, achieved not only by oil and commodity exporters, but also by coastal and landlocked countries. While rising fuel and commodity-based exports have played a major role, African countries have also been able to expand nontraditional manufacturing exports and to diversify export destinations, especially to new destinations in Asia with strong demand for resource-based products.[10]

The combination of more open economies in a benign external environment, together with improved and more consistent policy implementation, reforms to strengthen the business environment, and official actions to reduce debt burdens, has allowed SSA countries to attract rising private capital inflows, as well as to benefit from some step-up in aid inflows and rising remittances. Foreign direct investment has

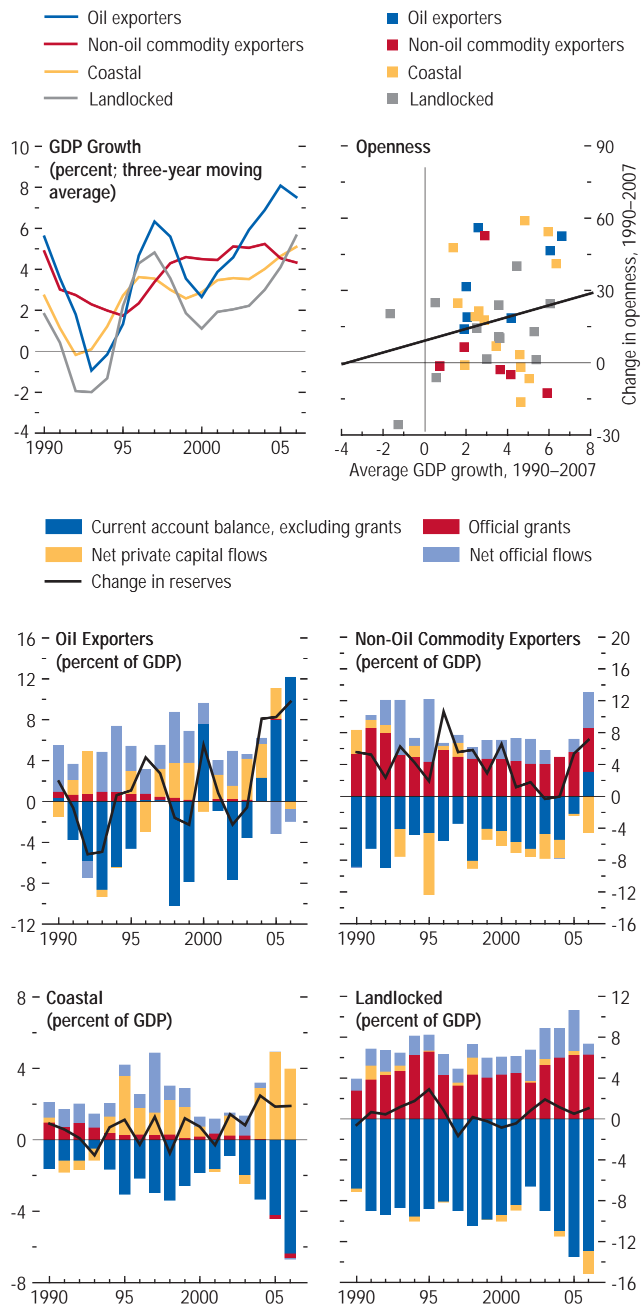
[10]See, for more detail, International Monetary Fund (2007).

been particularly strong to resource-rich countries, but also elsewhere, for example, to fund tourism projects. A smaller number of countries have also begun to attract interest from private portfolio investors—South Africa, with its well-developed financial structure, receives the bulk of these funds, but other countries, such as Ghana and Uganda, which have demonstrated increased policy credibility, have also been experiencing rising capital inflows. Official grants have not risen significantly at the aggregate level, despite commitments made at the Gleneagles Summit, but a number of countries have attracted rising aid inflows, particularly landlocked countries such as Lesotho, Malawi, and Rwanda.

SSA countries have so far experienced less severe trade-offs from the challenges of managing foreign exchange inflows than other parts of the developing world, but must be ready to face these issues. Most countries in the region have continued to run significant current account deficits; the buildup in international reserves has been welcome, but reserves remain quite low (outside the oil producers); and upward movements in the real effective exchange rate have been limited. The challenges are most pressing for oil exporters. Similar to other oil producers, the oil-exporting countries in Africa have made large terms-of-trade gains from recent fuel price increases, and international reserves have risen rapidly. These countries must be careful to spend oil windfall gains in a prudent manner, without straining domestic absorptive capacity, and saving appropriately for future generations. As discussed in IMF (2007), it will be important to combine well-targeted increases in government spending with measures to improve the supply-side response in the non-oil economy. Similar lessons also apply to considering how best to use stepped-up aid flows. Although such increased inflows would provide an important opportunity for poverty reduction, care will be needed to avoid crowding out other productive activities through upward pressure on scarce domestic resources (Box 2.3).

Figure 2.8. Sub-Saharan Africa: Benefiting from Globalization

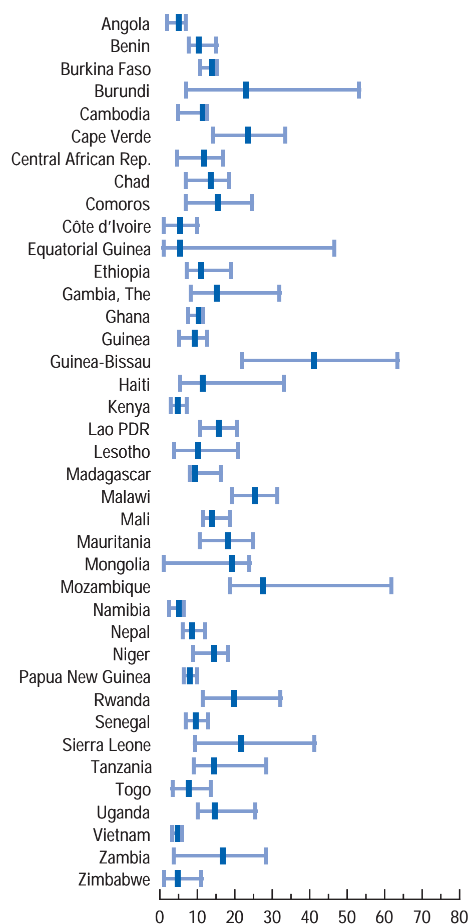
Most African countries have grown robustly in recent years, helped by rising trade openness. Oil-exporting countries have grown particularly rapidly, with export revenues pushing up reserve levels fast. Net private inflows have risen, especially to coastal countries, while official flows have risen significantly to landlocked countries, financing rising current account deficits in both groups of countries.



Source: IMF staff calculations.

Box 2.3. Managing the Macroeconomic Consequences of Large and Volatile Aid Flows

Variations in Aid Flows in Poor Countries, 1990–2005[1]
(Percent of GDP)



Source: IMF staff calculations.
[1]Chart displays minimum, median, and maximum aid flows over the period, excluding outliers.

At the G-8 meeting in Gleneagles, Scotland, in 2005, world leaders pledged a large increase in official development assistance to low-income countries. The objective was to help poor countries achieve the Millennium Development Goals agreed upon at the Millennium Summit of the United Nations in 2000. The promised surge in aid flows is a unique opportunity to fight poverty on a large scale; however, it raises some macroeconomic challenges that need to be addressed to ensure that aid flows have the most beneficial impact.

Aid Flows Are Volatile

Aid flows to poor countries are often large and very volatile (Bulíř and Hamann, 2006). Between 1990 and 2005, about 40 poor countries experienced net aid inflows (excluding debt relief) above 10 percent of GDP (figure). This compares with net private capital flows to emerging markets, which in the past two decades have generally been less than 5 percent of GDP. Moreover, annual changes in net aid flows can be huge, easily exceeding 10 percent of GDP, and even more than 20 percent of GDP for a handful of countries. Moreover, recent research shows that aid is volatile and unpredictable even in countries that follow reasonable policies (Celasun and Walliser, forthcoming). Such volatility poses particular macroeconomic challenges to policymakers in low-income countries, which often suffer from weak public expenditure management, shortages of skilled workers, undiversified production structures, and shallow financial markets.

Challenges in Macroeconomic Managing of Aid Flows

The problem of managing large aid inflows has several dimensions. First, the volatility and unpredictability of aid can complicate public expenditure management. It would be highly damaging if spending on recurrent expenditures (such as in the health and education sectors) had to be adjusted upward and downward on an annual basis because of aid fluctuations. Moreover, sustained periods of large aid inflows could weaken efforts in mobilizing domestic revenues, resulting in significant public financing gaps when aid is phased out. Finally, institutional constraints (such as weak capacity

Note: The main author of this box is Thierry Tressel.

to manage and monitor public expenditure, or even corruption) may limit the capacity to quickly absorb large amounts of aid effectively.

Another key macroeconomic concern arises when large aid flows are spent on goods and services produced in the domestic economy, which can push up the price of nontraded goods relative to the price of traded goods (the real exchange rate), resulting in a loss of competitiveness in export-oriented, high-value-added sectors. This phenomenon is often called Dutch disease. As an example, consider the case in which aid is spent on hiring skilled workers, such as nurses, doctors, and teachers. Because skilled workers are in short supply, their wages quickly go up. As a result, wages of educated people in manufacturing industries and other sectors also increase, hurting exporters who cannot pass on their higher costs to customers.

Rajan and Subramanian (2005) confirm that Dutch disease is a real concern by showing that in countries that received more aid in the 1980s and 1990s, export-oriented, labor-intensive manufacturing industries grew more slowly than other industries. Similarly, Prati and Tressel (2006) find that foreign aid inflows depress overall exports of poor countries, as Dutch disease would imply. They do not find, however, any negative effect of aid disbursed when countries experience large exogenous shocks (droughts, large negative commodity price shocks, hurricanes, or earthquakes) or during post-war reconstruction. This suggests that aid may help production recover from adverse events.

Policies to Mitigate the Side Effects of Aid

Country case studies find that aid-recipient countries were often reluctant to let the real exchange rate appreciate as aid flowed in (Berg and others, 2007). In some countries, the fiscal authority simply did not spend the aid in the year it was received, while the central bank accumulated foreign exchange reserves (Ethiopia and Ghana). In other countries, the fiscal authority increased spending in line with the surge in aid, while the monetary authority tried to prevent real exchange rate appreciation by sterilizing the monetary expansion associated with the increase in public spending (Mozambique, Tanzania, and Uganda).

Gradually phasing in a spending buildup so as to limit the strain on domestic capacity and sterilizing the monetary expansion associated with aid spending both amount to temporarily saving part of the aid in the form of international reserves and can mitigate Dutch disease problems and other side effects of aid. Indeed, Prati and Tressel (2006) show that these policy responses eased the aggregate demand and real appreciation pressures associated with aid inflows. The effectiveness of such policy responses may also explain why Berg and others (2007) do not find symptoms of Dutch disease in a small group of countries that have recently experienced aid surges.

However, policies aimed at redistributing aid resources over time for the purpose of managing the macroeconomic consequences of large aid flows pose specific challenges. In poor countries, shallow financial markets may make it difficult to execute sterilization operations in the bond markets and result in a burden on banks, for example, through higher reserve requirements. Sterilization policies could also lead to an undesired increase in interest rates and crowding out of private investment.

As a general principle, countries receiving aid should aim at spending it over time as part of their poverty reduction strategy. However, in the short term, saving part of volatile and unpredictable aid flows in the form of international reserves can be justified from both a public finance and a macroeconomic management perspective. First, from a public finance perspective, if a temporary spurt of aid is all spent when it arrives (as was often the case in the past), a subsequent sharp drop in aid receipts could prompt the need for either a costly retrenchment of spending or recourse to higher domestic financing of expenditures, which could lead to loss of monetary control and inflation (Celasun and Walliser, 2006). In contrast, saving part of temporary aid surges would help avoid

Box 2.3 ***(concluded)***

excessive reliance on domestic financing and prevent an unsustainable buildup of expenditures. On the whole, effective medium-term budgeting requires that aid-recipient countries smooth recurrent expenditures, so that all programs undertaken are funded while providing for key lumpy expenditures (Heller, 2005). Finally, to prevent aid dependency, periods of sustained large flows should not diminish efforts to mobilize domestic revenues (Gupta, Powell, and Yang, 2006).

From a macroeconomic management perspective, saving part of temporary increases in aid flows reflects the need to smooth aggregate consumption and to balance demand against supply. Building reserve buffers to self-insure against future negative shocks is particularly important in countries that have low reserve coverage of imports and are subject to frequent exogenous shocks (such as terms-of-trade shocks and droughts). Saving part of aid to smooth spending paths may also be necessary when a country's absorptive capacity is weak and when there are risks of loss of competitiveness from Dutch disease.

In choosing aid spending and absorption paths, policymakers in recipient countries should take into account country specifics such as macroeconomic stability, current and projected improvements in absorptive capacity, the risks of Dutch disease, and debt sustainability. Given the challenges associated with achieving optimal aid spending paths through macroeconomic policy adjustments, donors would contribute to a more effective use of aid by committing to coordinated multiyear aid disbursements tailored to country-specific circumstances. In this perspective, the 2005 Paris Declaration on Aid Effectiveness is a welcome step in improving aid predictability.

More generally, to take full advantage of globalization, SSA countries must continue to build institutions that will help sustain improved macroeconomic management, push through governance and other reforms to strengthen poverty alleviation, and develop the infrastructure and business environment to foster the rising productivity and investment needed to sustain high growth even in the face of a less benign global environment. Many countries will need to develop more flexible exchange rate regimes and more active monetary policy management in response to greater trade and capital interlinkages with the rest of the world. South Africa provides a leading example on the continent of such management, and it is encouraging that other countries, such as Ghana, are moving or preparing to move in a similar direction to put in place inflation-targeting regimes with more actively floating currencies. It will also be important to be prudent in taking advantage of opportunities for external funding to make sure that projects are carefully chosen and that gains from official debt reduction are preserved.

Middle East: Balancing Cyclical and Long-Term Considerations in Fiscal Policy

The long spell of strong growth in the Middle East continues to be supported by high oil prices and robust domestic demand. Regional growth has been maintained at over 5 percent a year in the past four years, reaching 5.6 percent in 2006 (Table 2.8). Although investment in the oil sector stagnated in real terms because of increasing investment costs, GDP growth in oil-exporting countries was sustained by expansion in the non-oil sectors, pushed by rising government spending out of oil revenues, foreign capital inflows, and rapidly growing domestic private credit. A buildup of government spending on infrastructure and social projects, as well as investment programs to expand oil production and refining capacity, narrowed fiscal surpluses and external

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

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Middle East	**5.4**	**5.6**	**5.9**	**5.9**	**6.9**	**7.5**	**10.8**	**9.2**	**19.4**	**19.7**	**16.7**	**16.0**
Oil exporters[3]	**5.6**	**5.4**	**5.7**	**5.6**	**6.7**	**8.4**	**11.0**	**9.7**	**22.3**	**22.7**	**19.2**	**18.5**
Iran, I.R. of	4.4	4.9	6.0	6.0	12.1	13.6	19.0	17.7	8.8	8.7	7.6	6.6
Saudi Arabia	6.1	4.3	4.1	4.3	0.7	2.2	3.0	3.0	28.5	27.4	22.2	20.1
Kuwait	10.0	5.0	3.5	4.8	4.1	2.8	2.6	2.6	40.5	43.0	37.8	35.3
Mashreq	**4.3**	**6.1**	**6.3**	**6.5**	**7.7**	**5.3**	**9.6**	**7.2**	**–2.3**	**–2.6**	**–2.4**	**–2.5**
Egypt	4.5	6.8	7.1	7.3	8.8	4.2	10.9	7.8	3.2	0.8	1.4	0.8
Syrian Arab Republic	3.3	4.4	3.9	3.7	7.2	10.0	7.0	7.0	–4.1	–6.1	–5.6	–6.6
Jordan	7.1	6.3	6.0	6.0	3.5	6.3	5.0	4.5	–17.9	–14.0	–12.6	–11.9
Lebanon	1.0	—	2.0	3.5	–0.7	5.6	3.5	2.5	–13.6	–6.2	–10.6	–9.4
Memorandum												
Israel	5.3	5.2	5.1	3.8	1.3	2.1	0.5	2.5	3.3	5.6	3.7	3.2

[1]Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.
[2]Percent of GDP.
[3]Includes Bahrain, Islamic Republic of Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, United Arab Emirates, and the Republic of Yemen.

current account surpluses, despite higher oil prices (Figure 2.9). Oil-importing countries, for their part, benefited from the favorable external environment and robust domestic demand, with growth rising to 6 percent in 2006 and early 2007. Growth remains strong and broad based in Egypt and Jordan, but the Lebanese economy is still weak in the aftermath of last year's military conflict.

Growth momentum should pick up near term, supported by high oil prices and expansionary fiscal policy. Regional economies are projected to expand by about 6 percent in both 2007 and 2008, with growth accelerating in the Islamic Republic of Iran and Egypt. Oil prices are forecast to remain near current high levels, but robust domestic demand is projected to lower current account surpluses in the region to 16 percent of GDP, down from almost 20 percent of GDP in 2006. Growth in oil-importing economies is expected to continue to outpace that in oil-exporting countries, supported by strong private and public consumption and investment growth. Risks appear broadly balanced. Slower global growth, increased financial market volatility, or regional geopolitical risks could hurt growth, but the strength of oil prices provides upside potential.

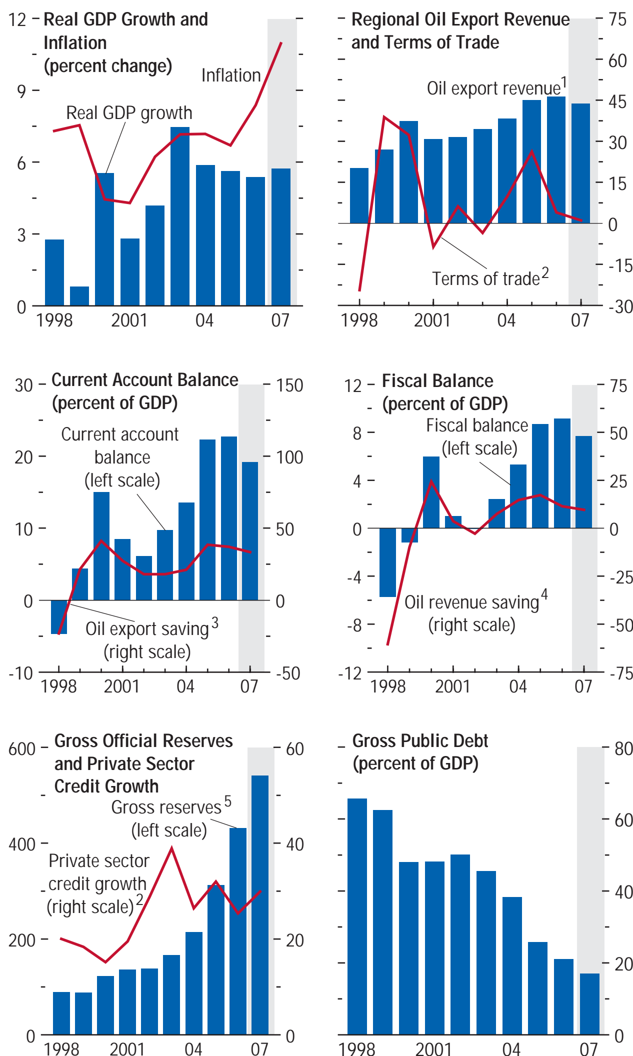
With resource utilization and import prices rising, inflation is accelerating (see Figure 2.9). In Saudi Arabia, inflation rose for the first time in a decade in 2006, although from very low levels. Inflation increases have also been moderate in Kuwait, given its open product and factor markets. In Egypt, inflation accelerated in 2006 and early 2007, owing to rising demand pressures and increases in administered prices (primarily fuel prices), as well as bird flu effects, but has been slowing in recent months, in part as a result of the tightening of the monetary stance in the second half of 2006. In the Islamic Republic of Iran, high inflation has become entrenched owing to an extended and significant policy stimulus.

Weakness of the U.S. dollar added to inflationary pressures in the Gulf Cooperation Council (GCC) countries. Most of these countries peg their currencies to the U.S. dollar, although in a surprise move in May 2007, Kuwait (one of the GCC members) abandoned the peg to the U.S. dollar in favor of pegging to an undisclosed currency basket and allowed its currency to adjust in line with movements in the basket.[11]

[11]By October 2, 2007, the cumulative appreciation of the Kuwaiti dinar was 3.4 percent.

Figure 2.9. Middle East: How Are Oil Revenues Used?

Governments increased investment in infrastructure and social projects, substituting oil revenues for debt financing. The twin fiscal and current account surpluses fell, and rising resource utilization pushed up inflation, despite moderating private credit growth.



Sources: IMF, *International Financial Statistics;* and IMF staff estimates.
[1]Percent of GDP.
[2]Annual percent change.
[3]Oil export saving, expressed as percent, is calculated as the ratio of current account balance to oil exports.
[4]Oil revenue saving, expressed as percent, is calculated as the ratio of fiscal balance to fiscal oil revenue.
[5]Billions of U.S. dollars.

Kuwait's move came shortly after Oman's decision not to join the planned common-currency block in the region, at least not as a founding member, because it would not be able to meet all the requirements by the target date of 2010. Although these steps need not undermine the single-currency project, together with other economic developments, they would make it hard to meet the 2010 deadline for launching the single currency. The GCC countries also agreed that each central bank would decide on its own policies to control inflation. Inflationary pressures are expected to persist in the GCC countries as domestic demand expands in response to the positive terms-of-trade and wealth developments, and the equilibrium real exchange rate should appreciate as a result of these developments. The acceleration of imports associated with expansionary fiscal policy and rising investment is expected to lower the GCC countries' current account surpluses, thereby contributing to the resolution of global imbalances.

Against this backdrop, the challenge for fiscal policy in oil- and non-oil commodity-exporting countries is striking a balance between the long-term developmental objectives and cyclical considerations. With the outlook for oil and other commodity prices projected to remain strong, raising the trend of government spending would be warranted, as it would allow the terms-of-trade and wealth gains to be spent partly on addressing infrastructure and social needs, in line with long-term growth and diversification objectives. However, these considerations will have to be balanced against the shorter-term, cyclical need to maintain fiscal surpluses as a counterbalance to strong private demand growth in an environment of rapidly expanding domestic liquidity. Policymakers thus need to carefully calibrate the speed of implementing investment and social projects to the absorptive capacity of their economies, while strengthening market mechanisms to keep long-term inflation expectations anchored at appropriate levels and improving expenditure management to ensure the efficiency and effectiveness of public spending.

For exporters of oil and other commodities, whose fortunes are tied to commodity price fluctuations, the main challenge is to diversify toward non-oil sectors, while containing cyclical inflationary pressures.[12] Policymakers in oil-exporting countries (for example, Saudi Arabia, Kuwait, Qatar, and the United Arab Emirates) thus need to calibrate the speed of implementing large-scale projects to the absorptive capacity of the economy, while improving the flexibility of markets to keep long-term inflation expectations anchored at low levels and developing tools for managing liquidity. In some countries (Qatar and the United Arab Emirates), slowing the pace of fiscal spending and large investments under the public-private partnership arrangements may be considered a means of helping contain domestic demand. In the Islamic Republic of Iran, sizable fiscal adjustment and monetary tightening will help ease demand pressures and put inflation on a downward path.

In the structural policy area, the diversification strategy of oil exporters hinges on reforms to improve the business climate and make investment in non-oil sectors more attractive. Increasing the role of the private sector in the provision of services that up to now have been supplied by governments, opening government procurement and domestic sectors to competition, and lifting price controls would go a long way in this regard. More flexible employment procedures and measures facilitating labor mobility and human capital development would also help relieve labor supply bottlenecks and create job opportunities for the young and rapidly growing population.

These policies are germane to the oil-importing countries as well, which also share rapid population growth and the challenges of forestalling a further rise in unemployment. These economies have also been experiencing significant capital inflows, owing to ample regional and global liquidity as well as domestic privatization programs (Egypt). Maintaining macroeconomic stability in these circumstances requires tightening fiscal and, where appropriate, monetary policies, while strengthening the quality of supervision and regulation would help develop and enhance the efficiency and soundness of financial systems in the region.

[12]Non-oil sectors with potential for development in the Middle East include, among others, tourism, energy-intensive processing industries, and infrastructure development. Addressing supply constraints in oil production and refining would also benefit the region and the global economy.

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