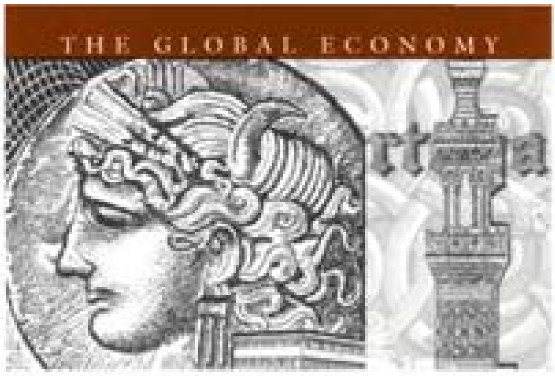

World Economic Outlook

The Board and the Interim Committee regularly review global economic developments and policies, based on World Economic Outlook reports prepared by the staff. These reports contain comprehensive analyses of short-term and medium-term prospects for the world economy, as well as for individual countries and country groups. This exercise constitutes the basic framework for assessing the interaction of economic policies of individual member countries.

In the period covered by this *Annual Report*, the Executive Board held two discussions on the World Economic Outlook, in September 1994 and in April 1995. Both sessions covered a wide range of topics. In September 1994, Directors reviewed developments in the world economy and stressed that the challenges ahead called for sustained commitment to the cooperative strategy set out in the Interim Committee's declaration of April 1993.[2] In April 1995, the discussion of policy requirements to meet the objectives of sustained global expansion, set out in the Madrid Declaration, added an important new dimension to the continuing efforts to strengthen Fund surveillance. Directors agreed that it was difficult to assess progress, given the short time span since the Madrid meeting, since it would take time to develop the domestic consensus to support fundamental fiscal and structural policy changes. Directors strongly welcomed the ratification of the Uruguay Round agreement and the establishment of the WTO as major achievements that would help to strengthen the global expansion. In July 1994 the Board also discussed a paper on unproductive public expenditures, which was prepared as a background paper to the April World Economic Outlook discussion (Box 1).

[2] *Annual Report, 1993*, page 1.

Global Situation

The fiftieth anniversary of the Bretton Woods Conference provided an appropriate occasion to reflect on the performance of the world economy over the previous five decades and to review the implications of recent developments for the Fund's role in the future. During its September 1994 discussions of global economic developments, the Board noted in particular the contribution to global prosperity of international policy cooperation, which was the hallmark of the Bretton Woods achievement. Trade grew significantly faster than output in almost all regions of the world, bringing about substantial and widespread benefits in terms of increased opportunities for specialization, greater incentives to invest, and more rapid technology transfer. Against the background of this favorable retrospective, however, several Directors pointed to the serious worsening of labor market conditions in many industrial countries, with rates of unemployment approaching levels not seen since the 1930s. They also stressed that not all regions had kept pace with the general increase in living standards and that in many developing countries per capita real GDP was lower than a decade or more ago.

Nevertheless, Directors were positive about longer-run trends in the world economy, citing improvements in economic policy and performance in a growing number of developing countries, improvements in economic management under way in transition economies, considerable progress toward price

Box 1

ECONOMIC IMPLICATIONS OF UNPRODUCTIVE PUBLIC EXPENDITURES

Economic implications of unproductive public expenditures and approaches to improving expenditure productivity were considered by the Board in July 1994. Directors agreed that the economic costs of unproductive expenditures were far reaching and that lowering or eliminating such expenditures could help not only to increase the overall productivity of public expenditures and reduce deficits, but also to free resources for social programs. Directors pointed out that an efficient and sustainable reduction in fiscal deficits required a sound mix of both revenue and expenditure policy measures.

Identifying Unproductive Expenditures

Directors concurred that, as a starting point, policymakers could make use of several rules of thumb, including the following:

- attempt to identify public sector outputs that can be provided or produced more efficiently by the private sector without compromising other possible objectives, such as an equitable distribution of income;
- examine if the primary objective of the project or program is being met in the most cost-effective way;
- attempt to identify unproductive projects or programs in both the recurrent and capital components of the budget by focusing on big-ticket items;
- note that the existence of generalized food subsidies or producer subsidies indicates there is potential for saving in expenditures;
- compare expenditure allocations with countries at the same level of development and in the same region;
- examine budgetary allocations for wage and nonwage expenditures for different ministries or sectors;
- analyze both overall and sectoral employment; and
- analyze the accounts of extrabudgetary funds or the central bank in its quasi-fiscal activities.

Directors felt that, despite the complicated technical work and political difficulties in establishing well-designed policies to reduce public expenditures, governments must inevitably implement such policies. In doing so, due consideration should be given to maintaining essential public services, protecting growth prospects, and pursuing an equitable distribution of income.

Potential Saving

From a global perspective, the Board noted that the potential increase in available resources through reducing unproductive public expenditures was large. International cooperation would help to achieve public expenditure efficiency in certain areas, such as export subsidies or military expenditures, that have important external effects on global resource allocation or world economic welfare. Furthermore, Directors agreed that all countries can increase public expenditure productivity by improving both the efficiency of public programs and the composition of public outlays. However, existing practices often fall short of this goal.

Directors encouraged the staff to strengthen efforts to obtain reliable statistical data and to extend its research and analysis on the efficiency and productivity of public expenditures so as to improve the design of Fund-supported adjustment programs.

stability in many countries, and growing recognition in industrial countries of the need to improve the functioning of labor markets and to strengthen the financial position of the public sector. Board members also stressed that the challenges ahead called for a sustained commitment to the cooperative strategy set out in the Interim Committee's declaration of April 1993 (see *Annual Report, 1993*, page 1). They emphasized that global economic performance (in terms of growth and efficiency) would be enhanced by the entry into force of the Uruguay Round trade agreement, by the deepening of regional integration, and by the welcome trend toward currency convertibility and liberalization of capital movements.

In their April 1995 discussions, Directors highlighted the relatively solid economic expansion in most of the world economy during the previous year, sharing the view that economic growth had proved stronger than previously expected. Continued expansion in most countries, with inflation contained in many countries, afforded governments an opportunity to take corrective action, as warranted.

Industrial Country Policies

During the September 1994 discussions, Directors agreed that recovery was finally under way in France, Germany, and other countries in continental Europe; that clearer signs of a turnaround were apparent in Japan; and that the expansion in the United States continued at a strong pace. In Canada, indicators were favorable, with strong growth through the second quarter of 1994, consumer prices essentially stable, and long-term interest rates declining. The expansion in the United Kingdom was also proceeding at a robust pace, with little immediate risk of rising inflation.

However, Directors stressed that a clearly warranted feeling of optimism about the period ahead should not lead to complacency over the medium term. Many policy challenges remained to be tackled to ensure a durable expansion, to avoid a repetition of past policy mistakes, and to take full account of important policy lessons from the 1980s. In this context, several Directors expressed concern about the sharp increases in long-term bond yields in the first

Box 2

ADEQUACY OF WORLD SAVING

Saving plays a central role in income determination, both in the short run through aggregate demand, and in the long run through capital formation and wealth accumulation. Currently, the prospect for aggregate saving is of particular relevance, in light of large potential future demands on world saving.

Determinants of Saving

Understanding the determinants of saving is necessary to assess the resources that will be available to finance investment, and the prospects for real interest rates. Many interrelated factors combine to generate observed saving behavior, two of which will be particularly important in the future. First, aging populations in the industrial countries are likely to put downward pressure on saving rates over the next few decades. Even if this decline in industrial country saving is offset by increases in saving in the developing world, this trend implies significant changes in the location and structure of world saving. Second, fiscal deficits also undermine both national and worldwide saving. The simplest and most direct way for governments to boost such saving is through reducing these imbalances.

Pressures on Global Saving

The April 1995 Board meeting on the World Economic Outlook included a discussion on the adequacy of world saving. Directors agreed that, although there were difficulties in measuring saving and real interest rates, strong pressures on the level of global saving were apparent. As evidence of a saving problem, several Directors pointed to the higher level of global real interest rates over the past decade, relative to previous decades. A likely explanation for the decline in the global saving rate and for the increase in the level of global real interest rates since 1980 was the decline in public saving, which fell to $^1/_2$ of 1 percent of GDP in 1981–93 from 4 percent of GDP in 1960–72. This decline provided all the more reason for governments to work harder to consolidate their fiscal positions.

Under conditions of limited capital mobility, increases in the stock of productive capital must be financed mainly by higher national saving. When capital is mobile, differences in saving and investment propensities may lead to large external imbalances. Referring to the staff's discussion of cases in which even successful countries encountered problems if capital inflows exceeded 4 to 6 percent of GDP a year, Directors noted countries' limited ability to rely on the saving of other countries, demonstrating, once more, the need to monitor carefully countries with persistently large current account deficits. Directors agreed, provided that most countries addressed their fiscal imbalances decisively, that prospects for world saving would be favorable over the long run.

Several Directors noted that shifting world demographic forces might not depress overall world saving. Some industrial countries would experience increasing dependency ratios as their population aged, thus contributing to a reduction in private saving rates. However, it was likely that this reduction would be offset by events in developing countries, where dependency ratios were projected to fall sharply as these countries' youth dependency ratios fell and the share of the working-age population increased. New sources of saving from rapidly developing countries, which were expected to become quite substantial over the next twenty to thirty years, could contribute greatly to meeting world financing requirements and would allow for the bulk of developing country investment to be funded domestically.

half of 1994, which were seen as a possible sign of underlying pressures in capital markets. Increased demand for funds in more strongly expanding industrial economies, combined with the ongoing need for investment capital in transition economies and in developing countries, pointed to a high level of private sector demand for capital in coming years. With private saving rates low or declining in many large countries, and with the considerable absorption of saving by the public sector, there was a risk of continued and perhaps increasing pressure on world real interest rates, which could constrain future growth (Box 2).

Most Directors reiterated their long-standing concern about the poor functioning of labor markets in Europe and the danger that the increase in cyclical unemployment might become structural and, hence, might persist. They underscored the urgent need for fundamental and far-reaching labor market reforms, as discussed in depth in the May 1994 *World Economic Outlook*. In many countries, further deregulation of labor, product, and capital markets would enhance economic dynamism and efficiency.

During the April 1995 discussions, Directors generally agreed with the staff's projection of continued healthy economic expansion among industrial countries, noting, nevertheless, significant differences in cyclical positions across countries. In the United States, Canada, the United Kingdom, Australia, and New Zealand, which had entered into the third or fourth year of expansion, growth was likely to moderate. For most of the continental European countries, where recovery was more recent, growth was expected to remain relatively strong. Finally, in Japan, growth was likely to pick up despite a relatively lackluster recovery, although the excessive strength of the yen constituted an important downside risk.

Concerns were more widespread with respect to structural reform and budgetary consolidation. The Madrid Declaration called for more forceful deficit-

reduction measures, and Directors emphasized the need for most countries to adopt, and implement, more ambitious medium-term fiscal objectives. Several Directors felt that market concerns about the fiscal situation in several countries had contributed in important ways to exchange market pressures. Directors also noted that there had been little further progress in the area of structural reform and, in particular, that labor market, social security, and pension reform programs had been inadequate in most countries.

Monetary and Exchange Rate Policies

In September 1994, Directors emphasized the importance of safeguarding the progress made toward price stability in many countries as a critical condition for a durable expansion. Overall, they considered the prevailing stance of monetary policy to be appropriate in most countries and generally agreed that the actions undertaken by the United States to shift monetary policy away from its earlier expansionary stance had been appropriate and timely. With respect to Japan, most Directors considered that it would be advisable to see how the current expansion developed before taking any action to adjust monetary policy.

Directors expressed some concern about movements in the exchange rate between the dollar and the yen, and they saw a risk that the strength of the yen might delay the resumption of stronger growth in Japan. More generally, Directors emphasized the need for more effective Fund surveillance to help foster conditions that would be conducive to a greater stability of exchange rate relationships.

During the April 1995 discussions, many Directors stressed that, while monetary policy had a critical role to play in avoiding another boom-and-bust cycle among industrial countries, fiscal policy constrained the ability of the monetary authorities to safeguard price stability. Although the battle against inflation was never won, Directors expressed cautious optimism about the pre-emptive tightening of monetary conditions in several countries that were well advanced in the cycle. They noted the importance of a strong commitment to resist inflationary pressures, which the Madrid Declaration had emphasized as a key condition for sustaining medium-term growth.

Most Directors were concerned about the effects of exchange rate developments in the major industrial countries. They noted that such pressures posed a threat to the prospects for sustained noninflationary growth, with adverse implications for all countries. Many Directors agreed with the staff that there was a strong case for coordinated interest rate actions among the major industrial countries to restore greater stability to currency markets, and that such action would satisfy both domestic and international objectives. The cut in official interest rates in Germany at the end of March 1995 was welcomed as a way to help alleviate exchange market pressures and reduce the risk of a weaker recovery. Most Directors suggested that the strength of the yen and the sluggishness of the Japanese recovery argued for further monetary stimulus beyond the limited easing of monetary conditions at the end of March, as well as for further structural action to deregulate and open the economy. While economic indicators in the United States suggested that the growth of domestic demand had slowed to a more moderate pace, an upside risk to output and inflation remained, and the weakness of the dollar could contribute to increasing price pressures. A number of speakers therefore recommended a further tightening of monetary conditions in the United States.

Fiscal Developments

In the September 1994 discussions, Directors were unanimous in their call for renewed commitments to containing and reducing fiscal deficits, as stressed in April 1993 by the Interim Committee. Such action was viewed as essential for alleviating pressures on long-term interest rates and to permit satisfactory rates of future economic growth and job creation. Efforts that went beyond the effects of automatic stabilizers were needed to place fiscal policy on a sound medium-term footing in virtually all countries. Directors underscored the need for decisive steps to improve the fiscal outlook in Italy and Sweden and noted that other countries should take advantage of the economic expansion to substantially reduce the public sector's absorption of private saving.

In April 1995, most Directors felt that there was little risk that more ambitious fiscal consolidation might weaken the global recovery. In fact, many speakers emphasized that more ambitious consolidation efforts could strengthen growth, even in the short run, by enhancing the credibility of policies, reducing risk premiums on interest rates, alleviating exchange market pressures, and improving confidence. On balance, most Directors agreed that a failure to step up the slow pace of fiscal consolidation in many countries would constitute a much larger threat to the global economic and financial outlook than the risks associated with fiscal tightening.

Developing Country Policies

In the September 1994 discussions, Directors were encouraged by the continued strong growth performance of many developing countries. However, they pointed out that the strong aggregate performance masked considerable diversity. In many countries, growth was weak, and standards of living had continued to stagnate or decline. Directors noted that such divergences in economic performance reflected the

varying degrees of success in implementing appropriate macroeconomic stabilization policies and structural reforms, as well as differences in external conditions faced by individual countries.

In sub-Saharan Africa, despite indications of a brightening economic outlook in several countries, economic conditions remained particularly difficult. Critical to reversing the pattern of declining living standards were increased domestic saving, reduced inflation in some countries, and an enlarged scope for market mechanisms. As in other regions, it was also important to improve governance. Directors also emphasized that the beneficial effects on growth associated with the adjustment of the CFA franc, and other currencies, would depend on a steadfast implementation of the accompanying stabilization policies and structural reforms in the countries concerned.

In the Middle East and Europe region, inflation remained relatively high, and growth slowed somewhat as the temporary boost from reconstruction in some countries during 1992–93 dissipated. Directors welcomed the prospect of a lasting peace settlement in the Middle East because this would offer the opportunity to revitalize adjustment and reform efforts, reduce defense expenditures, and address important issues in the areas of infrastructure and regional cooperation. Directors were particularly encouraged by the marked improvement in economic performance of many developing countries in the Western Hemisphere in recent years and by the continuing impressive performance of many Asian countries.

Directors welcomed the substantial rise in private capital flows to many developing countries since the late 1980s and were particularly encouraged by the rising share of foreign direct investment, which also brought a transfer of technology and helped to increase exports. The moderation of capital flows in the first half of 1994 seemed mainly to reflect the strengthening of the recovery in the industrial countries and the associated firming of interest rates.

At the same time, Directors noted that capital flows to developing countries required careful monitoring, given the tenuous nature of certain types of capital flows and the potential for adverse domestic side-effects. A number of Directors were concerned that the rise in capital inflows was driven by the general enthusiasm for emerging financial markets, which might put these countries at risk to sudden changes in market sentiment. Directors also expressed concern about the sustainability of capital flows to some countries where the flows were related to high short-term interest rates owing to an inappropriate mix of lax fiscal policy and tight monetary policy. They pointed out that where capital inflows were primarily the result of policy changes, such as structural reform and fiscal adjustment, a real exchange rate appreciation was more likely to be the appropriate equilibrating response to improvements in productivity and profitability. In contrast, where capital inflows were caused by restrictive credit policies that raised short-term interest rates and were not supported by sustainable fiscal policies, an exchange rate appreciation may be more disruptive. Moreover, such countries may be more vulnerable to sudden reversals of capital flows.

Finally, Directors noted that many developing countries attempted to slow the inflow of capital by resorting to a variety of mechanisms, such as ceilings on foreign borrowing, minimum reserve requirements on foreign loans, and interest rate equalization taxes. They cautioned that capital controls should not be viewed as a substitute for correcting policy imbalances and that restrictions on capital flows were unlikely to be effective over the longer run and might distort investment decisions.

During the April 1995 discussions, Directors commended the growing trend toward economic liberalization, which had contributed to improvements in economic performance across a broad range of developing countries. They welcomed the strengthening of reform and adjustment efforts, particularly in many low-income countries, but noted that some early achievements still appeared to be fragile, and that there would be risks of setbacks if stabilization and reform efforts were relaxed. Moreover, changes in market sentiment underscored the need for vigilance to safeguard domestic and external financial stability and to sustain growth. In the aftermath of the Mexican financial crisis, Directors particularly stressed the need for a number of developing countries to implement corrective measures to restore and maintain macroeconomic stability, and to be on guard against the volatility of short-term portfolio inflows.

Overall, Directors noted that long-term growth prospects in developing countries remained promising. They did, however, concur with the staff's projections that growth in many of those countries would slow somewhat in 1995–96 under the influence of tighter policies to reduce the risk of overheating and the reliance on foreign saving. Developing countries in the Western Hemisphere were likely to experience a relatively pronounced slowdown, partly as a result of a marked decline in capital inflows. Many Asian countries were also expected to witness some moderation in the strong pace of economic expansion seen in recent years. By contrast, growth was expected to strengthen somewhat in Africa and the Middle East as a result of the intensification of adjustment and reform efforts, and the cyclical recovery of commodity prices.

Directors emphasized that a large number of countries, especially in sub-Saharan Africa, continued to experience declining real per capita incomes. Many of those countries were particularly vulnerable to fluctua-

tions in their terms of trade. Diversification of production in line with comparative advantage should allow them to benefit fully from the liberalization of world trade resulting from the Uruguay Round agreement. Directors urged bilateral creditors to apply the new Naples terms flexibly, to provide the necessary debt relief for low-income countries that implement strong adjustment and reform programs.

The Board generally agreed with the staff's conclusion that the surge in capital flows to developing countries in recent years was explained in large part by open trade and investment regimes and improved long-term growth prospects brought about by strong adjustment and reform efforts, as evidenced by the strong inflows of foreign direct investment. Directors urged policymakers to ensure that capital inflows did not translate into higher consumption expenditures and become a substitute for domestic saving. They observed that, with the industrial economies rebounding, capital flows to developing countries were likely to be somewhat smaller over the next few years.

Directors felt that many developing countries needed to increase their vigilance over their financial markets. Concerns about the potential instability of capital flows, especially of portfolio investment, had led some countries to implement measures to deter short-term inflows while still maintaining convertibility for longer-term capital account transactions. Directors agreed that a reimposition of capital controls would be undesirable because it would entail longer-term efficiency costs.

Directors also emphasized the importance of prudential limits on the foreign exchange exposure of banking systems. They agreed that such controls should not be viewed as a substitute for efforts to address macroeconomic imbalances and correct unsustainable exchange rates. Several Directors called for further study of the advantages and possible drawbacks of different exchange rate regimes, in light of the difficulties experienced by some developing countries in "exiting" from an exchange rate peg that was no longer viable. While several Directors noted the difficulties of using the exchange rate as an anchor, except when fully supported by sound macroeconomic policies and strong economic fundamentals, others stressed that the potential benefits of an anchor should not be ignored.

Economies in Transition

In September 1994, Directors observed that those countries that went furthest in implementing financial adjustment and liberalization—including Albania, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Mongolia, Poland, the Slovak Republic, and Slovenia—demonstrated that macroeconomic stabilization and structural reforms were prerequisites for achieving economic growth and low inflation. In contrast, in Russia and many of the other transition countries, output continued to decline precipitously. A number of these countries made some progress toward stabilization and reform, but most had yet to reduce government budget deficits sufficiently or to bring inflation under control. Policy slippages exacerbated the decline in output associated with economic restructuring, jeopardized the credibility of the reform efforts, and created an uncertain investment climate. Directors emphasized that containment of government budget deficits was important in reducing inflationary pressures.

Directors recognized that budget deficits were difficult to keep within sustainable levels in all but a few of the countries in transition, and that in all countries the transformation process had profound implications for government revenues and expenditures. It was apparent that the budget deficits were to some extent a result of the transformation process, and this underscored the need to give high priority to reforming government fiscal systems. Directors attributed the persistence of budget deficits mainly to the sharp decrease in tax revenues resulting from the collapse in output and the inadequacy of tax systems, as well as to expenditure pressures related to the restructuring of state enterprises, the need to strengthen social safety nets, and the costs of support for aging populations.

Increases in unemployment were acknowledged to be largely unavoidable in the transformation to a market economy, which required large-scale enterprise restructuring and the reallocation of capital and labor. To protect the unemployed during the transition, Directors emphasized the need for well-targeted social safety nets that were accompanied by cuts in subsidies and unproductive expenditures. In addition, new labor market institutions should be established to promote flexibility and improve employment prospects. In addition to appropriate social safety nets, institutional efforts were required to establish sustainable social security systems.

Finally, Directors expressed concern that, although the problem of arrears among enterprises had receded in several transition economies, new problems had arisen in a number of cases. The increasing recognition by policymakers of the inflationary dangers of any bailout measures was welcomed, and it was agreed that continued progress with stabilization and structural reforms would help to reduce the scale and scope of interenterprise arrears.

In April 1995, Directors welcomed the improved outlook for many of the economies in transition. In most countries of central and eastern Europe, output was either increasing or likely to begin to recover. Inflation still remained too high in many transition countries, however, owing mainly to persistently large

fiscal imbalances. The achievement of rapid growth over the medium term would require credible fiscal, monetary, and exchange rate policies, as well as further progress toward institutional and structural reform. Several Directors welcomed the decisive market-oriented reforms adopted by a number of countries in transition that, until recently, had been reluctant to move in this direction. Encouraging progress had already been achieved in several cases, but sustained adjustment efforts remained necessary to consolidate early gains.

Directors welcomed the agreements recently concluded, or under discussion, between the Fund and a number of transition countries, especially the new stabilization and reform programs in Russia and Ukraine (see sections on Article IV Consultations and Fund Support for Member Countries). Those programs were in accordance with the Madrid Declaration's call for bolder efforts at stabilization and structural reform. Although some of the transition countries had yet to adopt comprehensive adjustment programs, the Board commended the efforts of those countries that had embarked on broadly based reform strategies early in the transition; those countries were experiencing the benefits of early action.