CHAPTER 2

World Economic Outlook

As part of its responsibility for surveillance over the exchange rate policies of member countries and of the international monetary system, the Executive Board periodically reviews global economic developments, based on World Economic Outlook reports prepared by the staff. The reports, usually published twice a year—but published more frequently if rapid changes in economic conditions require it—feature a comprehensive analysis of prospects for the world economy, individual countries and regions, and an examination of various topical issues.

During 1998/99, the Board met on three occasions to discuss staff analyses of the World Economic Outlook: in September 1998, December 1998 (to discuss an update to the September assessment by the staff), and April 1999.[3] These discussions focused on the turbulence in financial markets stemming from the recession in Asia, the crisis in Russia, and, subsequently, the financial turmoil in Brazil.

In September 1998, Directors agreed that the near-term outlook had deteriorated considerably, as the recession in Asia deepened and the crisis in Russia helped trigger a sell-off in equity markets worldwide. The crises underscored the vulnerability of economies with policy shortcomings to abrupt shifts in capital flows. Although signs were encouraging that policy programs in Korea and Thailand, and even Indonesia, had begun to restore financial market confidence, emerging market economies both in Asia and other regions faced a risk of setbacks. Downside risks to the world economy attested to the widening prevalence and intensity of contagion and its major role in driving financial crises in an increasingly globalized world economy. Directors pointed out that, while contagion effects were most evident in those countries with weak policies and inadequate institutions, some countries with reasonably well-managed economies, better fundamentals, and limited trade or financial linkages to crisis countries had not been spared.

In their December 1998 discussion, Directors agreed that the turbulence in mature markets from mid-August through early October had in many ways been unprecedented. The Board observed, however, that a measure of calm had returned to financial markets after mid-October. This was attributable largely to helpful policy actions, such as the easing of interest rates by the U.S. Federal Reserve, which was followed by other industrial country central banks, including those of the future euro area; strengthened policies in Japan to stimulate demand; commitments by Brazil to address its fiscal imbalances and the subsequent agreement on a support package by the international community; continued progress with stabilization and structural reform in Asia; and progress toward increasing the IMF's financial resources and thereby strengthening the international community's ability to assist countries in financial crisis. Several Directors also emphasized that countries' adjustment efforts in response to such developments as reduced access to capital markets and the effects of declining commodity prices deserved the support of the international community.

With the mitigation of market turbulence after mid-October, earlier fears of a global recession had diminished. Directors generally agreed with the staff's projection of a modest downward revision to the outlook for world output growth in 1999.

The Board stressed that a number of positive developments had occurred since it had discussed the fall World Economic Outlook. Growth was expected to remain relatively solid in continental Europe in 1999, although at a slower pace than in 1998. Directors saw the anticipated moderate slowdown in the U.S. economy in 1999 as suggesting a soft landing, which would help reduce the risk of a sharper slowdown at a later stage. Notwithstanding these developments, Directors felt it was premature to conclude that the danger had passed because conditions in financial markets

[3]The three reports were published as IMF, *World Economic Outlook* (Washington, October 1998 and May 1999), and *World Economic Outlook and International Capital Markets: Interim Assessment* (Washington, December 1998).

remained volatile and fragile and the supply of funds to most emerging market economies was still sharply reduced. The balance of the risks to the projections remained predominantly on the downside. If private capital flows fell short of the levels assumed in the projections, greater trade adjustment through demand compression and perhaps exchange rate adjustment was likely to be needed in emerging market economies. Directors warned, further, that some of these countries might have difficulty meeting their debt-service obligations if private financing did not recover. They also questioned whether the impact of the recent declines in commodity prices had been fully reflected in the projections. Weaker commodity prices, if sustained, coming on top of reduced access to international capital markets, would call for further adjustments in many commodity-exporting countries.

In their April 1999 discussion, Directors concurred that, while the global economic slowdown was likely to continue in 1999, the risk of a global recession had receded and a moderate pickup in growth was projected for 2000. They saw signs of the beginning of economic recovery in Asia's crisis-afflicted emerging market economies, the broad-based easing of monetary conditions in the industrial countries, and the continued strong growth of the U.S. economy. They also acknowledged that the baseline projections rested on a number of favorable developments—particularly the realization of a soft landing for the U.S. economy; a pickup in growth in the euro area, despite a somewhat unfavorable external environment; and a bottoming-out of the recession in Japan in 1999. Directors also felt that the Brazilian crisis, despite its limited contagion effects, had imparted a new contractionary impulse to the world economy and that financing conditions for many emerging market countries were likely to remain extremely tight.

The uneven pattern of growth among the United States, the euro area, and Japan since the beginning of the decade had increased global payment imbalances, which, in the view of many Directors, posed a worrisome risk to the outlook. Directors argued that the imbalances—in particular the U.S. external deficit that had aided global adjustment in the wake of the emerging market crises—might give rise to destabilizing movements in exchange rates among the major currencies and further increase protectionist pressures. Several Directors pointed to the challenge of restoring global growth to near potential in a period when domestic demand growth in the United States would probably have to slow to allow some narrowing in the U.S. current account deficit. This, they argued, highlighted the priority that should be attached to policies aimed at generating early recovery in Asia, including Japan, and at countering and reversing the recent slowdown in much of continental Europe.

United States, Japan, and Europe

The continued momentum of the U.S. expansion was remarkable for its length and the absence of inflation. Directors attributed the long expansion to fiscal consolidation, prudent and responsive monetary policies, and flexible labor and product markets. Declining energy and other commodity prices had contributed to maintaining low inflation. But Directors also concurred that the run-up in equity prices, which in part reflected falling inflation expectations and lower bond yields, had helped sustain demand. Possible sharp corrections in the equity market and the exceptionally low rate of household savings posed important downside risks to the outlook.

The strength of the U.S. economy was beginning to present a dilemma for U.S. policymakers, according to many Directors. If domestic demand growth did not slow to a more moderate pace at an early stage, several Directors felt that an early monetary tightening might be needed to guard against the risks of overheating. These and other Directors were apprehensive that current and projected private sector and external imbalances were unsustainable in the long run, and that past evidence suggested that the longer they continued, the greater were the chances of a sharp and painful correction. Abrupt reductions in U.S. imports, as well as potentially disruptive swings in exchange rates, equity markets, and monetary conditions, could transmit adverse consequences of such a correction to other countries. Most other Directors, however, preferred a wait-and-see approach, arguing that preemptive monetary tightening was not needed, because monetary conditions in the United States were already quite tight, taking into account the low level of inflation and the strength of the dollar, and that such action could jeopardize recoveries elsewhere, especially in countries emerging from crisis. Regarding fiscal policy, Directors urged the United States to resist pressures to spend current and prospective fiscal surpluses in order to meet longer-term financial needs and to create room for fiscal policy to be used temporarily for stabilization if the need were to arise.

The continued weakness of activity in Japan was of special concern to the Board. Most Directors felt that room for additional fiscal stimulus was limited, given the estimated deficit of more than 10 percent of GDP at fiscal year-end in March 1999, but that the full implementation of the previously planned stimulus to support demand was critical at both the central and local government levels. With regard to monetary policy, many Directors agreed that the deflationary forces in the economy justified maintaining short-term interest rates as low as possible, as well as measures to ensure adequate growth of liquidity through open market operations.

Directors also emphasized the need for structural reform in key areas to reinvigorate growth and job cre-

ation over the medium term. They considered bank reform to be essential and welcomed the commitment of public funds to recapitalize the banking system. They cited progress in strengthening major banks, resolving insolvent institutions, establishing legislation to facilitate the disposal of nonperforming assets, and improving disclosure and supervision, and urged the Japanese authorities to press forward with the financial stabilization program, especially where acute problems remained. Some questioned whether the reforms under way or planned went far enough. These Board members particularly stressed the growing need for corporate restructuring, as underscored by excess capacity in some sectors and troublesome corporate debt burdens, which complicated resolving banking sector difficulties. More generally, Directors saw the need to reduce further inefficiencies in the economy and to remove obstacles to the creation of new enterprises. Deregulation initiatives in some sectors had already helped increase competition and reduce costs, but many restrictions remained in agriculture, distribution, transportation, and construction, and these impeded growth and job creation.

Turning to Europe, the Board welcomed the start of the third stage of European Economic and Monetary Union (EMU), but cautioned that euro-area policymakers continued to face formidable challenges. Since late in 1998 indications had increased that growth in the euro area had been slowing, mainly because of the weakening external environment, but also because of weak business confidence. Growth in the area was expected to be below its potential rate in 1999, and while recovery was expected in 2000, Directors worried about downside risks. Although medium-term requirements remained important, it was at the same time essential that policies be adequately attuned to supporting the domestic demand needed to close the sizable output gap and absorb the cyclical component of unemployment. Many Directors also underscored the importance of the euro area playing a greater role in supporting global growth, not only through domestic demand, but also through structural reform. In light of these considerations and the limited room for maneuver in fiscal policies—and with inflation recently below the middle of the target range—a number of Directors argued that the case was strong for further monetary easing. Early action carried few risks but held significant benefits to both the euro area and the world economy more generally. It was important that those euro-area countries experiencing relatively strong growth respond to further monetary easing by taking countercyclical fiscal actions to prevent overheating. A number of other Directors, however, were not convinced about the case for further monetary easing, pointing to the strength of consumer confidence and the weakness of the euro. Nonetheless, all Directors agreed that the European Central Bank should act decisively to lower interest rates if it appeared that the slowdown was persisting. (Soon after this discussion, in early April, the ECB reduced its leading interest rates.)

Directors also agreed that success in labor and product market reforms would be central to enhancing growth and employment prospects in Europe, especially in the medium term. Indeed, those countries that had achieved the most progress showed considerable evidence of the positive effects of labor market reforms. Poor labor market performance had imposed a heavy burden on many European economies in terms of the hardship borne by the unemployed, the fiscal impact of forgone revenues and transfer payments, and, more generally, through the impact of output and welfare losses.

Directors recognized that, although conditions differed across countries with regard to both the extent and the specific nature of the problems to be addressed, the overall thrust of the required action was clear: to remove obstacles to job creation and disincentives for the nonemployed to work. This would require easing job protection legislation, reducing excessive tax burdens on labor, and minimizing the disincentive effects of unemployment benefits and other social transfers. As many labor and product market rigidities tended to reinforce one another, comprehensive reforms were more likely to succeed than partial or piecemeal actions.

Crisis-Afflicted Economies

The Executive Board agreed that public sector imbalances had been at the root of the crisis in Brazil. The growing fiscal imbalance had also contributed to a widening of the external deficit, making Brazil highly vulnerable to changes in investor sentiment and adding to a widespread perception that the country's crawling peg was unsustainable. Some Directors noted that the recent Brazilian experience had highlighted anew the importance of strong macroeconomic policies to support the credibility of a pegged exchange rate regime. Moreover, several Directors pointed to the need for a determined tightening of monetary policy in the early stages of an economic crisis, while others underscored the importance of sufficient exchange rate flexibility. Looking ahead, Directors thought that the Brazilian economy would begin to recover in 2000, as the crisis did not appear to be rooted in structural problems outside of the fiscal area and the financial system was relatively robust. The pace of recovery would depend crucially on how quickly the authorities addressed the fiscal deficit and on their success in containing inflation expectations and stabilizing exchange markets. Directors were encouraged by early signs that inflation was contained, but emphasized that strong implementation of the recently approved program was crucial to restoring confidence and allowing monetary conditions to ease gradually.

Although Directors cautioned that the recession in Brazil might have a significant regional impact, they were heartened by its moderate effect on financial markets elsewhere in Latin America. Most economies of the region appeared to be well placed to withstand spillover effects, a reflection of the considerable strengthening of the region's economic fundamentals over the past decade. Nonetheless, the required economic adjustments and the risks of further contagion called for determined policy discipline and reinvigorated reform efforts, especially in those countries suffering from fiscal and external imbalances that had been exacerbated by commodity price weaknesses and unfavorable financial market conditions. In a number of cases, financial sector fragilities required particular attention.

Directors expressed deep concern about the deterioration in Russia's economic performance since the August 1998 financial crisis, with a sharply increased inflation rate and the dangers of a prolonged recession and significant adverse spillovers in neighboring economies. They cited recent indications of the Russian authorities' efforts to address the underlying fiscal and structural problems and underscored that a strong commitment to reform was required to arrest and reverse the serious problems facing the country. Directors emphasized particularly the need for a strong fiscal adjustment program to limit the need for central bank financing of the budget and stop the accumulation of budget arrears. They also stressed the importance of reinvigorated structural reform efforts in those areas where implementation had been unsatisfactory, of reversing the setbacks that had occurred since August 1998, and of addressing the additional financial sector problems that had emerged following the crisis.

Directors were encouraged by signs that economic recovery was set to begin or already under way in the Asian emerging market economies that had suffered deep contractions following the financial crises in the second half of 1997. The turnaround appeared to be most advanced in Korea, followed by Thailand. Improvements in external payments positions and investor confidence, stronger exchange rates, a resumption of capital flows, and improved financial market conditions underpinned the recoveries in these and other crisis countries. The return of confidence assisted the recovery. A turnaround in activity in Indonesia might begin emerging in the second half of 1999, although delays in reform and continued political instability had hindered a return of confidence. In considering the steps required to transform the nascent recoveries in the region into sustainable growth, Directors strongly emphasized the need for banking and corporate sector restructuring and reforms aimed at fostering well-functioning markets and a more efficient allocation of resources.

Other Emerging Economies

China, India, and some African countries appeared to have weathered the recent financial crises relatively well in 1998. To varying degrees, the resilience of these countries reflected limited trade links with the crisis countries, relatively low reliance on private capital inflows, or limited integration with international financial markets. It was encouraging that the Chinese economy achieved a strong growth performance in 1998. At the same time, several Directors noted the problems in the financial and state-owned-enterprise sectors and encouraged the authorities to continue their efforts at strengthening the financial sector and reforming state-owned enterprises. Directors agreed that, in the areas of macroeconomic and exchange rate policy, China had steered an appropriate course in maintaining the stability of the renminbi and providing stimulus for the economy, which had played an important role in regional economic adjustment and recovery. The repercussions from the Asian crisis had been relatively modest in India, although the country's medium-term growth prospects continued to be constrained by serious fiscal and structural weaknesses.

With regard to Africa, improved policy implementation had helped a number of countries strengthen their economic performance and reduce their vulnerability to adverse external developments. At the same time, recent declines in the prices of oil and other commodities had led to significant falls in real income in many exporting African countries, although the growth of economic activity was affected only slightly. Several Directors considered that more external-debt-reduction options and continued international financial assistance were necessary to support the adjustment and reform efforts of these countries. Some Directors also suggested that industrial countries needed to improve market access for developing country exports, particularly agricultural products. Directors were also concerned about the severe economic and social costs of the armed conflicts in several parts of the continent and called for adequate provision of international assistance to the affected countries.

Oil price declines had also led to substantial shortfalls in export earnings and fiscal revenue among Middle Eastern oil exporters. These countries met the shortfalls partly by drawing on official reserves and through increased external borrowing. Directors encouraged these countries to build on adjustment efforts already under way to safeguard macroeconomic stability, especially if export price weakness continued.

Preventing Contagion

Financial crises in emerging market countries in recent years had in some cases spread among countries with apparently limited trade or financial links and in the absence of a significant common shock. Directors

agreed that this unusual phenomenon might be partly the result of increased globalization of financial markets, which, while providing benefits of access to external financing, made economies more vulnerable to sudden, sharp changes in investor sentiment. In fact, the increased globalization of financial markets had meant that balance of payments crises involved the capital account more than in the past, which tended to make crises less predictable. While financial contagion helped explain the increased incidence of crises, contagion was not indiscriminate. The crises were usually associated with common weaknesses in economic fundamentals—especially with regard to the external position or vulnerabilities in the financial system, including those arising from excessive exposure to short-term external liabilities.

Although efforts to strengthen the international financial architecture were essential both for crisis prevention and crisis management, the problem of contagion also had to be addressed at the country level. Directors, therefore, stressed the central role of domestic economic policies in preventing crises in the first place and in reducing a country's vulnerability to contagion. In particular, they noted the importance of avoiding significant exchange rate overvaluation and of pursuing fiscal and monetary policies to that end. Directors also emphasized that policies to address weaknesses in financial systems were crucial in any effective crisis prevention strategy. To guard against liquidity crises, governments had to pay attention to the maturity structure and currency composition of banks' debt and the corporate sector. The maturity structure of public debt had also to be managed carefully, because a change in investor sentiment could make it difficult for the government to roll over a large stock of short-term debt. Directors also emphasized the need in many countries to enhance the effectiveness of prudential regulation and supervision of banks and other financial institutions. Some referred in particular to the importance of prudential standards regarding short-term foreign currency borrowing by banks. In this regard, some Directors pointed to the need to improve the regulatory oversight, on the supply side, of the highly leveraged activities of financial institutions.

Because many emerging market crises in recent years had occurred in countries with pegged exchange rates, several Directors questioned the viability of pegged but adjustable regimes under conditions of increased globalization of financial markets. They emphasized that in many cases a greater degree of exchange rate flexibility might help make domestic and foreign investors more aware of exchange rate risks. Other Directors argued that a fixed exchange rate could be especially useful as a nominal anchor and help rein in high inflation. A currency board could be an attractive option in some cases, but Directors acknowledged that such a regime was particularly demanding in its requirements—in terms of the adequacy of reserves, financial system soundness, market flexibility, and fiscal performance. Directors agreed that the optimal exchange rate arrangement varies across countries and that, irrespective of the regime chosen, economic policies must support the arrangement and foster macroeconomic stability to guarantee its success.