World Economic Outlook

The Executive Board regularly reviews global economic developments and policies, based on World Economic Outlook reports prepared by the staff. The reports, which are usually published twice a year, contain comprehensive analyses both of prospects for the world economy and for individual countries and regions, and of topical issues.

In 1997/98, the Board held three discussions on the World Economic Outlook: in August 1997, December 1997 (on the basis of an "Interim Assessment" by the staff), and March 1998.[4] The central focus was the Asian financial crisis.[5] In August 1997, a number of Directors had already cautioned that, while there were many reasons to believe the world expansion could be sustained, there was no room for complacency about the risks and fragilities confronting individual countries that could affect regional and global economic and financial conditions. Especially in the developing world, large external imbalances and fragile banking systems, several Directors noted, had adversely affected investor confidence and heightened the risks associated with volatile capital movements. These difficulties were not expected to affect the generally positive long-term prospects of those countries, provided that disciplined macroeconomic policies and the necessary structural reforms were implemented on a timely basis to ensure the elimination of unsustainable economic imbalances. Directors stressed, however, that those policy efforts would have to be supported by a broader range of institutional reforms aimed at increasing the efficiency of public administration, developing human capital, strengthening financial sector management, setting up transparent regulatory and legal systems, and improving governance. Such reforms would help establish and maintain private sector and investor confidence, which are critical for sustained, high-quality growth.

[4]The three reports were published as IMF, *World Economic Outlook*, issues dated October and December 1997 (the latter subtitled *Interim Assessment*) and May 1998.

[5]Chapter V reviews the Board's discussion of the causes and appropriate policy responses to the crisis.

In their March 1998 discussion, Executive Directors agreed that, while the financial market turmoil in Asia would have a significant negative impact on short-term growth prospects for the world economy, the slowdown was likely to be less pronounced than in earlier episodes of global economic weakness (in 1974–75, 1980–83, and 1990–91). Corrective actions by most countries at or near the center of the turmoil, the robust economic performance of most industrial countries, and policy reforms in many developing and transition economies over the past decade were seen as critical in containing the crisis and its global repercussions. Although growth projections for countries at the center of the crisis had been lowered considerably since the August 1997 discussion of the World Economic Outlook, Directors in March 1998 felt that prospects for other developing and transition economies remained generally encouraging.

This said, Directors noted that uncertainty still remained regarding the resolution of the crisis; resolute implementation of reforms by the crisis countries was therefore essential. Recent declines in oil and other commodity prices, moreover, could lengthen the adjustment process in some crisis countries and pose considerable challenges for commodity and oil-exporting countries in all regions. Also, a reevaluation of risks by international lenders as a result of the crisis, while welcomed, could limit financial flows to developing and transition economies to levels below those justified by the fundamentals. More generally, Directors were concerned that some emerging market economies had relied too heavily on foreign borrowing and short-term instruments to finance public deficits, thus increasing their risk of future financing difficulties.

Advanced Economies

In their March 1998 review of the outlook for the advanced economies, Directors observed that the spillovers from the Asian crisis for Japan were particularly unwelcome, given that its nascent recovery had already stalled in the first half of 1997; this stalling was due both to a fiscal policy that, in hindsight, was overly

tight and to continuing fragilities in the financial system. Directors stressed that boosting confidence and fostering stronger sustainable growth in Japan—through a combination of macroeconomic, financial sector, and structural policies—was critical, given the economy's importance for the region and for the world. Economic recovery should be supported by a more expansionary fiscal stance in the near term, while maintaining the objective of medium-term consolidation. Some Directors noted that a permanent tax cut would boost the prospects for an increase in private consumption but cautioned against overreliance on increased public works spending since it would have only a temporary impact and had not proven very effective in the past. In contrast, some other Directors expressed reservations about the effectiveness of tax cuts, fearing that the increase in disposable income might be added to household savings with little or no effect on consumption and growth. Pointing to the government debt accumulated in recent years and the prospective fiscal pressures associated with an aging population, some Directors argued that any backsliding with fiscal consolidation would pose risks while having little positive effect on activity.

Directors noted indications from the Japanese authorities that a substantial fiscal stimulus package would soon be announced. They emphasized that, to have significant and durable effects, the measures needed to be accompanied by serious regulatory and financial sector reforms. Most Directors welcomed recently announced measures committing public funds to protect depositors of failed institutions and to recapitalize viable ones. These measures promised to restore public confidence and strengthen banks' willingness to lend. Directors cautioned, however, against indiscriminate support to banks where closures or consolidation were more appropriate. They suggested that any further allocation of public funds be accompanied by clear measures to facilitate the write-off of bad bank loans to ensure a fair sharing of the burden of restructuring costs and to limit moral hazard. At its April 1998 meeting, the Interim Committee welcomed the Japanese economic policy package, as well as Japan's steps to strengthen its financial system.

Directors agreed that the U.S. economy, in contrast to the Japanese economy, was likely to suffer relatively little from adverse developments in Asia, owing largely to the strength of its cyclical position prior to the crisis and to the positive developments in bond markets, which, in the view of many Directors, reflected a "flight to quality" of international investment flows. They judged the current stance of monetary policy as appropriate, noting that the moderating effects of the Asian crisis—together with the appreciation of the U.S. dollar and the decline in world commodity prices—had alleviated the need for an increase in official interest rates. In view of the tightening labor market conditions, however, the authorities would need to monitor the situation closely, looking for signs that would tip the balance of monetary policy assessment in either direction.

The risks posed by the Asian crisis for the advanced economies in Europe were also likely to be relatively small, Directors agreed. Among the economies operating near full capacity, Directors believed that the previous year's monetary tightening and continued fiscal consolidation in the United Kingdom were likely to keep demand close to productive capacity limits and hold inflation near to target. But further action would be warranted if inflation prospects worsened. In the same vein, the Interim Committee in its April 1998 meeting emphasized the need for the U.K. authorities to remain vigilant as always to inflation risks. In Germany, France, and Italy, where output—while remaining below potential—had recovered quite well since the beginning of 1997, Directors expected the overall impact of the Asian crisis also to be small. Some Directors, however, cautioned against overoptimism, noting that exports had been the main source of demand growth in some of these countries. A weakening of export markets could slow, and possibly stall, the recovery if domestic demand did not pick up. In continental Europe generally, with monetary union among a large number of countries scheduled to begin in nine months, attention had to be given to labor and product market reforms, to continuing fiscal consolidation, and to monetary policy in the transition period.

Developing and Transition Countries

Directors noted that the Asian crisis was affecting most developing and transition economies, albeit to varying degrees. The effects were being felt through, for example, increases in risk premiums in borrowing costs, lower commodity prices, losses in competitiveness to countries at or near the center of the turmoil, or the slowdown in demand in those countries. Several countries—including Brazil, Chile, the Czech Republic, and Mexico—that had suffered exchange market pressures in connection with the Asian crisis had been able to avoid full contagion through appropriate policy adjustments. Although these countries had generally weathered the crisis well, Directors felt it prudent for them to continue strengthening policies to avoid further challenges down the road. In this connection, it was particularly important to contain external imbalances, avoid overheating, and enhance the quality and timeliness of economic and financial information generally. Also critical was a strong financial sector infrastructure, including prudential regulation, internationally accepted accounting standards, and, for some, preestablished exit rules regarding shifting from a fixed exchange regime to a flexible one (see Chapter VI). Several

Directors welcomed China's commitment not to devalue its currency and its efforts to strengthen its banking system.

Many Directors expressed concern about recent trends in commodity prices and the potentially adverse implications for commodity-exporting developing countries of both a deterioration in the terms of trade and increased price volatility. For Africa, the impact of these forces, combined with poor weather and the continuing heavy debt burden, was of particular concern. Nevertheless, Directors remained cautiously optimistic about Africa's growth prospects, based on the expectation of continued implementation of macroeconomic adjustment and structural reforms and of an appropriate flow of foreign assistance. Directors underscored the need to create a favorable environment for foreign direct investment, including through a further opening up of their economies.

Regarding the economies in transition, Directors expressed satisfaction that both Russia and the transition countries as a group had recorded positive growth in 1997 for the first time since the transition began. They noted, however, that although considerable progress was being made in macroeconomic stabilization in virtually all countries, differences in the pace of reform and progress in transformation appeared to have grown larger. Most countries had made substantial progress toward reasonable fiscal balance, but sizable deficits continued to be registered in a number of countries, including Russia and Ukraine. Financing these deficits through foreign currency and short-term borrowing, Directors observed, put the sustainability of fiscal policies in question, indirectly threatened to undermine the soundness of banking sectors, and endangered hard-earned economic stabilization achievements. Severe revenue collection problems in a number of transition countries, moreover, were preventing governments from carrying out their proper functions. Further tax policy reform and improvements in tax administration were unlikely to show their full effect, Directors recognized, unless the political will to collect taxes was also strengthened. Directors also advised central and eastern European transition countries to improve the cost-effectiveness of their social security and welfare systems, and thereby reduce the overall level of government spending.