II

World Economic Situation and Short-Term Prospects

In 1995, world output growth slowed slightly to 3½ percent. Economic expansion weakened significantly in many of the industrial countries and among the developing countries of the Western Hemisphere but strengthened in sub-Saharan Africa (particularly the CFA countries) and the Middle East. In the developing countries of Asia, growth moderated somewhat, allaying to some extent concerns about overheating, but was still rapid by most standards. In the countries in transition, the decline in output abated further, with vigorous growth proceeding in a number of cases.

The near-term outlook is for a slight pickup in global growth to 3¾ percent in 1996 as a whole, and a further modest strengthening to about 4 percent in 1997—projections that are little changed from those presented in the May 1996 *World Economic Outlook*.[2] Among the industrial countries, growth is expected to strengthen slightly to 2¼ percent in 1996, with a markedly stronger expansion in Japan and a pickup in growth in the United States being partly offset by a substantial slowdown in much of Europe, including most notably Germany and France. The easing of monetary conditions already seen in most European countries is expected to lead to a recovery of growth in the latter part of 1996, which should carry forward into 1997. Other factors contributing to the projected strengthening of activity in Europe are the declines in long-term interest rates since late 1994, an end to the drawdown of inventories, and the establishment of a more favorable configuration of exchange rates. In the developing countries of the Western Hemisphere, the recovery from the Mexican crisis and related developments is expected to gain momentum, particularly in Mexico itself and Argentina. In Africa and the Middle East and Europe region, economic conditions are expected to improve further, although growth across countries remains uneven, and in the developing countries of Asia growth is expected to continue to moderate. For the countries in transition, aggregate output is projected to stabilize in 1996 and to grow significantly next year for the first time since the transition process began.

Chart 4. Commodity Price Indices
(1990 = 100)

Nonfuel commodity prices rose in late 1995 and early 1996 owing to an increase in the prices of cereals and foodstuffs. Oil prices also rose.

[2] The margins of uncertainty that necessarily attach to any projections of growth, inflation, and other economic variables are illustrated in a recent study summarized in Annex I.

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Table 2. Industrial Countries: Real GDP, Consumer Prices, and Unemployment Rates
(Annual percent change and percent of labor force)

	Real GDP				Consumer Prices				Unemployment Rates			
	1994	1995	1996	1997	1994	1995	1996	1997	1994	1995	1996	1997
Industrial countries	**2.8**	**2.1**	**2.3**	**2.5**	**2.3**	**2.4**	**2.3**	**2.4**	**8.1**	**7.7**	**7.8**	**7.6**
Major industrial countries	2.8	2.0	2.2	2.5	2.2	2.3	2.2	2.3	7.2	6.8	7.0	6.9
United States[1]	3.5	2.0	2.4	2.3	2.6	2.8	2.8	2.8	6.1	5.6	5.6	5.6
Japan	0.5	0.9	3.5	2.7	0.7	–0.1	0.2	1.3	2.9	3.1	3.5	3.4
Germany	2.9	1.9	1.3	2.4	2.7	1.8	1.6	1.7	9.6	9.4	10.3	10.0
France	2.8	2.2	1.3	2.4	1.7	1.8	2.1	1.6	12.3	11.6	12.4	12.1
Italy	2.2	3.0	1.1	2.2	4.0	5.2	3.9	3.0	11.3	12.0	12.2	11.5
United Kingdom[2]	3.9	2.5	2.2	3.0	2.4	2.8	2.7	2.4	9.3	8.2	7.7	7.3
Canada	4.1	2.3	1.4	3.2	0.2	1.9	1.5	2.0	10.4	9.5	9.6	9.4
Other industrial countries	3.0	2.8	2.3	2.6	3.1	3.0	2.7	2.7	12.7	12.0	11.7	11.4
Spain	2.1	3.0	2.2	2.9	4.7	4.7	3.4	3.1	24.2	22.9	22.6	21.8
Netherlands	2.7	2.4	2.2	2.5	2.7	2.0	2.5	2.9	8.7	8.4	8.2	7.9
Belgium	2.2	1.9	1.4	2.4	2.4	1.5	2.0	2.0	13.0	13.0	13.1	12.8
Sweden	2.6	3.0	1.6	2.0	2.2	2.5	1.6	2.3	8.0	7.7	7.7	6.9
Austria	3.0	1.8	0.7	1.0	3.0	2.2	2.1	1.9	4.4	4.6	4.7	5.5
Denmark	4.4	2.8	1.9	2.5	2.0	2.1	1.6	1.9	12.2	10.3	8.9	8.9
Finland	4.4	4.2	2.7	4.1	1.1	1.0	1.0	2.0	18.4	17.2	16.5	15.3
Greece	1.5	2.0	2.5	2.7	10.9	9.3	8.4	6.6	9.6	9.5	9.3	9.2
Portugal	0.7	2.3	2.3	2.8	5.2	4.1	3.3	3.0	6.8	7.2	7.4	7.4
Ireland	6.5	10.3	7.0	5.5	2.3	2.5	2.3	2.5	15.5	13.1	12.4	12.0
Luxembourg	4.1	3.5	3.0	3.5	2.2	1.9	1.8	2.0	2.7	2.8	2.8	2.8
Switzerland	1.2	0.7	0.0	1.5	0.9	1.8	0.9	1.5	4.7	4.2	4.5	4.4
Norway	5.0	3.3	4.5	2.3	1.4	2.5	2.0	2.5	5.4	4.9	4.5	4.3
Iceland	3.6	2.0	4.5	3.3	1.6	1.6	2.7	3.2	4.8	5.0	4.2	3.9
Australia[3]	5.4	3.2	3.8	3.0	2.0	2.7	2.9	3.0	9.7	8.5	8.3	7.8
New Zealand[3]	4.1	2.2	2.3	2.8	1.8	2.5	2.4	1.5	8.1	6.3	6.1	5.9
Memorandum												
European Union	2.8	2.5	1.6	2.5	2.9	2.9	2.6	2.3	11.6	11.2	11.4	11.0

[1]The projections for unemployment have been adjusted to reflect the new survey techniques adopted by the U.S. Bureau of Labor Statistics in January 1994.
[2]Consumer prices are based on the retail price index excluding mortgage interest.
[3]Consumer prices excluding interest rate components; for Australia also excluding other volatile items.

Inflation has remained subdued among the industrial countries and has declined further in many developing countries and countries in transition, even though the prices of oil, cereals, and feedstuff increased quite sharply in late 1995 and early 1996 (Chart 4). Nonfuel commodity prices overall increased slightly during the first eight months of 1996, by about 1 percent in U.S. dollar terms as measured by the IMF's nonfuel commodity price index.[3] In 1997, inflation is expected to remain low in the industrial countries and to decline further in the developing countries and countries in transition.

[3]This net outcome masks two notable developments that were largely offsetting. Cereals and feedstuff prices rose by 18 percent in the first half of the year as harsh weather and resulting poor crop yields in the United States put pressure on low world inventories, particularly of maize and wheat. Offsetting this increase, however, was a 30 percent decline in copper prices (from mid-May to the end of June), which was triggered by a failed attempt to control the world copper market. A detailed account of the factors contributing to recent movements in oil prices is contained in Annex II. The oil price assumptions underlying the projections in the *World Economic Outlook* are based on oil futures market prices as of August 21 and are \$19.42 and \$17.94 a barrel in 1996 and 1997, respectively.

Economic Activity, Inflation, and Policy Stances in Industrial Countries

In 1995, economic growth slowed in most of the industrial countries, with Japan, Italy, and some of the smaller European countries being the most notable exceptions (Table 2). Since late 1995, the pattern of growth has been more uneven, with stronger expansions in Japan and the United States contrasting with continuing sluggishness in most of continental Europe. The United States stands out as the only major industrial economy operating close to estimated full capacity (Chart 5).

As discussed in the May 1996 *World Economic Outlook*, a preemptive tightening of monetary conditions and rising bond yields in 1994 slowed growth

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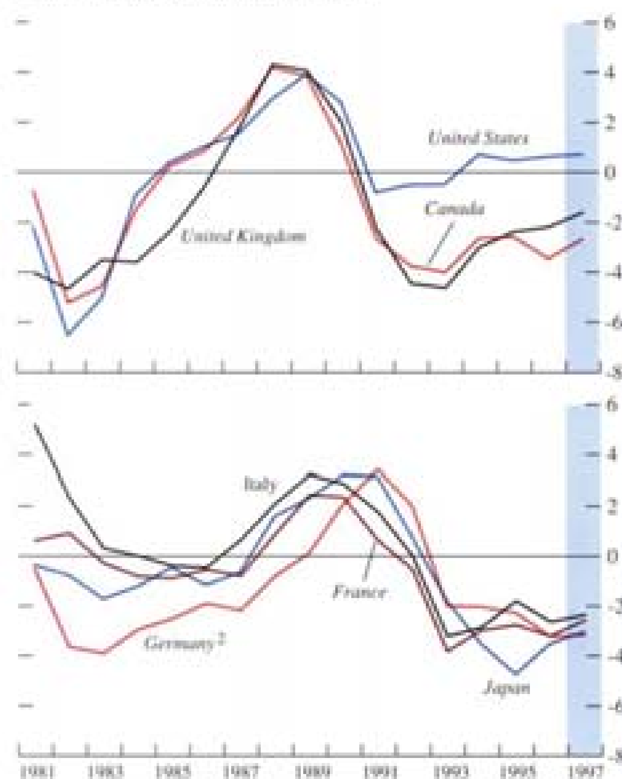
Chart 5. Major Industrial Countries: Output Gaps[1]
(Actual less potential, as a percent of potential)

Recently, greater differences have emerged in the relative cyclical positions of the major industrial countries.



[1]Shaded areas indicate IMF staff projections. The gap estimates are subject to a significant margin of uncertainty. For a discussion of the approach to calculating potential output, see *World Economic Outlook*, October 1993, p. 101.

[2]Data through 1991 apply to west Germany only.

during 1995 in the United States, the United Kingdom, and Australia, from rates considerably above potential to rates more consistent with sustainable noninflationary growth. Growth slowed more markedly last year in those continental European countries with strong currencies, particularly in Germany, France, other countries closely linked to the deutsche mark, and Switzerland, but was generally well sustained in those countries whose currencies had depreciated in recent years—most notably, Italy, Spain, and Sweden. The slowdown in the former group was of particular concern since there were still considerable margins of slack and high unemployment—remnants from the 1992–93 recession. In Japan, by contrast, the prolonged economic slowdown that began in 1991 gave way to recovery in the course of 1995 with the help of supportive monetary and fiscal policies and a substantial correction of an overvalued yen.

In early 1996, however, signs of renewed growth became evident in the United States, partly reflecting the response to three reductions in short-term interest rates beginning in mid-1995, as well as the decline in bond yields throughout last year (Chart 6). Signs of a pickup in activity also became visible in Canada, where monetary conditions were eased significantly, and in Australia where growth of private consumption and business investment resumed. In Japan, exceptionally strong growth in the first quarter, though partly due to special factors, indicated that the long-awaited recovery was gathering strength.

In continental Europe, in contrast to 1995—when growth slowed in some countries but was sustained in others—developments in early 1996 showed a more pervasive weakness. Although there were signs of a pickup by midyear in some countries, especially Germany, a more generalized revival of growth was still not apparent. Consumer confidence remained particularly low, especially compared with the recovery of confidence in the United States (Chart 7). And with business confidence deteriorating further, industrial production in early 1996 declined in a number of countries, including Germany (up to February) and Italy. Unemployment also continued to edge up across much of Europe, reaching near record levels in France. In the United Kingdom, Italy, Spain, and many of the smaller European countries, faltering exports to European trading partners contributed to the dampening of growth.

Since late last year, however, successive cuts in interest rates in Germany and to a greater extent in France and several other European countries, together with the weakening of the deutsche mark and closely related currencies, have eased overall monetary conditions significantly in most countries (Chart 8). Moreover, with committed efforts toward fiscal consolidation the policy mix has generally shifted in a direction that is more conducive to sustainable medium-term growth. In some countries, especially Italy, Spain, and

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Sweden, progress toward fiscal consolidation has narrowed risk premiums in interest rates and helped to correct the undervaluation of currencies. And signs of a pickup in activity have begun to emerge. The drawdown of inventories has slowed, and industrial orders and consumer confidence have stabilized.

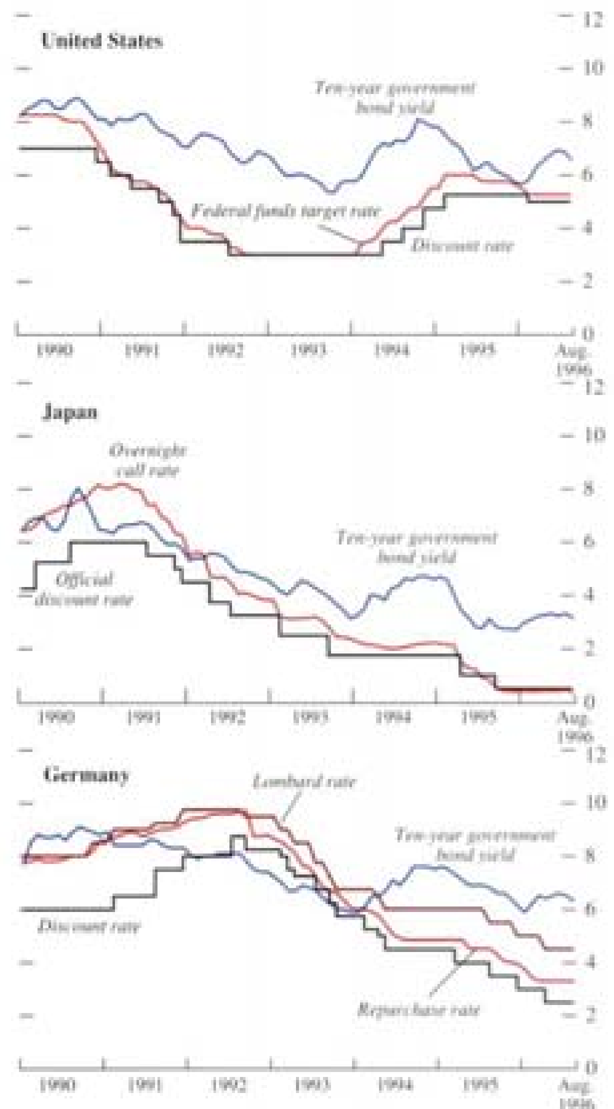
With these signs expected to turn into a moderate recovery of output in the second half of the year, European growth is projected to amount to 1½ percent in 1996 as a whole, and to strengthen further in 1997 in almost all countries. The strength of the expected revival, however, remains uncertain because of underlying risks to the outlook. The recovery in Europe may be weaker than projected because it may be restrained, to a greater extent than assumed, by the short-term contractionary effects of fiscal consolidation efforts being implemented in most EU countries partly to satisfy the Maastricht criteria by 1997, and also by uncertainties about policy implementation and concerns about high levels of unemployment (Table 3). Moreover, notwithstanding considerable progress in reducing inflation and the strong commitment to reduce fiscal imbalances, absence of a convincing recovery in economic activity may renew concerns about the ability of countries to satisfy the convergence criteria, which could result in the reemergence of risk premiums in interest rates in some countries, and again sap confidence and dampen demand.

Low inflation continues to be a particularly encouraging aspect of economic conditions in almost all the industrial countries. Consumer price inflation on average in these countries is expected to remain below 2½ percent in 1996 and 1997. Success in keeping inflation down generally stems from the commitment of policymakers to a high degree of price stability, but increased global competition may also have been playing a role, by diminishing the scope for excessive price and wage increases. Relatively large output gaps, particularly in Canada, Germany, France, Italy, and Japan among the major countries, have also contributed to subdued inflation. Indeed, across a broad range of indicators, inflationary pressures in these countries seem largely absent (Table 4).

Turning to country-specific developments and projections, in the *United States*, following the pickup in growth in the first quarter, the expansion strengthened further in the second quarter, to a rate well in excess of the growth of potential. But the rise in long-term interest rates since January, as well as the further modest increase in short-term interest rates assumed in the projections, are likely to moderate growth in the second half of the year. Growth in 1997 is expected to remain at 2¼ percent. Despite virtually full employment for the last two years, consumer price inflation during 1995 remained below 3 percent. It picked up to about 4 percent in the second quarter of 1996, owing mainly to the weather-related temporary increases in food and energy prices, and there was also some pickup in wage

Chart 6. Three Major Industrial Countries: Policy-Related Interest Rates and Ten-Year Government Bond Yields[1]
(In percent a year)

Policy-related interest rates in Germany and Japan have fallen significantly during the past year.



[1]The U.S. federal funds target rate, Japanese overnight call rate, German repurchase rate, and all ten-year government bond yields are monthly averages. All other series are end of month.

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Chart 7. European Union and the United States: Indicators of Consumer Confidence[1]

Consumer confidence remains particularly weak in the countries of the European Union.

Sources: For the United States, the Conference Board; and the European Commission.

[1]Indicators are not comparable across countries.

[2]Percent of respondents expecting an improvement in their situation minus percent expecting a deterioration.

rates. Although inflation is expected to remain under 3 percent in 1996 as a whole and in 1997, the possibility of overheating and the associated need to tighten monetary conditions present some risks to the outlook. With capacity utilization already at a high level, and unemployment reaching a seven-year low of 5.1 percent in August, persistent growth above potential would be likely to rekindle inflation.

Monetary policy, which was eased with reductions in the target federal funds rate from 6 percent to 5¼ percent in three quarter-point steps in July and December 1995 and January 1996, aided the reacceleration of growth after the slowdown during the first half of 1995. The run-up in long-term interest rates since late January 1996 appears to have reflected expectations of monetary tightening in response to the pickup in economic growth, as well as revised expectations about the prospects for a balanced budget. The general government deficit (on a national accounts basis) has declined steadily since 1992 and is expected to reach about 1¼ percent of GDP in 1996—the lowest deficit ratio since 1979 (Table 5). This improvement in the fiscal situation is the result of both the federal budget measures put in place in 1993 and the cyclical recovery. The administration's fiscal year 1997 budget, released in March 1996, contains proposals that are aimed at achieving a balanced budget by fiscal year 2002, but the prospects for legislative approval are uncertain.

Economic activity in *Canada*, which was sluggish through 1995 and early 1996, is expected to pick up following a significant decline in interest rates since late last year and the strengthening of the expansion in the United States. Consumer spending has already rebounded, housing starts have risen considerably, and employment growth has increased. GDP growth is expected to pick up from just 1½ percent in 1996 as a whole to 3¼ percent in 1997. In contrast to the United States, the high level of excess capacity in the Canadian economy leaves considerable room for noninflationary growth. Through substantial cuts in government expenditures, and despite a large margin of slack, Canada has continued to make considerable progress in reducing its fiscal deficit toward the government's goals of 3 percent of GDP by 1996/97 and 2 percent of GDP in 1997/98. The federal budget for 1996/97, presented to Parliament in March, reaffirmed the government's commitment to balancing the budget over the medium term, introduced additional spending cuts, and adopted longer-term reforms to the federal system of income support for the elderly.

The long-awaited recovery in *Japan* finally appears to have become firmly established. Although output in 1995 as a whole expanded by only 1 percent, signs of solid recovery were evident in the fourth quarter, when growth picked up to 3½ percent at an annual rate. In the first quarter of 1996, however, growth widely exceeded expectations, jumping to almost 13 percent at

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an annual rate. Private consumption, public investment, and residential investment rose sharply. But various special factors, including an increase in public investment that will not be sustained, also contributed, and the underlying pace of recovery appears to remain relatively moderate, as suggested by other indicators of activity, such as industrial production and employment. Taking into account not only the spurt of growth in the first quarter, but also the waning of public investment expected during this year and the expected moderation of growth in private consumption and residential investment, projected real GDP growth for the year as a whole has been revised up, to about 3½ percent. In 1997, the expansion is expected to continue at a more moderate pace of 2½–3 percent.

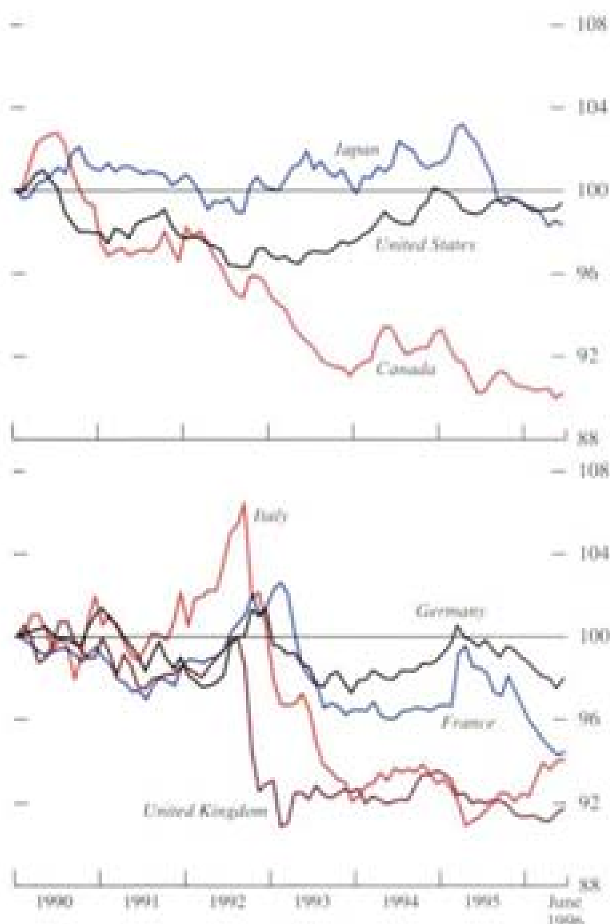
Last year's fiscal stimulus measures have played an important role in reviving demand. Much of the fiscal stimulus came from public investment, which is expected to level off in mid-1996 and to decline moderately in 1997. The general government budget deficit (excluding social security) is expected to rise in 1996 to 6¾ percent of GDP, of which 5½ percent is estimated to be structural (the structural deficit including social security is 2½ percent of GDP). The actual deficit (excluding social security) is forecast to decline to 5 percent of GDP in 1997 as public investment falls, temporary cuts in income taxes are reversed, and the consumption tax is raised.

The easing of monetary policy—which brought the official discount rate down to ½ of 1 percent in September of 1995—is also contributing to the recovery. For much of last year the strong exchange rate provided a powerful offsetting influence, but since the middle of 1995 the correction of the exchange rate has implied a further easing of monetary conditions broadly defined to include the effects of interest rates and the exchange rate (see Chart 8). Inflationary pressures are expected to remain negligible, given the high level of excess capacity, but official interest rates will obviously need to be adjusted upward as the recovery gets further under way.

In Europe, the slowdown in economic activity in late 1995 and early 1996 was particularly acute in *Germany*, but a rebound in activity in the second quarter of 1996 is expected to result in growth of 1¼ percent for the year as a whole. Appreciation of the deutsche mark and high wage settlements early in 1995 hampered competitiveness, sapped business confidence, and undermined a recovery that was already weak relative to previous recoveries. Although real GDP increased by almost 2 percent in 1995 as a whole, growth was negative during the second half of the year. Winter-depressed construction activity contributed to a further contraction in the first quarter of 1996, but there is now clear evidence that economic activity has turned around and that business confidence is improving. Activity is expected to continue to strengthen in the second half of 1996 and in 1997, sup-

Chart 8. Major Industrial Countries: Monetary Conditions Indices[1]

An easing of monetary conditions—broadly defined to include both interest rates and exchange rates—in Germany and France is expected to support a resumption of growth.



[1]For each country, the index is defined as a weighted average of the percentage point change in the real short-term interest rate and the percentage change in the real effective exchange rate from a base period (January 1990). Relative weights of 3 to 1 are used for France, Italy, and the United Kingdom, 4 to 1 for Germany and Canada, and 10 to 1 for Japan and the United States. The weights are intended to represent the relative impacts of interest rates and exchange rates on aggregate demand; they should be regarded as indicative rather than precise estimates. For instance, a 3-to-1 ratio indicates that a 1 percentage point change in the real short-term interest rate has about the same effect on aggregate demand over time as a 3 percent change in the real effective exchange rate. Movements in the index are thus equivalent to percentage point changes in the real interest rates. The lag with which a change in the index may be expected to affect aggregate demand depends on the extent to which the change stems from a change in the interest rate or the exchange rate, and varies depending on the cyclical position; the lag also differs across countries. No meaning is to be attached to the absolute value of the index; rather, the index is intended to show the degree of tightening or easing in monetary conditions from the (arbitrarily chosen) base period. Small changes in the relative weights may affect the value of the index but not the qualitative picture.

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Table 3. European Union: Convergence Indicators for 1995, 1996, and 1997
(In percent)

	Consumer Price Inflation			General Government Balance/GDP				Gross Government Debt/GDP[2]			Long-Term Interest Rates[3]
	1995	1996	1997	1995	1996	1997	1997[1]	1995	1996	1997	August 1996
Germany	1.8	1.6	1.7	–3.5	–4.0	–3.0	–2.5	58.1	60.8	61.9	6.3
France	1.8	2.1	1.6	–5.0	–4.0	–3.0	–3.0	52.9	56.2	57.3	6.4
Italy	5.2	3.9	3.0	–7.1	–6.7	–5.5	–5.4	124.9	124.3	122.8	9.5
United Kingdom[4]	2.8	2.7	2.4	–5.5	–4.4	–3.3	. . .	47.2	49.5	50.8	7.8
Spain	4.7	3.4	3.1	–6.9	–4.6	–3.4[5]	–3.0	65.7	67.1	67.1	8.9
Netherlands	2.0	2.5	2.9	–3.8	–3.1	–2.5	. . .	79.0	78.4	77.3	6.3
Belgium	1.5	2.0	2.0	–4.1	–3.2	–3.0	–3.0	133.5	132.3	129.6	6.6
Sweden	2.5	1.6	2.3	–8.1	–5.0	–3.0	–2.6	78.7	80.1	78.5	8.1
Austria	2.2	2.1	1.9	–6.2	–4.5	–3.0	–3.0	69.4	72.3	73.8	6.4
Denmark[6]	2.1	1.6	1.9	–1.6	–1.3	–1.0	. . .	72.0	70.9	69.5	7.3
Finland	1.0	1.0	2.0	–5.2	–2.9	–1.8	–0.5	59.4	61.6	61.8	7.1
Greece[7]	9.3	8.4	6.6	–9.2	–7.6	–6.0[5]	–4.2	111.7	108.2	106.2	14.2
Portugal	4.1	3.3	3.0	–5.2	–4.0	–3.8[5]	–3.0	71.7	71.3	70.7	8.7
Ireland	2.5	2.3	2.5	–2.1	–2.4	–2.3	. . .	84.8	78.9	76.3	7.3
Luxembourg	1.9	1.8	2.0	0.4	—	—	. . .	6.3	6.7	6.8	6.6
All EU[8]	2.9	2.6	2.3	–5.2	–4.5	–3.5	. . .	72.2	73.8	73.9	7.5
Reference value[9]	**2.9**	**2.9**	**3.2**	**–3.0**	**–3.0**	**–3.0**	**–3.0**	**60.0**	**60.0**	**60.0**	**9.2**

Sources: National sources; and IMF staff projections.

Note: The table shows the convergence indicators mentioned in the Maastricht Treaty, except for the exchange rate. The three relevant convergence criteria are (1) consumer price inflation must not exceed that of the three best-performing countries by more than 1½ percentage points; (2) interest rates on long-term government securities must not be more than 2 percentage points higher than those in the same three member states; and (3) the financial position must be sustainable. In particular, the general government deficit should be at or below the reference value of 3 percent of GDP. If not, it should have declined substantially and continuously and reached a level close to the reference value, or the excess over the reference value should be temporary and exceptional. The gross debt of general government should be at or below 60 percent of GDP or, if not, the debt ratio should be sufficiently diminishing and approaching the 60 percent value at a satisfactory pace. The exchange rate criterion is that the currency must have been held within the normal fluctuation margins of the ERM for two years without a realignment at the initiative of the member state in question.

[1]Official targets or intentions. The IMF staff's fiscal projections shown in the two preceding columns are in some cases based on different growth, inflation, or interest rate assumptions from those used by national authorities and do not take into account further consolidation measures that are planned by EU governments in accordance with their convergence programs but that have not yet been announced. See Box 1 for the IMF staff's fiscal assumptions for each EU member.

[2]Debt data refer to end of year. They relate to general government but may not be consistent with the definition agreed at Maastricht.

[3]Ten-year government bond yield or nearest maturity.

[4]Retail price index excluding mortgage interest.

[5]IMF staff estimates for Greece, Portugal, and Spain differ from those of national authorities at least in part because, owing to intercountry differences in budgetary processes, sufficient information on the measures to be proposed in the 1997 budget is not yet available. See Box 1 for details regarding the IMF staff's fiscal assumptions for each EU member.

[6]Government deposits with the central bank, government holdings of nongovernment bonds, and government debt related to public enterprises amounted to some 20 percent of GDP in 1995.

[7]General government balance includes capitalized interest; long-term interest rate is 12-month treasury bill rate.

[8]Average weighted by GDP shares, based on the purchasing power parity (PPP) valuation of country GDPs for consumer price index, general government balances, and debt.

[9]The Treaty is not specific as to what methodology should be used to calculate reference values for inflation and the interest rate beyond noting that they should be based on the three lowest-inflation countries. For illustrative purposes, a simple average for the three countries is used in calculating the reference values.

ported by the easing of monetary conditions during the past year, including notably the depreciation of the deutsche mark from its overly strong level of spring last year. Significant labor market slack should contain wage increases and overall inflation at very moderate rates.

In mid-April 1996, the Bundesbank reduced two of its benchmark official interest rates by 50 basis points—the discount rate to 2½ percent, and the Lombard rate to 4½ percent—and in late August lowered the repurchase rate, for the first time since February, by 30 basis points to an historic low of 3 percent. In early September, short-term market rates in Germany were a full percentage point lower than a year earlier. In terms of fiscal policy, the government proposed a fiscal consolidation package in April that includes cuts in social services and a freeze on public sector salaries; if fully implemented, these measures are expected to reduce the general government deficit from 4 percent of GDP in 1996 to 3 percent by 1997.

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Table 4. Major Industrial Countries: Questions About Inflationary Pressures[1]

	Canada	France	Germany	Italy	Japan	United Kingdom	United States
1. Is inflation outside a range authorities consider to be consistent with price stability?	No	No	No	Yes, but decelerating	No	Slightly above	No
2. Does the IMF forecast that inflation will pick up in 1997?	Only slightly	No	Only slightly	No	Increase mainly reflecting higher consumption taxes	No (underlying rate,excluding mortgage interest)	No
3. Do private forecasters expect inflation to pick up in 1997? (*Consensus Forecasts*, Consensus Economics, Inc.)	Only slightly	No	Only slightly	No	Increase mainly reflecting higher consumption taxes	Only slightly (headline rate)	Only slightly
4. Is there concern about money growth?	No	No	No, M3 recently decelerating toward target range	No	No	Yes	No
5. Has the output gap been closing?	No	No	No	No	Yes, but remains relatively large	Yes	Yes
6. Is excess capacity being taken up too quickly?	No	No	No	No	No	No	Little, if any, remaining slack
7. Are labor market conditions tight?	No	No	No	No	No	No, but limited margin of slack	Yes
8. Do yield curves or changes in market interest rates suggest a rise in inflation expectations?	No[2]	No[2]	No[2]	No	No[2]	No[2]	Maybe
9. Is exchange rate weakness stimulating inflation?	No	No	No	No	No	No	No
10. Do external accounts show signs of overheating?	No	No	No	No	No	No	No
11. Have equity prices risen rapidly?	No	No	No	No	No	Yes, up to early 1996	Yes, up to early 1996
12. Have real estate prices recently been rising rapidly?	No	No	No	No	No	Real estate market seems to be recovering after a long stagnation	No

[1]This table is intended to provide a broad cross-country survey of inflationary pressures and reflects IMF staff judgments. For individual countries, various indicators will differ in the extent to which they contribute to the inflationary process.
[2]Yield curve has steepened but this appears unlikely to reflect increased inflation expectations.

In 1995, growth slowed to 2¼ percent in *France*, with activity being particularly weak in the fourth quarter of the year, partly owing to public sector strikes. Although the economy rebounded in the first quarter of 1996, output fell by about ½ of 1 percent in the second quarter and growth is expected to average only 1¼ percent in 1996 as a whole. In June and July, unemployment stood at 12½ percent, which is close to the record levels reached in early 1994. Consumer confidence and household consumption remain at low levels. Nevertheless, with the easing of monetary conditions and the improvement in growth prospects for Germany, it appears that the underlying conditions for a strengthening of activity in the second half of 1996 are in place. This should allow growth to firm to 2½ percent in 1997, although as in many other coun-

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Table 5. Industrial Countries: General Government Fiscal Balances and Debt[1]
(In percent of GDP)

	1980–89	1990	1991	1992	1993	1994	1995	1996	1997	2001
Major industrial countries										
Actual balance	–3.0	–2.1	–2.7	–3.8	–4.3	–3.5	–3.3	–2.9	–2.3	–1.5
Output gap	–0.4	2.7	0.5	–0.4	–1.8	–1.2	–1.4	–1.4	–1.1	0.2
Structural balance	–2.8	–3.3	–3.0	–3.5	–3.3	–2.7	–2.5	–2.1	–1.6	–1.5
United States										
Actual balance	–2.6	–2.7	–3.3	–4.4	–3.6	–2.3	–2.0	–1.3	–1.4	–0.9
Output gap	–0.7	2.8	–0.8	–0.5	–0.5	0.7	0.5	0.7	0.7	0.5
Structural balance	–2.3	–3.8	–3.1	–4.1	–3.4	–2.6	–2.2	–1.6	–1.7	–1.1
Net debt	34.7	44.8	48.3	52.0	54.4	55.3	56.2	55.9	55.5	52.2
Gross debt	48.0	57.5	61.3	64.0	66.2	66.0	66.7	66.8	66.3	62.4
Japan										
Actual balance	–1.5	2.9	2.9	1.4	–1.6	–2.1	–3.1	–3.9	–2.3	–2.7
Output gap	–0.2	3.2	3.2	0.8	–1.7	–3.5	–4.7	–3.5	–3.0	—
Structural balance	–1.4	1.7	1.8	1.1	–1.0	–0.8	–1.2	–2.5	–1.1	–2.7
Net debt	22.0	9.5	4.8	4.2	4.8	7.8	10.8	14.3	16.1	23.2
Gross debt	66.2	69.1	66.6	69.9	75.1	82.2	88.5	92.4	95.0	104.4
Memorandum										
Actual balance excluding social security	–4.3	–0.6	–0.8	–2.0	–4.8	–5.0	–5.9	–6.7	–4.9	–5.4
Structural balance excluding social security	–4.3	–1.6	–1.8	–2.2	–4.2	–3.9	–4.3	–5.5	–3.9	–5.4
Germany[2]										
Actual balance	–2.1	–2.0	–3.3	–2.8	–3.5	–2.5	–3.5	–4.0	–3.0	–1.2
Output gap	–1.6	2.1	3.4	2.0	–2.0	–2.0	–2.2	–3.2	–3.1	—
Structural balance	–1.3	–3.2	–5.2	–3.8	–2.4	–1.2	–2.2	–2.0	–1.1	–1.1
Net debt	20.8	21.6	21.4	27.7	35.4	40.4	49.0	52.0	53.4	51.8
Gross debt	39.8	43.4	41.1	44.1	48.2	50.2	58.1	60.8	61.9	58.8
France										
Actual balance	–2.0	–1.4	–2.0	–4.0	–5.8	–5.8	–5.0	–4.0	–3.0	–1.6
Output gap	0.3	2.4	0.6	–0.5	–3.8	–3.0	–2.7	–3.2	–2.6	–0.1
Structural balance	–2.1	–2.7	–2.4	–3.5	–3.3	–3.7	–3.2	–1.8	–1.3	–1.5
Net debt[3]	21.5	25.1	27.1	30.2	34.4	40.2	43.5	46.1	47.4	48.4
Gross debt	29.0	35.5	35.8	39.7	45.7	48.6	52.9	56.2	57.3	56.5

tries of the European Union, there are still downside risks to the projection. Inflation is expected to remain subdued, reflecting moderate wage settlements and the persistence of a sizable output gap.

Over the past year, there has been significant progress with fiscal consolidation in France. In late 1995, the government announced further plans to reduce the budget deficit, including wide-ranging reform of the social security system as well as other expenditure cuts. In early 1996, cuts in spending amounting to about ¼ of 1 percent of GDP were announced to offset the revenue effects of weaker-than-expected economic activity. While the efforts to reduce the fiscal deficit have probably had a contractionary direct impact on domestic demand—the structural deficit is expected to fall by 1¼ percentage points of GDP in 1996—the government's demonstrated resolve to reduce the deficit has been a key factor boosting market confidence and allowing substantial declines in interest rates in absolute terms and relative to Germany. Thus short-term interest rates have declined by some 4 percentage points from their peaks in March 1995, and long-term rates by 1½ percentage points in the same period.

In *Italy*, strong exports owing to the lira's depreciation during 1992–95 and buoyant investment boosted growth in 1995 as a whole to 3 percent. However, growth slowed down in late 1995 as the lira strengthened, European export markets weakened, and temporary tax incentives for investment were phased out. Continued appreciation of the lira in 1996, and the recently enacted corrective fiscal package, have led to a halving of projected GDP growth for 1996 to about 1 percent—the largest downward revision among the industrial countries. After reaching over 5 percent in 1995, annual average inflation is expected to recede to less than 4 percent in 1996, and to 3 percent in 1997. Disinflation has been supported by a firm monetary policy, the appreciation of the lira, and subdued domestic demand.

Considerable progress has been made with fiscal consolidation in Italy in recent years. Combined with the alleviation of political uncertainty following the election earlier this year, this progress has contributed

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Table 5 *(concluded)*

	1980–89	1990	1991	1992	1993	1994	1995	1996	1997	2001
Italy										
Actual balance	–10.9	–11.0	–10.2	–9.5	–9.6	–9.0	–7.1	–6.7	–5.5	–2.8
Output gap	2.1	2.9	1.8	0.0	–3.2	–2.9	–1.8	–2.6	–2.4	—
Structural balance	–11.8	–12.3	–11.1	–9.6	–8.0	–7.6	–6.1	–5.4	–4.4	–2.8
Net debt	71.2	92.9	96.3	103.0	111.8	117.3	116.5	114.3	112.0	99.3
Gross debt	77.1	97.9	101.4	108.5	119.3	125.5	124.9	124.3	122.8	109.2
United Kingdom										
Actual balance	–2.0	–1.2	–2.5	–6.3	–7.8	–6.8	–5.5	–4.4	–3.3	–1.4
Output gap	–0.9	2.0	–2.3	–4.5	–4.6	–3.0	–2.4	–2.2	–1.6	—
Structural balance	–1.0	–3.7	–2.7	–3.8	–4.4	–4.0	–3.6	–2.8	–2.0	–1.2
Net debt	41.6	27.2	26.7	28.1	32.5	37.7	40.9	44.1	44.3	42.0
Gross debt	49.3	34.4	33.6	34.9	40.4	46.0	47.2	49.5	50.8	48.5
Canada										
Actual balance	–4.5	–4.1	–6.6	–7.4	–7.3	–5.3	–4.1	–2.4	–1.1	–0.3
Output gap	–0.1	1.2	–2.6	–3.7	–4.0	–2.6	–2.6	–3.4	–2.6	–0.4
Structural balance	–4.4	–4.9	–4.9	–4.8	–4.6	–3.6	–2.7	–0.5	0.3	–0.1
Net debt	28.7	44.0	49.7	56.9	61.9	64.7	67.5	69.3	67.5	58.2
Gross debt	59.0	72.3	79.4	86.9	92.5	94.6	98.3	100.6	97.8	83.9
Other industrial countries[4]										
Actual balance	–4.1	–2.5	–3.8	–4.7	–6.0	–5.1	–4.4	–2.9	–2.0	–1.6
Output gap	–0.6	2.5	1.1	–0.1	–2.3	–1.6	–1.2	–1.2	–1.1	–0.1
Structural balance	–3.8	–4.3	–4.8	–4.7	–4.3	–3.8	–3.5	–2.1	–1.4	–1.5

[1]The output gap is actual less potential output, as a percent of potential output. Structural balances are expressed as a percent of potential output. The structural budget balance is the budgetary position that would be observed if the level of actual output coincided with potential output. Changes in the structural budget balance consequently include effects of temporary fiscal measures, the impact of fluctuations in interest rates and debt-service costs, and other noncyclical fluctuations in the budget balance. The computations of structural budget balances are based on IMF staff estimates of potential GDP and revenue and expenditure elasticities (see the October 1993 *World Economic Outlook*, Annex I). Net debt is defined as gross debt less financial assets, which include assets held by the social security insurance system. Estimates of the output gap and of the structural budget balance are subject to significant margins of uncertainty.

[2]Data before 1990 refer to west Germany. For net debt, the first column refers to 1986–89. Beginning in 1995, the debt and debt-service obligations of the Treuhandanstalt (and of various other agencies) were taken over by the general government. This debt is equivalent to 8 percent of GDP, and the associated debt service to ½ of 1 percent of GDP.

[3]Figure for 1980–89 is average of 1983–89.

[4]For 1980–89, includes Spain, the Netherlands, Belgium, Sweden, Austria, Denmark, Ireland, Australia, and New Zealand; for years thereafter also includes Finland, Greece, Norway, and Portugal. See Statistical Appendix Table A16 for details.

to a significant improvement in market sentiment, with the lira strengthening and interest rate differentials reaching their lowest levels since the early summer of 1994. In June, the new government introduced a package of corrective fiscal measures (in an amount close to 1 percent of GDP) to compensate for lower-than-expected growth, higher interest payments, and other budgetary overruns. The package aims at reducing the 1996 state sector deficit to 6.1 percent of GDP against an original target of 5.8 percent. The government has also updated the privatization calendar and is seeking delegated powers to enact tax and public administration reform. Monetary conditions, broadly defined, have tightened over the past year, with the moderate decline in short-term market interest rates outweighed by the appreciation of the lira. In late July, following indications that inflation had fallen clearly below 4 percent, the Bank of Italy lowered key official interest rates, which had remained unchanged since May 1995, by 75 basis points.

In the *United Kingdom*, growth moderated in 1995, with both the tightening of monetary conditions in the preceding year and the weakening of export markets playing a role. Both net exports and investment expenditures weakened; steady growth in consumption expenditures continued. The manufacturing sector has been particularly weak since early 1995, and an overhang of stocks is expected to continue to restrain expansion in that sector through 1996. A strengthening of consumer spending, already apparent in mid-1996, is expected to lead to growth above potential in 1997. Unemployment is expected to decline somewhat further from its recent level of 7½ percent. Moderate economic expansion and the continuing output gap have contributed to the containment of inflation that—at its current level of 2¾ percent—is the lowest in thirty years.

The slowdown of growth since 1994 and noncyclical revenue shortfalls have complicated the process of fiscal consolidation. The outturn for fiscal year 1995/96 (ended March 1996) was a public sector borrowing requirement (PSBR) of 5 percent of GDP (excluding privatization receipts), roughly ½ of 1 percent of GDP larger than revised estimates contained in

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the November 1995 budget. Most of this slippage stemmed from a shortfall of general government revenue, and in particular corporate and value-added tax collections. In 1996/97, the PSBR is projected to decline to 3½ percent of GDP. Monetary conditions have eased with the lowering of official interest rates by 1 percentage point, in four steps, between December 1995 and June 1996. Monetary aggregates have been showing rapid growth; in particular, M4 has been growing above its 3–9 percent monitoring range since late last year, partly owing to increased merger and acquisition activity and the development of the gilt repo market.

After increasing by 3 percent in 1995, economic activity has slowed considerably in *Sweden*, and modest growth of 1½ percent is projected for 1996. Inflation has fallen below the Riksbank's central target of 2 percent, the krona has continued to strengthen, and long-term interest differentials with Germany have narrowed further. Taking advantage of these developments and against the background of a weakening economy and the government's strong commitment to fiscal consolidation, the Riksbank has eased monetary policy significantly, lowering the repo rate by more than 3 percentage points since the beginning of the year.

In Austria, Belgium, and Switzerland, declines in exports to European trading partners have added to weaknesses in domestic demand. In *Austria*, growth is expected to fall below 1 percent in 1996 reflecting weaker external demand and lower private consumption and investment. Public finances deteriorated during 1995, bringing the government deficit to more than 6 percent of GDP, and the gross public debt ratio to nearly 70 percent of GDP. A new consolidation package with ambitious fiscal objectives for 1996–97 has been put in place to address these imbalances. In *Belgium*, a slowdown in growth occurred during 1995, as foreign demand for Belgian exports declined sharply. Subdued domestic demand has also contributed to the slowing of economic activity. Growth in 1996 is projected to be about 1½ percent and the rate of unemployment is expected to remain at about 13 percent. Economic activity in *Switzerland* contracted in the first quarter of 1996, owing to a continued fall in exports, weak consumer spending and construction investment, and cuts in government spending. Although the lagged effects of the easing of monetary conditions during 1995, and a resumption of growth in other European countries, and particularly in Germany, should contribute to a gradual recovery, year-on-year growth in 1996 is expected to be virtually flat.

In the Netherlands, Denmark, and Finland, strength in various components of domestic demand has offset to some extent declines in exports to major trading partners in Europe, and helped to support activity. In the *Netherlands*, private consumption remained strong in 1995 owing to substantial gains in employment, and investment accelerated. The outlook for the remainder of 1996 is favorable, with growth slowing only slightly to 2¼ percent for the year as a whole. In *Denmark*, buoyancy in domestic demand has remained broadly based. Despite the slowdown in Europe, consumer and investment spending have been strong and unemployment has fallen below 10 percent from over 12 percent in 1994. Nevertheless, growth is expected to slow to 2 percent in 1996 before picking up in 1997. In *Finland*, there are some encouraging signs that growth is strengthening after the lull in economic activity that lasted for most of 1995. Domestic demand appears to have recently picked up and growth is expected at 2½ to 3 percent in 1996 and 4 percent in 1997.

In Spain and Portugal, the pace of economic activity has also slowed since mid-1995, although it remains stronger than in many other European countries. In *Spain*, despite a recovery in real disposable income, consumer confidence and spending weakened in the middle of 1995 as did private investment. With the export sector in Spain having remained buoyant, a pickup in growth hinges on a revival of consumer spending, the timing and magnitude of which are uncertain. Fiscal consolidation and sound monetary policy brought inflation down to 3½ percent in early 1996—the lowest rate in more than two decades. Growth is projected to fall to between 2 percent and 2½ percent in 1996 before picking up in 1997. In *Portugal*, weakening exports combined with a slowdown in investment resulted in a deceleration in growth in the second half of 1995, which continued in early 1996. In the remainder of 1996, as recovery takes hold in Europe, growth is expected to rebound, and also to reach some 2 to 2½ percent for the year. A stable exchange rate and robust productivity gains should help to reduce inflation further.

In contrast to much of the rest of Europe, Ireland and Norway have maintained solid growth. In *Ireland*, financial discipline, outward-looking policies, and considerable foreign direct investment have continued to yield broad-based and robust economic growth, which picked up to over 10 percent in 1995 and is projected to moderate to 7 percent in 1996. Exports have remained remarkably buoyant, and investment and consumer spending have continued to grow at a robust pace. Unemployment fell to about 13 percent in 1995—a significant drop from its peak of about 17 percent in 1993. Growth in *Norway* has also remained robust with strong consumption and large external surpluses supporting economic activity. These positive developments have caused the krone to appreciate, leading the central bank to lower interest rates despite concerns about overheating.

In Australia and New Zealand, in response to buoyant growth in recent years and signs of overheating, monetary policy was tightened during 1994 in both

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countries, which helped to slow growth to more sustainable rates in 1995, although the inflationary pressures were not completely preempted. In *New Zealand*, growth is expected to remain steady in 1996 and increase to 3 percent in 1997. Tightness in the labor market and strong activity in the construction sector have raised inflation, which is likely to remain slightly above the upper end of its target range of zero to 2 percent through the remainder of this year. In *Australia*, after a strong first quarter, output is expected to slow somewhat, but may nevertheless expand by 3½ to 4 percent in 1996 as a whole, followed by a moderation to 3 percent in 1997.

Economic Situation and Prospects in Developing Countries

In the developing countries, output increased by about 6 percent in 1995, continuing the solid expansion that has been under way since the beginning of the decade, and the average inflation rate slowed significantly to 20 percent (Table 6). In 1996, aggregate growth is projected to continue at about the same pace as in recent years, with some tendency for country growth rates to converge; and inflation is expected to ease further in most countries. Significant further progress is also expected in reducing fiscal imbalances throughout most of the developing world (Table 7).

Among the developing countries of the *Western Hemisphere*, following the disappointing performance in 1995, growth is expected to recover to 3 percent in 1996 and inflation to decline further. In Mexico, tight fiscal and monetary policies helped reduce actual and expected inflation in the first half of the year, contributing to further gains in confidence, declines in interest rates, and the stabilization of the peso. Growth in 1996 could exceed 3½ percent, with an end-of-year inflation rate close to 25 percent. Led by a recovery in consumer confidence and an easing of credit conditions, output in Argentina is expected to increase by about 2½ percent in 1996 following a decline of 4½ percent last year. Continued fiscal tightening aimed at supporting the currency board arrangement is expected to keep inflation subdued, at the lowest rates in more than fifty years. In Brazil, the currency stabilization plan has continued to contain inflation to about 1 percent a month, but growth is projected to slow to 2½ percent in 1996. In Venezuela, a stabilization and reform program has been initiated to correct the deterioration of economic conditions in the early 1990s. Inflation accelerated to 7½ percent a month during the first quarter of 1996, but the measures that have been taken and that are planned are expected to reduce the rate substantially in the second half of the year. In Chile, despite increased inflationary pressures in the early part of the year owing to higher oil and wheat prices, inflation is expected to moderate in the second half following a further tightening of monetary conditions, including increases in the central bank's target interest rates. Output growth in 1996 is also projected to moderate, to 7½ percent.

Following the marked improvements in *Africa*'s economic performance in 1994–95, there seem to be reasons for cautious optimism that growth is strengthening more significantly in 1996 and that inflation may decline for the third consecutive year. Although the sharp increases in prices of certain export commodities, especially coffee, witnessed in 1995 have been largely reversed, and activity in the industrial countries—the major trading partners—is likely to recover at a relatively slow pace, many African countries are expected to reap the benefits of fiscal consolidation, reduced inflation rates, greater private sector participation in the economy, liberalization of trade and exchange systems, and more realistic exchange rates. In South Africa, strengthening exports and private investment are contributing to stronger growth, which is projected to reach 4 percent in 1996. Despite a significant depreciation of the rand in early 1996 and a large but gradually declining fiscal deficit, tightened monetary conditions are expected to contain inflation at 7½ percent, although inflationary pressures and the weakness of the exchange rate remain of concern. In Uganda, the credibility of macroeconomic policies has continued to improve, and strong performance in the manufacturing and construction sectors is expected to contribute to a growth rate of around 6 percent in 1996. In Kenya, following a slowdown in the second half of 1995, growth picked up in the first quarter of 1996 and output is projected to rise by about 5 percent again in the year as a whole. Aided by a further reduction in the fiscal deficit and restrained credit policies, inflation is projected to remain below 5 percent. Tight demand management and wage restraint in Algeria are likely to reduce inflation further to about 17 percent in 1996, while output is projected to increase by about 4 percent led by further expansion in the hydrocarbon sector. In Ethiopia, growth should pick up to about 8 percent in 1996 as a result of a favorable agricultural season. The increase in agricultural production along with monetary restraint is expected to bring the rate of inflation down to about 6½ percent in 1996. In Zambia, economic conditions remained difficult in the first half of 1996 as a result of the need to import substantial quantities of maize following the drought in 1995, and also the sharp drop in copper prices. In Nigeria, growth in 1996 is expected to strengthen somewhat despite a stagnant petroleum sector, while inflation is projected to decline.

In many countries of the CFA franc zone, growth has picked up since the 1994 devaluation, and inflation has recently declined. Solid growth is expected to continue through 1996, and inflation should fall further, but these projections are contingent on the continuation of restrained fiscal and credit policies. In

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Table 6. Selected Developing Countries: Real GDP and Consumer Prices

(Annual percent change)

	Real GDP			Consumer Prices		
	1994	1995	1996	1994	1995	1996
Developing countries	**6.6**	**5.9**	**6.3**	**46.8**	**19.8**	**13.3**
Median	**3.9**	**4.2**	**4.5**	**10.8**	**9.4**	**6.8**
Africa	**2.9**	**3.0**	**5.0**	**36.8**	**32.1**	**21.3**
Algeria	–0.9	4.3	4.2	29.0	29.8	16.9
Cameroon	–2.5	3.3	5.0	12.7	26.9	6.3
Côte d'Ivoire	1.8	7.0	6.5	26.0	14.3	6.6
Ghana	3.8	4.5	5.0	24.9	59.5	44.9
Kenya	3.9	5.0	5.0	28.8	1.7	5.0
Morocco	11.5	–6.9	9.2	5.1	6.1	5.0
Nigeria	1.3	3.0	3.8	57.0	70.0	40.0
South Africa	2.7	3.3	4.0	9.0	8.7	7.5
Sudan	4.3	4.5	4.0	118.0	57.0	85.0
Tanzania	3.6	4.0	5.0	30.2	34.0	25.0
Tunisia	3.3	2.5	7.5	4.7	6.3	5.0
Uganda	11.0	6.5	6.0	6.1	8.0	5.0
SAF/ESAF countries[1]	3.8	4.9	5.8	24.3	24.6	16.6
CFA countries	1.6	4.4	4.7	27.0	14.9	5.1
Asia	**9.1**	**8.6**	**8.0**	**13.4**	**10.9**	**7.9**
Bangladesh	4.7	4.7	4.8	6.3	7.4	7.5
China	12.6	10.2	9.0	21.7	14.8	9.0
Hong Kong	5.4	5.0	5.0	8.1	9.0	7.5
India	5.7	6.8	6.4	9.9	10.2	7.9
Indonesia	7.5	8.1	7.8	8.5	9.4	9.1
Korea	8.6	9.0	7.2	6.3	4.5	5.2
Malaysia	9.2	9.5	8.8	3.7	3.4	4.0
Pakistan	3.8	4.5	6.0	11.7	12.1	11.0
Philippines	4.4	4.8	5.9	9.0	8.1	8.5
Singapore	10.1	8.9	7.5	3.1	1.7	1.7
Taiwan Province of China	6.5	6.1	6.0	4.1	3.7	3.6
Thailand	8.8	8.7	8.3	5.0	5.8	6.0
Vietnam	8.8	9.5	9.5	14.5	12.8	9.0
Middle East and Europe	**0.5**	**3.6**	**3.9**	**31.5**	**32.5**	**25.6**
Egypt	2.9	3.2	4.2	9.0	9.4	7.2
Iran, Islamic Republic of	0.9	2.8	4.2	35.2	49.4	29.3
Israel	6.5	7.1	5.1	12.3	10.0	14.0
Jordan	5.9	6.4	6.5	3.5	2.4	4.5
Kuwait	0.2	1.6	1.6	2.3	1.0	2.1
Saudi Arabia	–0.1	–0.8	0.7	0.6	5.0	1.8
Turkey	–4.7	7.5	4.8	106.3	93.6	85.0
Western Hemisphere	**4.7**	**0.9**	**3.0**	**210.9**	**35.6**	**20.4**
Argentina	7.4	–4.4	2.5	4.2	3.2	0.3
Brazil[2]	5.7	4.2	2.5	2,123.6	. . .	12.3
Chile	4.2	8.5	7.4	11.4	8.2	7.6
Colombia	5.5	5.2	3.2	22.8	20.9	20.5
Dominican Republic	4.3	4.8	5.0	8.3	7.1	5.0
Ecuador	4.3	2.3	3.0	27.3	23.0	18.4
Guatemala	4.0	4.9	4.0	12.5	8.4	10.6
Mexico	3.5	–6.9	3.6	7.1	35.0	34.1
Peru	13.1	7.0	3.0	23.7	11.1	10.7
Uruguay	6.8	–2.4	1.0	44.7	42.2	27.5
Venezuela	–2.8	2.2	–1.1	60.8	60.0	94.4

[1]African countries that had arrangements, as of the end of 1995, under the IMF's Structural Adjustment Facility (SAF) or Enhanced Structural Adjustment Facility (ESAF).

[2]"Consumer prices" are based on a price index of domestic demand, which is a weighted average of the consumer price index, the wholesale price index, and a price index for construction activity. The year-on-year increase in 1995 in this price index was 59.6 percent, which largely was the result of carryover effects from the high inflation rate prevailing prior to the introduction of the real on July 1, 1994. Consequently, the inflation rate from December 1994 to December 1995, which was 14.8 percent, better reflects the underlying rate during 1995.

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Table 7. Selected Developing Countries: General Government Budget Balance[1]
(In percent of GDP)

	1993	1994	1995	1996	1997
Developing countries	**–3.4**	**–2.7**	**–2.7**	**–2.2**	**–1.8**
Africa	**–8.5**	**–6.0**	**–3.8**	**–2.4**	**–0.3**
Algeria[2]	–8.7	–4.4	–1.4	0.3	1.2
Cameroon	–6.4	–9.1	–4.5	–1.6	–0.9
Cote d'Ivoire	–12.0	–6.8	–3.6	–2.6	–2.0
Kenya	–8.3	–3.8	–0.8	–0.3	–0.2
Nigeria	–17.4	–8.5	0.4	0.7	9.1
South Africa	–6.2	–5.8	–5.7	–5.2	–4.6
Uganda	–3.8	–2.4	–1.3	–1.6	–0.8
Asia	**–3.2**	**–2.5**	**–2.4**	**–2.3**	**–1.9**
China	–2.1	–1.6	–1.7	–1.6	–0.9
Hong Kong[2]	2.3	1.3	0.1	0.5	2.4
India	–10.6	–10.3	–9.7	–9.3	–9.1
Indonesia	–0.6	0.1	0.8	—	–0.2
Korea[2]	0.3	0.5	0.4	—	—
Malaysia	–4.7	1.3	0.6	–1.0	—
Pakistan[2]	–7.7	–5.4	–5.3	–4.3	–3.9
Philippines[2]	–1.6	–1.6	–1.4	–0.4	0.1
Singapore[2]	14.4	13.3	12.4	11.4	10.1
Taiwan Province of China[2]	–1.3	0.4	0.5	–1.9	–2.2
Thailand	1.1	1.8	2.4	2.1	1.9
Middle East and Europe	**–7.7**	**–6.2**	**–5.0**	**–3.5**	**–4.1**
Egypt[2]	–3.5	–2.1	–1.3	–1.3	–1.1
Israel	–3.6	–2.2	–3.4	–3.5	–2.5
Saudi Arabia	–10.5	–9.4	–4.6	1.0	–1.0
Turkey	–9.1	–6.0	–6.0	–9.3	–11.9
Western Hemisphere	**0.3**	**–0.1**	**–1.9**	**–1.1**	**–0.9**
Argentina	0.9	–0.5	–1.3	–2.1	–1.0
Brazil	0.2	0.5	–5.1	–2.5	–1.8
Chile	2.2	2.2	3.9	3.0	3.7
Mexico	0.7	–0.1	—	–0.4	–1.0
Peru	–2.6	–2.3	–2.6	–1.3	–0.7

[1]In calculating the regional and developing country aggregates, central government budget balance is used when general government balance is unavailable. Cambodia is excluded from the Asia and developing country aggregates because data are unavailable. Estimates for Argentina, Brazil, and Peru cover the combined public sector; those for Brazil refer to the operational balance. Projections for Mexico include the inflation adjustment components of indexed government bonds.

[2]Central government balance.

Côte d'Ivoire, a projected deterioration in the terms of trade is expected to be offset by a strong increase in oil production, leading to overall growth in output of about 6 percent in 1996. A further reduction in the fiscal deficit along with a restrained credit stance are expected to reduce inflation to about 7 percent. With a favorable crop season and continued expansion of export-oriented activities, growth in Senegal could approach 5 percent in 1996. Demonstrating their strengthened commitment to the liberalization of trade and payments, most of the CFA franc countries recently accepted the obligations of current account convertibility under Article VIII of the IMF's Articles of Agreement.

Among the developing countries of *Asia*, policies have been tightened in a number of cases in response to growing concerns about inflationary pressures and deteriorating external positions. Export growth in a number of these economies has decelerated over the past year, and the pace of economic expansion is expected to slow somewhat in the period ahead. Inflation in the region is projected to decline further in 1996, to about 8 percent. In Malaysia and Thailand, the earlier tightening of monetary conditions is expected to be more fully felt in the latter part of 1996 as growth slows somewhat further, reducing the risk of overheating. Inflation in both countries is expected to increase only slightly over the next year. Tighter credit policies during 1996 in Indonesia are also expected to moderate growth, to below 8 percent. In Korea, growth is expected to slow to about 7 percent this year owing to a weakening of exports and equipment investment from the exceptionally rapid rates of expansion in 1995. Consumer spending and construction are expected to remain strong, and inflation to increase slightly as a result of higher food prices. In China, tighter controls on investment approvals and credit have helped to slow growth and alleviate price pressures in 1996, but the

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Table 8. Countries in Transition: Real GDP and Consumer Prices
(Annual percent change)

	Real GDP			Consumer Prices		
	1994	1995	1996	1994	1995	1996
Countries in transition	**–8.8**	**–1.3**	**0.4**	**265**	**128**	**41**
Median	**0.4**	**1.8**	**3.0**	**130**	**41**	**25**
Central and eastern Europe	**–2.9**	**1.2**	**1.6**	**153**	**75**	**30**
Excluding Belarus and Ukraine	3.4	4.9	4.2	46	26	21
Albania	9.4	8.6	7.0	23	8	12
Belarus	–12.2	–10.2	–5.5	2,220	709	70
Bulgaria	1.8	2.6	—	96	62	73
Croatia	0.8	2.0	5.0	97	3	3
Czech Republic	2.6	4.8	5.2	10	9	9
Estonia	–0.1	3.2	3.1	48	29	27
Hungary	2.9	1.5	1.2	19	28	23
Latvia	2.2	0.4	2.1	35	25	21
Lithuania	1.0	3.1	1.6	72	39	29
Macedonia, Former Yugoslav Rep. of	–8.2	–3.0	3.0	123	16	7
Moldova	–31.2	–3.0	4.0	330	30	24
Poland	6.0	6.5	5.5	32	28	19
Romania	3.9	6.9	4.0	137	32	23
Slovak Republic	4.9	7.4	6.5	13	10	6
Slovenia	4.9	3.5	3.0	20	13	10
Ukraine	–23.7	–11.8	–8.0	891	376	70
Russia	**–15.0**	**–4.0**	**–1.3**	**302**	**190**	**51**
Transcaucasus and central Asia	**–13.7**	**–4.4**	**0.6**	**1,611**	**259**	**69**
Armenia	5.4	6.9	6.5	5,276	177	26
Azerbaijan	–14.0	–8.3	–3.8	1,664	412	23
Georgia	–11.4	2.4	8.0	17,272	169	50
Kazakstan	–25.0	–8.9	0.4	1,880	176	39
Kyrgyz Republic	–20.1	1.3	2.4	278	43	20
Mongolia	2.3	6.3	3.5	88	57	37
Tajikistan	–21.4	–12.5	–7.0	350	635	633
Turkmenistan	–20.0	–10.4	6.2	1,749	1,005	904
Uzbekistan	–4.2	–1.8	–1.0	1,568	305	49

authorities will need to follow a tight monetary stance to ensure that inflation remains within the target range.

Growth prospects remain buoyant in a number of other Asian countries as well. In the Philippines, the process of economic adjustment and recovery is now well under way following earlier difficulties, and output expanded by 4½ percent in both 1994 and 1995. Real GDP growth is projected to increase further in 1996 to 6 percent, reflecting the continued strength of both domestic demand and the export sector. Inflation is likely to remain around 8 percent in 1996 as a whole, but should wane significantly by the end of the year. The macroeconomic situation in Vietnam remains strong with robust growth continuing and inflation falling during 1996. In India, the economic expansion is expected to slow from its recent rapid pace, owing to infrastructural bottlenecks and the high real interest rates arising from the policy mix of a large fiscal deficit and the resulting need for a tight monetary stance. Inflationary pressures are likely to become more prominent in the latter part of the year reflecting adjustments in administered prices. In Pakistan, a rebound in agricultural sector activity from depressed levels a year earlier, and better prospects in the mining and construction sectors are expected to contribute to some improvement in overall growth in 1996. Considerable risks to the outlook remain, including the effects of a widening current account deficit, which is linked to a lack of fiscal discipline.

Following a rebound in economic activity in 1995 in the *Middle East and Europe* region, growth is expected to strengthen somewhat to about 4 percent in 1996. In Kuwait and Saudi Arabia, efforts to eliminate substantial budget deficits through expenditure reductions continue to have a short-term restraining impact, although the increase in oil prices since mid-1995 and particularly in late August has provided an offsetting source of strength. In Egypt, a number of recent economic reforms in the area of privatization and deregu-

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lation are expected to help raise output in 1996 by about 4 percent, the strongest growth rate since 1987. In late July, an agreement in principle was reached between Egypt and the IMF on financial support for a package of economic policy reforms. In Jordan, prudent monetary and fiscal policies should continue to promote robust growth with low inflation over the next year. The failure to implement needed economic reforms has contributed to renewed economic difficulties in Turkey, with growth projected to slow from 7½ percent in 1995 to 5 percent in 1996 and inflation likely to remain in the 80 to 90 percent range. In Israel, more moderate growth of domestic demand is expected to slow the growth of output to 5 percent this year. Inflation, however, is expected to pick up—partly as a consequence of the worsening fiscal conditions over the past year and a half.

Developments and Prospects in Countries in Transition

In the countries in transition, economic activity overall is projected to stabilize in 1996 after five years of decline (Table 8). Eight countries are expected to register growth of 5 percent or more. Further gains in reducing inflation are also projected, with four countries registering annual inflation in the single digits.

In the *countries more advanced in the transition process*, sustained growth and further progress toward financial stabilization, and in particular fiscal consolidation, are expected (Table 9). In Poland, strengthening domestic demand is expected to contribute to continued robust growth with inflation slowing further (Chart 9). Strong domestic demand in the Czech Republic should support robust growth, with inflation likely to remain broadly at last year's level. Steady progress in lowering inflation has been made in other countries, including Estonia, Latvia, and Lithuania, while Croatia has achieved virtual price stability. Continued growth is expected in all these countries, but the short-term prospects of some, including Lithuania, have been adversely affected by banking sector problems that emerged in late 1995. In the Slovak Republic, growth this year is projected to moderate to 6½ percent, down from almost 7½ percent in 1995. Inflation has also continued to moderate and is expected to fall to 6 percent in 1996. Concerns have emerged, however, regarding the sharp deterioration in the current account—from a surplus of 4 percent of GDP in 1995 to a deficit of 5 percent in the first quarter of 1996—which can be traced to a decline in exports and strong domestic demand. In Hungary, growth is projected to slow to about 1 percent in 1996, reflecting the tightening of fiscal policy and the slowdown in western Europe. Recent policy initiatives have helped to restore macroeconomic balance, with the fiscal and current account deficits declining sharply, and have laid the basis for recovery.

Among the *countries less advanced in transition*, delays in reforms and policy slippages have led to financial market instability in some cases. In Bulgaria, a banking and exchange crisis that came to a head in late spring stemmed from failure to address the entrenched problem of lax financial discipline in the enterprise and banking sectors and the consequent high level of nonperforming loans. Efforts are under way to address the macroeconomic situation within the framework of an IMF-supported adjustment program, but as a result of the financial disruption, growth has come to a halt and inflation has increased significantly. In Romania, an exchange crisis had erupted earlier in the year,

Table 9. Selected Countries in Transition: General Government Budget Balance
(In percent of GDP)

	1993	1994	1995	1996	1997
Countries in transition	–6.9	–6.7	–3.9	–3.7	–2.3
Armenia	. . .	–16.5	–9.9	–6.8	–4.6
Bulgaria[1]	–15.7	–7.0	–5.7	–4.7	–2.6
Czech Republic[2]	1.4	–1.3	–2.1	–1.3	0.9
Estonia	–1.1	1.3	–0.8	–1.4	–0.5
Hungary	–6.3	–7.6	–3.7	–0.5	–2.8
Kazakstan[1]	–1.2	–6.8	–3.0	–2.8	–2.4
Latvia	0.6	–3.9	–1.0	–0.7	0.6
Mongolia	–14.6	–24.6	–11.1	–10.9	–10.6
Lithuania	–4.9	–4.7	–3.0	–3.5	–2.4
Poland	–4.0	–2.0	–2.7	–2.7	–2.5
Romania	–0.1	–1.0	–2.5	–2.2	–2.0
Russia	–7.6	–10.1	–5.0	–5.5	–3.0
Slovak Republic	–7.1	–1.3	0.1	–1.5	—

[1]Central government balance
[2]Includes privatization revenues.

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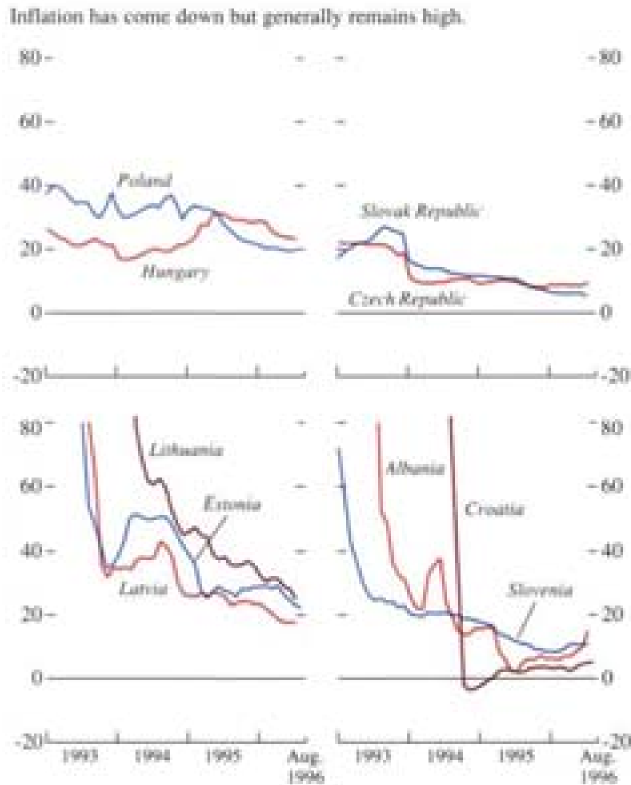
Chart 9. Selected Countries More Advanced in Transition: Inflation

(Twelve-month percent change in the consumer price index)

Inflation has come down but generally remains high.



prompting the government to reimpose administrative controls on the exchange markets. Subsequently, monetary and fiscal policy have also become more lax. Inflationary pressures have been accelerating, prompting the government to introduce administrative price controls in August.

Encouraging progress continues in many other countries less advanced in the transition process, the majority of which should soon see the beginning of a reversal of the sharp output contraction experienced since the start of the transition. In Russia, even though there was some increase in financial market volatility in the weeks preceding the presidential elections, the exchange market was relatively calm. There has been further significant progress in 1996 in reducing inflation. Prices declined slightly in August (in part owing to seasonal factors), marking the first month with approximate price stability since the start of reforms; and in the first eight months of the year monthly inflation averaged about 1.9 percent (Chart 10). In 1996 as a whole, consumer prices are projected to be 50 percent higher than in 1995. Weaknesses in government finances, however, continue to be a cause for concern. Growth is expected to pick up in the second half of 1996, although for the year as a whole real GDP is projected to be about 1 percent below its 1995 level. Significant progress toward moderate inflation has continued in other countries less advanced in transition, particularly Armenia, Georgia, and Ukraine. While inflation rose through the first half of 1996 in the Kyrgyz Republic, largely as a result of ongoing adjustments to administered prices, it has recently receded again. Strong growth is expected to continue in Armenia, where last year output expanded by almost 7 percent, as well as in Georgia. In contrast, further output declines are expected in Belarus due to a lack of macroeconomic discipline and reforms, and in Azerbaijan and Uzbekistan because of policy slippages.

Financial and Foreign Exchange Markets

Divergent cyclical developments and evolving prospects for fiscal consolidation have both been reflected in developments in industrial countries' financial markets in 1996. Short-term interest rates have declined significantly further since the beginning of the year in Canada and most of Europe, where generally weak growth and subdued inflation have led authorities to ease monetary conditions, but are little changed or slightly firmer in the United States and Japan, where growth has been stronger (Chart 11). Long-term interest rates turned upward in most countries early in the year, but subsequently took a variety of paths: they have risen most in the United States, and substantially in several other countries also, but they have declined in some cases where activity has been weak or fiscal

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prospects have improved. Associated changes in international interest differentials have contributed to a further moderate strengthening of the U.S. dollar against most other major currencies. Foreign exchange markets generally have been notably calm in recent months, with the currencies of the exchange rate mechanism (ERM) fluctuating in relatively narrow ranges close to their central parities since the spring. Generally low inflation, the marked reduction since spring 1995 of certain currency misalignments, and increased market confidence that EMU will proceed as planned all appear to have contributed to the recent relative stability in exchange markets. Meanwhile equity prices in most countries have risen moderately since the end of 1995.

In the early weeks of the year, monetary authorities in almost all industrial countries guided *short-term interest rates* lower by ¼–½ of 1 percentage point in response to indications of weakening growth and continuing, subdued inflationary pressures. The most notable exception was Japan, where short-term rates have remained at the historically low levels established in September 1995. Since the end of January, short-term market rates in the United States have firmed somewhat as economic activity has strengthened, but the Federal Reserve has taken no further action to adjust monetary conditions. In Germany, the Bundesbank held short-term market rates broadly unchanged between early February and late August, even though in mid-April it signaled an increased readiness to ease monetary conditions by lowering its discount and Lombard rates by 50 basis points, to historically low levels. The growth of M3 above its target range was a consideration deterring the Bundesbank from allowing any further easing of market rates in this period.

In most other industrial countries, monetary authorities allowed short-term rates to decline further between February and August to support demand and activity. In the ERM, upward pressures on most currencies vis-à-vis the deutsche mark during the first half of the year facilitated declines in short-term rates, which reduced interest premiums significantly relative to Germany. Thus by early July, the differential between French and German short-term rates had narrowed to about 40 basis points, which was less than half of the differential prevailing at the end of 1995. As the deutsche mark strengthened during July and August, however, this narrowing of interest differentials was partly reversed. In late August, the Bundesbank, citing international considerations as well as slower M3 growth and a subdued inflation outlook, took action to lower market rates by reducing its repurchase rate by 30 basis points; France and a number of other European countries followed with cuts in their main money market rates. By early September, short-term market rates were about 70 basis points lower than at the beginning of the year in Germany, a number of other core ERM countries, and the United

Chart 10. Selected Countries Less Advanced in Transition: Inflation

(Monthly percent change in the consumer price index)

Inflation in most countries slowed down considerably during 1995, and in many countries these gains have been sustained.

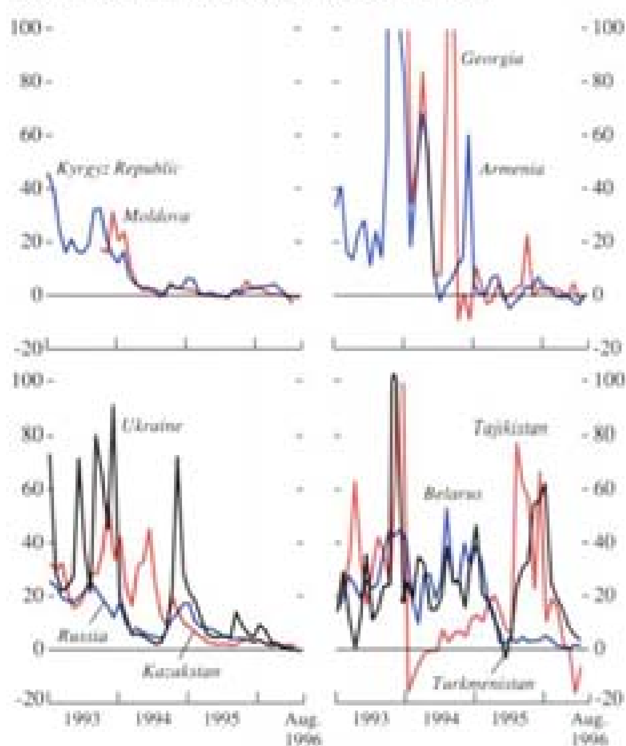

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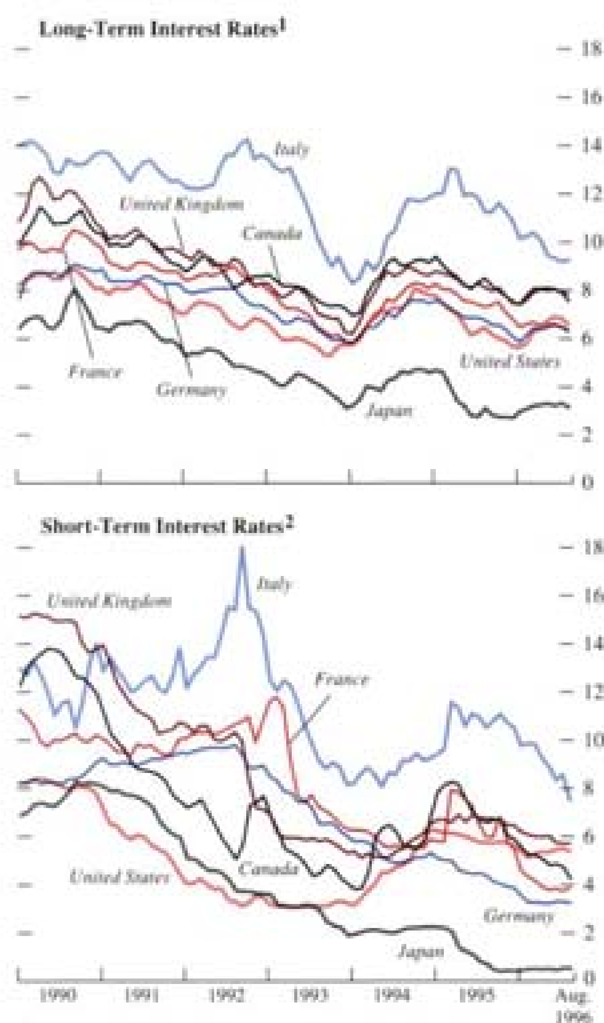
Chart 11. Major Industrial Countries: Nominal Interest Rates
(In percent a year)

Interest rate movements in 1996 have differed significantly across the major industrial countries.



Sources: WEFA, Inc.; and Bloomberg Financial Markets.
[1]Yields on government bonds with residual maturities of ten years or nearest.
[2]Three-month maturities.

Kingdom, but almost 100 basis points lower in France and close to 200 basis points lower in Italy and Spain. Outside Europe, declines in short-term rates in Canada opened up a premium of U.S. rates over comparable Canadian rates early in the year, which by early September had widened to about 140 basis points.

Long-term interest rates turned upward in most industrial countries in late January, but they subsequently moved in tandem for only a limited time. In the United States, bond yields had an upward trend until mid-June and then fluctuated around levels roughly midway between the troughs reached early in the year and the peaks of late 1994. In Germany, France, most other European countries, and Canada, long-term rates stabilized about three months earlier, in mid-March, and in some cases declined subsequently. In Japan, the upturn in rates, which had begun in late 1995, came to a halt in early May. As a result of these disparate movements, net changes in rates since early in the year vary considerably. In the United States, long-term rates in early September were about 130 basis points higher than in late January: this is the only case where the rise in bond yields since early 1996 has reversed as much as half of the decline experienced in the preceding 12–15 months. Elsewhere, changes in long-term rates since late January have ranged from increases of around 40 basis points in Germany, the United Kingdom, and Canada to declines of around 80 basis points in Italy and Spain. In Japan, France, and Switzerland, yields are roughly unchanged. One notable outcome of these various movements is that in the spring, U.S. long-term rates rose above German rates for the first time in more than a year; in early September, the premium of U.S. over German rates was about 60 basis points. Another is that the premium of French over German yields on ten-year government bonds, which stood at about 50 basis points in late January, was virtually zero, for the first time since early 1994, between early May and early August; it subsequently widened slightly but remained less than 10 basis points.

The uneven movements in bond yields that have occurred in 1996 seem attributable to a number of influences. Factors that have tended to push rates upward include revised expectations about monetary policy adjustments as a result of the strengthening of growth performance in the United States; the dissipation of expectations of a balanced budget agreement in the United States; and worsening fiscal performance in Germany, the United Kingdom, and a number of other European countries. There seems little evidence of any significant rise in expected future inflation, though this may plausibly have been a factor in the United States. The declines in yields experienced in Italy and Spain seem largely attributable to improved prospects of budgetary consolidation following elections that clarified the outlook for economic policies. Improved fiscal prospects also seem to have helped to prevent

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any sustained rise in long-term rates in France. But the convergence of French and German rates also seems indicative of improved market confidence in prospects for EMU, at least for a core group of countries. Exchange rate expectations may also have played a role in the reversal of the U.S.-German differential, in that the appreciation of the U.S. dollar (to be considered below) may have led to revised expectations about future currency movements, which asset holders required to be offset by relatively more attractive nominal yields on dollar-denominated assets.

In *foreign exchange markets* in 1996, the U.S. dollar has appreciated moderately further against most other major currencies. After weakening somewhat from peaks reached around midyear, the dollar in early September was around 6 percent higher than at the beginning of the year in terms of the Japanese yen and the Swiss franc, and 4 percent higher against the deutsche mark and the French franc. The value of the pound sterling in terms of the U.S. dollar was roughly unchanged in this period. The only major currencies to have appreciated significantly against the U.S. dollar during 1996 are the Italian lira and the Australian dollar. The value of the lira in early September was 4½ percent higher in terms of the U.S. dollar and 7½ percent higher in terms of the deutsche mark than at the end of last year. Compared with its trough of April 1995, the U.S. dollar in early September was 34 percent higher against the yen, 9½ percent higher against the deutsche mark, and 8 percent higher in nominal effective terms. In real effective terms, the dollar has risen to levels last seen in early 1994, while the yen has declined to the levels of early 1993 (Chart 12).

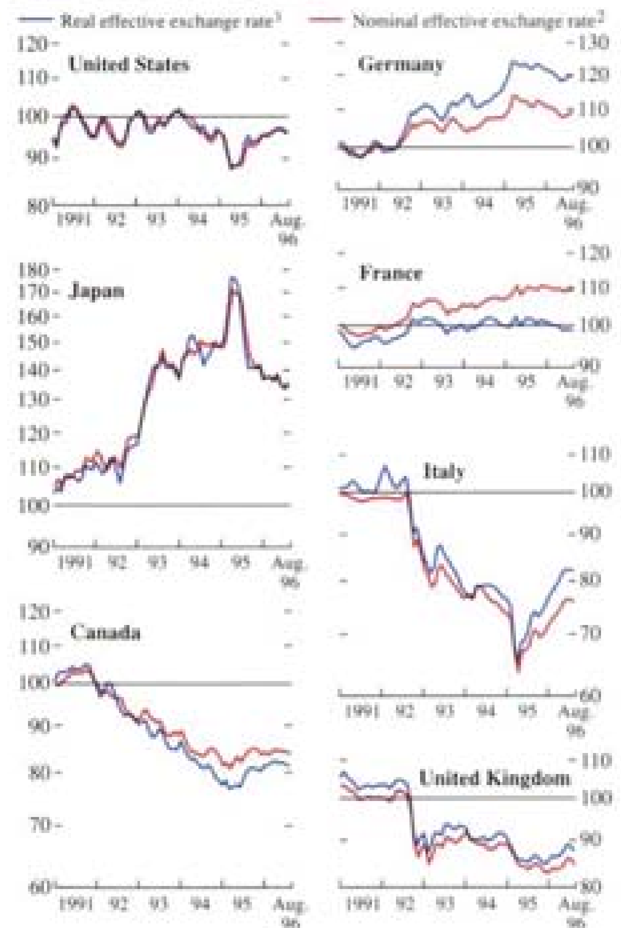
The U.S. dollar's continued appreciation during 1996 is attributable in part to movements in interest differentials in favor of dollar-denominated assets and thus to the relative strength of the U.S. economy. And the further decline of the Japanese yen may have owed something to the apparent acceleration of the reduction in Japan's current account surplus. But in addition, the dollar's further moderate rise during 1996—especially against the Japanese yen, deutsche mark, and Swiss franc—as well as the general appreciation of the Italian lira, may be viewed as having brought the exchange values of these currencies to levels more consistent with fundamentals. The improved configuration of exchange rates among the major currencies this year may help to explain why exchange rate fluctuations have for the most part been the narrowest in a number of years, although generally low rates of inflation are also likely to have contributed to exchange market stability by bringing about relatively small changes in international competitiveness.

The movement of currencies closer to values consistent with fundamentals and improved exchange market stability help to explain why accumulations of official foreign exchange reserves in 1996 have for the

Chart 12. Major Industrial Countries: Effective Exchange Rates

(1990 = 100; logarithmic scale)

As the dollar has risen to levels last seen in 1994, the yen has declined to the levels of early 1993.



[1]Defined in terms of relative normalized unit labor costs in manufacturing, as estimated by the IMF's Competitiveness Indicators System, using 1989–91 trade weights.

[2]Constructed using 1989–91 trade weights.

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Table 10. Changes in Foreign Exchange Reserves
(In billions of U.S. dollars)

						1995				1996	
	1987	1992	1993	1994	1995	I	II	III	IV	I	II
All countries	**205.4**	**0.9**	**104.5**	**152.3**	**199.4**	**55.0**	**77.9**	**43.8**	**22.7**	**47.4**	**58.1**
Industrial countries	148.3	–25.0	22.7	61.8	80.6	32.3	32.4	18.8	–3.0	24.2	26.7
Of which:											
United States	–4.2	–5.9	1.5	–0.3	7.9	9.4	2.2	–2.5	–1.3	–2.2	–0.8
Japan	38.0	0.1	26.8	26.4	57.3	16.2	15.0	23.6	2.6	20.9	6.3
Germany	27.0	28.4	–13.2	–0.5	5.6	3.2	0.3	0.4	1.7	—	–0.2
Italy	9.7	–20.5	0.2	5.0	2.8	–4.1	10.0	–5.3	2.3	0.4	13.8
Other countries and regions	57.1	25.9	81.8	90.5	118.8	22.7	45.4	25.0	25.7	23.2	31.4
Of which:											
Brazil	0.5	14.5	8.1	6.5	12.6	–5.2	–0.4	15.0	3.2	3.9	4.3
China	4.7	–23.2	1.8	30.4	22.0	6.3	4.7	7.1	3.8	7.2	5.8
Hong Kong	3.6	6.4	7.8	5.9	6.1	3.5	0.8	–1.4	3.2	3.1	–1.2
Korea	0.3	3.3	3.1	5.3	6.9	0.8	1.7	2.8	1.5	0.7	3.1
Malaysia	1.4	6.4	10.0	–1.9	–1.9	–0.5	1.3	–1.5	–1.3	–0.3	2.0
Singapore	2.2	5.7	8.4	9.8	10.5	3.1	5.0	0.5	1.9	1.6	1.9
Taiwan Province of China	30.4	–0.1	1.3	8.9	–2.1	5.5	2.5	–9.8	–0.3	–7.8	2.2
Thailand	1.2	2.7	4.1	4.8	6.6	–0.3	4.8	0.9	1.1	1.9	0.9

most part been somewhat smaller than in 1995. Last year, large-scale intervention in support of the dollar contributed to the largest absolute rise in global reserves since 1987, the year of the Louvre Accord among the major industrial countries on policies to improve exchange rate stability (Table 10).

Movements in *stock market prices* in the industrial countries in 1996 have been more even across countries and more moderate than in 1995. Major indices in most countries in early September were between 6 percent and 12 percent higher than at the beginning of the year, after declining somewhat from peaks reached around the middle of the year. In the United States and the United Kingdom, the rise in prices has been markedly slower than last year, partly reflecting the turnaround in bond markets. The moderation of equity price rises in the United States, in particular, has contained the widening of the yield gap between equities and interest-bearing assets, and thus reduced the risk of a more significant correction (Chart 13). In Germany and France, by contrast, equity prices have been more buoyant this year than in 1995.

In contrast to most of 1995, *foreign exchange markets in the developing countries* were relatively stable during the first half of 1996, in part because of the sustained recovery of capital flows, but also because of policy tightening measures in countries that had been adversely affected by the Mexican crisis last year. In Mexico, the peso in real effective terms has appreciated gradually, albeit with some degree of volatility, reflecting the return of investor confidence as a result of the authorities' commitment to financial stability and sustained fiscal restraint. In Venezuela, exchange controls were eliminated in April and exchange rates were unified with the official rate set within a 7½ percent band of the prevailing market rate. These and other measures helped to stabilize the bolívar and stem the marked depreciation that occurred earlier this year. In response to a surge in capital inflows in January and early February, the authorities in Brazil extended the coverage of the 5 percent tax on capital inflows, raised the minimum maturity for borrowing abroad, and prohibited banks from borrowing abroad to invest in domestic government securities. These measures have aided in keeping the real broadly stable in recent months.

Large capital inflows have put further upward pressure on a number of Asian currencies. In some cases, such as China, the authorities have succeeded in maintaining broadly stable exchange rates. However, in other countries such as Indonesia and Korea, despite relatively stable exchange rates against the U.S. dollar, real effective exchange rates have risen further owing to the general depreciation of the yen as well as to relatively high domestic inflation. In Thailand, the baht came under downward pressure in late July and substantial intervention by the central bank was necessary to defend the currency against rumors of devaluation. In India, the rupee continued to fall early in the year, but exchange market pressures have subsided since February because of administrative measures and rising private capital inflows. Among other emerging market countries, in South Africa exchange market pressures were particularly strong at times between February and August, with the rand depreciating by about 20 percent. And in Turkey, the lira depreciated by over 40 percent in the first half of the year, roughly in line with inflation.

Equity prices in many emerging market countries strengthened in the first half of 1996, following rela-

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tively weak performance during 1995 (Chart 14). Although all markets had recovered from the spillover effects of the Mexican crisis by the middle of last year, the International Finance Corporation (IFC) composite index registered only a modest increase for 1995 as a whole (Chart 15). Nevertheless, the trend growth in the size of emerging markets, their overall levels of liquidity, and the number of companies listed continued to increase despite the poor price performance—market capitalization of the IFC composite index fell by only 1 percent in 1995. Moreover, capital flows to developing countries, including equity investment flows, continued to increase. The longer-term trend in price-earnings ratios also suggests that despite greater volatility, valuations in the emerging equity markets are converging toward industrial country levels. With the exception of Chile, where industrial strife contributed to some weakening this year, equity prices in most Latin American countries rebounded strongly beginning in mid-1995, in part boosted by the decline in domestic interest rates. In Asia, monetary tightening to contain overheating pressures, the sharp slowdown in export growth in a number of east Asian countries, and political uncertainty in some countries contributed to a marked weakening of equity prices in recent months. In other emerging market countries, including Turkey and South Africa, equity markets have remained highly volatile, reflecting high inflation in some cases and also concerns about fiscal imbalances.

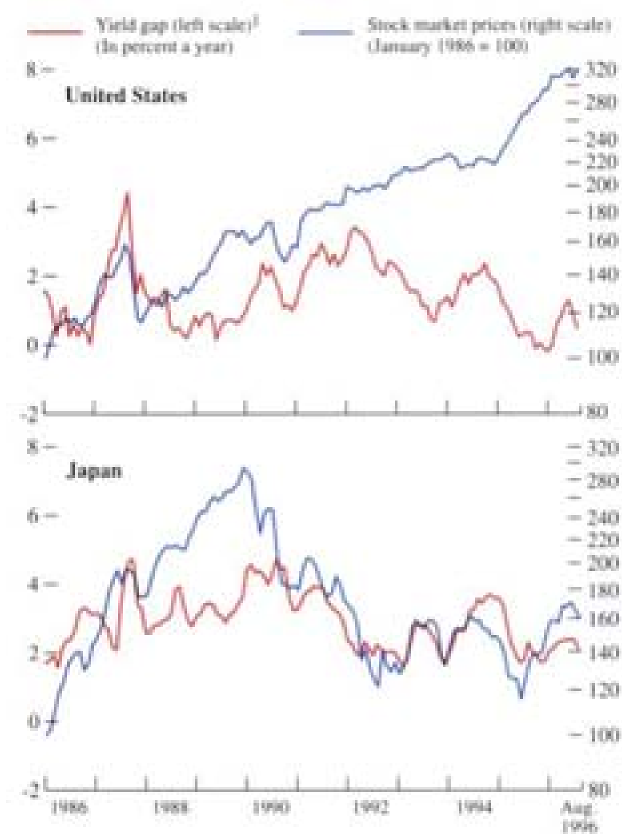
External Payments, Financing, and Debt

In recent years, world trade in goods and services has expanded substantially faster than past relationships between the growth of world trade and output would have predicted (Chart 16). Although recessions in the industrial countries in the early 1990s led to slower expansion of their import demand, this was partly offset by the robust growth of activity and imports, particularly of capital goods, in developing countries. Also, in 1995, developing country imports provided a substantial boost to world trade as import demand in Europe slowed, reflecting the weakness in economic activity. Growth in world trade is expected to remain buoyant in 1996 and 1997 (see Chart 1).

Current account developments in 1995 and developments projected for 1996 largely reflect relative growth rates of economic activity and the lagged effects of earlier movements in exchange rates (Table 11).[4] In most of the major industrial countries, further reductions in current account imbalances are projected for 1996 and 1997, while in the developing

Chart 13. United States and Japan: Equity Yield Gap and Stock Market Prices

Despite strong gains in equity prices since 1994, bond yields have declined in relation to equity yields in both the United States and Japan.



Sources: WEFA, Inc.; and Morgan Stanley Capital International.
[1]The equity yield gap is defined as the difference between the yield on ten-year government bonds and the inverse of the price-earnings ratio of stocks.

[4]Difficulties in projecting current acccount balances are exacerbated by the existence of a significant and variable global current account discrepancy—see Annex III.

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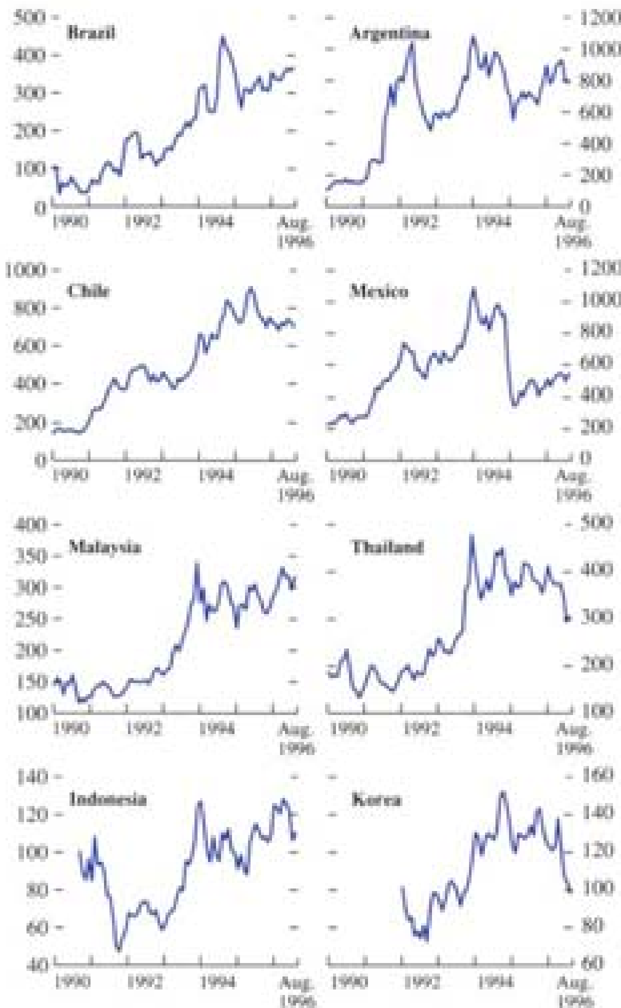
Chart 14. Selected Emerging Market Countries: Equity Prices
(In U.S. dollars)

Equity prices in many emerging market countries strengthened in the first half of 1996, although prices in some Asian countries weakened in recent months.



countries of Asia, current account deficits, which have been one of the symptoms of overheating, are projected to narrow to some extent.

Among the industrial countries, the U.S. current account deficit declined slightly to 2 percent of GDP in 1995 and is expected to remain at this level in 1996. In Japan, the current account surplus contracted to 2¼ percent of GDP in 1995 and is projected to drop further to about 1½ percent of GDP in 1996, the lowest level since 1990, reflecting stronger domestic demand growth, continuing structural change, and the lagged effects of the appreciation of the yen in recent years, which has been only partly reversed since mid-1995. Canada's current account deficit is also expected to narrow further, reflecting the continued strong growth of exports related to the depreciation of the Canadian dollar since 1991, as well as strong demand from the United States. Indeed, in the second quarter of 1996, Canada registered its first quarterly current account surplus in twelve years. In Germany, weak domestic demand is expected to result in a slight reduction of the current account deficit. In the United Kingdom, the current account is expected to remain in small deficit, with a continued strengthening of the services balance largely offset by relatively weak export performance and the upward trend in import penetration. The current account surplus in France is expected to remain at about 1 percent of GDP. In Italy, however, the current account surplus is expected to narrow somewhat in 1997 as a result of the lira's recent real appreciation.

In several of the smaller industrial countries, current account imbalances widened considerably in 1995 but are projected to narrow over the next year. The recent deterioration of Finland's terms of trade should help to reduce its current account surplus, which reached nearly 4½ percent of GDP in 1995. In Austria, considerable progress with fiscal consolidation is expected to reduce the current account deficit, which doubled to 2 percent in 1995. With a slowing of domestic demand and an improvement in the terms of trade, the Australian current account deficit, is expected to diminish over the next year. And, in New Zealand, while the current account deficit has widened in recent years, there have been fiscal surpluses and large inflows of foreign direct investment; a slight narrowing in the deficit is expected in 1997.

In a number of the developing countries, current account deficits are projected to widen, reflecting the growth of domestic demand and continuing large capital inflows. In some cases, the outlook also will be influenced by developments in commodity prices, especially those of oil and copper, which have recently been volatile. In Mexico, the strong adjustment efforts and contraction of domestic activity in 1995 in the wake of the recent financial crisis virtually eliminated the current account deficit, which had reached nearly 8 percent of GDP in 1994. A slight deficit is expected

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in 1996, reflecting economic recovery, the resumption of capital flows, and drought related imports. In Argentina, the current account deficit is projected to remain at about 1½–2 percent of GDP in 1996. The current account balance in Chile is projected to deteriorate by over 3 percentage points of GDP in 1996, although much depends on movements of copper prices following the sharp drop in mid-May. In Uganda, the current account deficit is projected to widen slightly to 2½ percent of GDP with increased private transfers projected to compensate for the reversal in coffee prices. The current account deficit of South Africa is likely to remain broadly unchanged at around 2½ percent of GDP reflecting the recent gains in competitiveness, the continued benefits of trade liberalization, and strengthening domestic growth.

Among the developing countries of Asia, current account imbalances, which have been a symptom of overheating, have stabilized in Thailand and Malaysia owing to more moderate growth of domestic demand, but remain relatively large. China's trade surplus narrowed in the first half of 1996, as a result of weakness in exports following the very rapid gains in the preceding two years, and a pickup in imports, in particular of raw materials and capital goods. In India, a surge in oil imports, together with slowing export growth, suggests that the current account deficit is likely to widen to 2 percent for 1996 as a whole. The current account deficit in Korea is expected to widen to about 3 percent of GDP, reflecting significant weakness in the prices of key exports.

The recovery of net capital flows to developing countries following the Mexican crisis gathered momentum in the first half of 1996. Private capital flows to developing countries this year look set to exceed their record level of 1995, although the disparity among the major developing country regions, especially the increasing proportion of aggregate flows to Asian countries, has persisted (Table 12). The resumption of private capital flows to many Latin American countries, including Mexico, reflects strong adjustment measures that have helped to stabilize financial markets and restore investor confidence. Foreign direct investment continues to account for a substantial share of private capital flows to most of the emerging market countries in Asia.

Among the countries in transition, the Czech Republic and Hungary experienced sizable capital inflows in 1995, exceeding (in relation to GDP) the flows into the rapidly growing Asian countries.[5] Although these inflows reflect sustained progress with financial stabilization and structural reform, they have also complicated the reform process by increasing money growth and exacerbating inflationary pressures. In the first half of 1996, however, there was a

[5]See Table 29.

Chart 15. Emerging Market Countries: Equity Prices

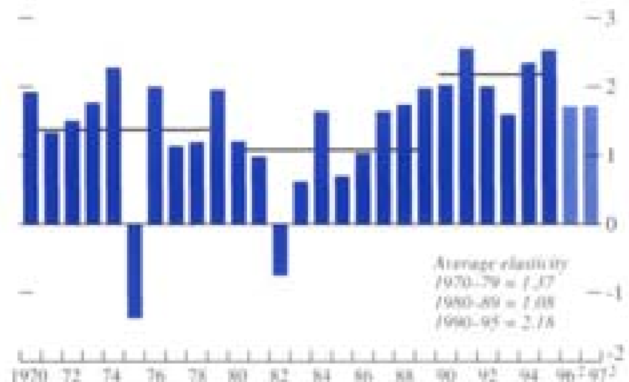
(In U.S. dollars; logarithmic scale; January 1990 = 100)

Stock markets have been more stable for most of this year compared with the turbulence of last year.

Sources: WEFA, Inc.; and International Finance Corporation, Emerging Markets Data Base.

Chart 16. Elasticity of World Trade with Respect to World Output[1]

During the 1990s, world trade has grown substantially faster than world output.



[1]World trade includes goods and services and is calculated as the average of annual percent change for world exports and imports. The elasticity is calculated as the annual percent change in world trade divided by the annual percent change in world GDP.
[2]IMF staff estimate.

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Table 11. Selected Countries: Current Account Positions
(In percent of GDP)

	1993	1994	1995	1996	1997
United States	–1.5	–2.1	–2.0	–2.0	–1.9
Japan	3.1	2.8	2.2	1.4	1.5
Germany	–0.7	–1.0	–0.9	–0.8	–0.7
France	0.7	0.6	1.2	1.4	1.5
Italy	1.1	1.5	2.5	2.4	1.9
United Kingdom	–1.8	–0.3	–0.8	–0.3	–0.3
Canada	–4.0	–3.0	–1.4	—	–0.2
Australia	–3.6	–5.1	–5.3	–4.1	–3.9
Austria	–0.4	–0.9	–2.0	–1.6	–0.8
Belgium-Luxembourg	5.4	5.6	5.6	6.0	6.0
Denmark	3.5	2.0	0.9	1.4	1.5
Finland	–1.3	1.3	4.5	4.0	2.8
Greece	–0.4	0.2	–1.5	–1.8	–2.1
Ireland	3.9	2.7	2.2	1.7	1.7
Netherlands	4.0	4.0	3.9	4.3	4.4
New Zealand	–1.2	–3.0	–4.3	–5.0	–4.8
Norway	3.0	2.4	3.1	6.0	6.6
Spain	–1.1	–1.4	0.2	0.5	0.5
Sweden	–2.2	0.4	2.0	2.5	2.7
Switzerland	8.4	7.1	7.0	7.2	7.3
Algeria	1.6	–4.3	–5.5	–4.7	–4.9
Argentina	–3.1	–3.7	–1.4	–2.2	–2.7
Brazil	–0.2	–0.3	–2.6	–2.4	–2.5
Cameroon	–5.9	–5.6	–1.4	–1.6	–0.9
Chile	–4.5	–1.2	0.2	–3.8	–3.8
China	–2.7	0.6	0.2	–1.2	–1.5
Côte d'Ivoire	–11.0	–1.2	–4.2	–5.5	–4.9
Egypt	4.7	0.4	2.7	0.2	–1.1
India	–0.4	–0.6	–1.4	–2.2	–2.5
Indonesia	–1.6	–1.7	–3.7	–3.6	–3.7
Israel	–3.4	–5.0	–4.7	–5.2	–4.6
Korea	0.1	–1.2	–2.0	–3.1	–2.5
Malaysia	–4.6	–5.9	–8.3	–8.2	–6.9
Mexico	–6.5	–7.9	–0.3	–0.9	–1.1
Nigeria	–2.9	–2.4	–0.7	–0.7	–0.8
Pakistan	–7.7	–3.8	–4.2	–4.9	–3.9
Philippines	–5.5	–4.6	–2.6	–3.1	–3.1
Saudi Arabia	–14.6	–7.5	–4.4	2.0	–0.4
Singapore	7.2	15.9	17.7	15.5	13.9
South Africa	1.5	–0.5	–2.6	–2.5	–2.5
Taiwan Province of China	3.0	2.6	1.9	2.1	1.9
Thailand	–4.9	–5.5	–8.1	–7.9	–7.5
Turkey	–3.5	2.0	–1.4	–2.7	–2.7
Uganda	–1.5	–2.3	–2.3	–2.6	–2.5
Czech Republic	2.2	–0.1	–4.2	–4.7	–3.7
Hungary	–9.0	–9.4	–5.6	–4.0	–3.3
Poland[1]	–0.1	2.3	3.4	1.0	–0.5
Russia	3.4	1.2	1.3	–0.4	–1.3

[1]Based on data for the current balance, including a surplus on unrecorded trade transactions, as estimated by IMF staff.

substantial decline in capital flows to the Czech Republic. This reflected receding expectations of appreciation of the koruna, which was partly due in turn to the continued widening of the current account deficit, and also greater exchange rate uncertainty related to the adoption of a wider currency band at the end of February.

With most emerging market countries projected to maintain strong growth, and interest rates in industrial countries expected to remain at moderate levels in the period ahead, net capital flows to developing countries should be sustained at high levels and might well continue to increase. With growing demand for finance for infrastructure projects, especially in Asia, and further progress with privatization programs in a number of other emerging market countries, both foreign direct investment and portfolio investment flows are projected to rise markedly. Net capital flows to African

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Table 12. Developing Countries: Capital Flows[1]
(Annual average, in billions of U.S. dollars)

	1973–77	1978–82	1983–88	1989–95	1994	1995
Developing countries						
Net private capital flows[2]	10.1	27.4	17.0	117.8	140.4	166.6
Net direct investment	3.6	9.4	12.5	42.0	69.3	73.6
Net portfolio investment	0.2	1.8	4.0	41.3	47.8	35.7
Other net investments	6.3	16.3	0.5	34.5	23.4	57.4
Net official flows	11.1	23.4	27.8	16.4	17.2	28.9
Change in reserves[3]	–20.2	–21.3	–8.5	–56.9	–59.8	–74.3
Africa						
Net private capital flows[2]	4.5	6.6	3.6	7.9	12.4	14.4
Net direct investment	1.0	0.7	1.0	2.2	3.2	2.8
Net portfolio investment	0.1	–0.2	–0.9	–0.2	0.5	2.0
Other net investments	3.4	6.2	3.4	5.8	8.8	9.6
Net official flows	2.4	5.1	4.8	5.3	5.3	3.8
Change in reserves[3]	–1.4	0.7	0.1	–2.6	–5.8	–4.0
Asia						
Net private capital flows[2]	4.2	13.2	13.2	47.4	76.8	98.0
Net direct investment	1.4	3.0	5.4	25.4	44.6	50.3
Net portfolio investment	0.1	0.2	0.9	9.8	14.6	18.3
Other net investments	2.7	10.1	6.8	12.2	17.6	29.3
Net official flows	4.1	7.4	6.6	7.2	5.6	6.4
Change in reserves[3]	–6.9	–6.7	–17.6	–37.7	–63.1	–41.3
Middle East and Europe						
Net private capital flows[2]	–10.3	–21.5	2.1	28.3	–0.0	15.4
Net direct investment	–1.3	–0.1	1.2	1.2	0.5	1.2
Net portfolio investment	—	–0.2	5.2	13.8	15.6	10.8
Other net investments	–9.1	–21.2	–4.2	13.2	–16.1	3.4
Net official flows	2.3	6.6	6.6	–0.7	10.0	–1.7
Change in reserves[3]	–14.2	–17.7	9.5	–5.0	0.2	–6.4
Western Hemisphere						
Net private capital flows[2]	11.8	29.0	–1.9	34.2	51.2	38.9
Net direct investment	2.5	5.8	4.8	13.1	20.9	19.3
Net portfolio investment	—	2.0	–1.2	17.9	17.1	4.5
Other net investments	9.2	21.2	–5.5	3.2	13.1	15.0
Net official flows	2.3	4.4	9.8	4.6	–3.7	20.4
Change in reserves[3]	2.2	2.4	–0.5	–11.6	8.9	–22.7

[1]Net capital flows, comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing.
[2]Because of data limitations other net investment may include some official flows.
[3]A minus sign indicates an increase.

countries have consisted mainly of official flows, but the recent strengthening of reform efforts in a number of countries, and the continued easing of payments restrictions, such as in the CFA countries, will help to improve the climate for foreign direct investment and other private flows. For the countries more advanced in transition, capital inflows are expected to remain high, whereas for the countries less advanced, inflows remain contingent on further progress with macroeconomic stabilization and structural reform, including the liberalization of trade and payments.

With much of these capital inflows being non-debt-creating, the burden of external debt for developing and transition countries is projected to decline further in 1996 and 1997, continuing the trend noted in recent issues of the *World Economic Outlook* (Chart 17). The ratio of debt to GDP is projected to decline to 30 percent at the end of 1996, and the ratio of debt to export earnings to 104 percent. The ratio of debt-service payments to exports is also projected to ease. Despite substantial progress in reducing overall levels of debt in a number of countries, unsustainable debt burdens persist, particularly in sub-Saharan Africa. Chapter IV provides a more detailed assessment of the debt burden of the heavily indebted poor countries.

Since the May 1996 *World Economic Outlook*, a number of countries have completed debt and debt-service agreements with official and commercial creditors. Under the aegis of the Paris Club, Russia signed an agreement in April that covers $38.7 billion in debt to be repaid over 25 years and provides a 6-year grace period during which only interest has to be paid, effectively reducing Russia's debt-servicing obligations to official creditors in 1996 from $8.5 billion to $2 billion.

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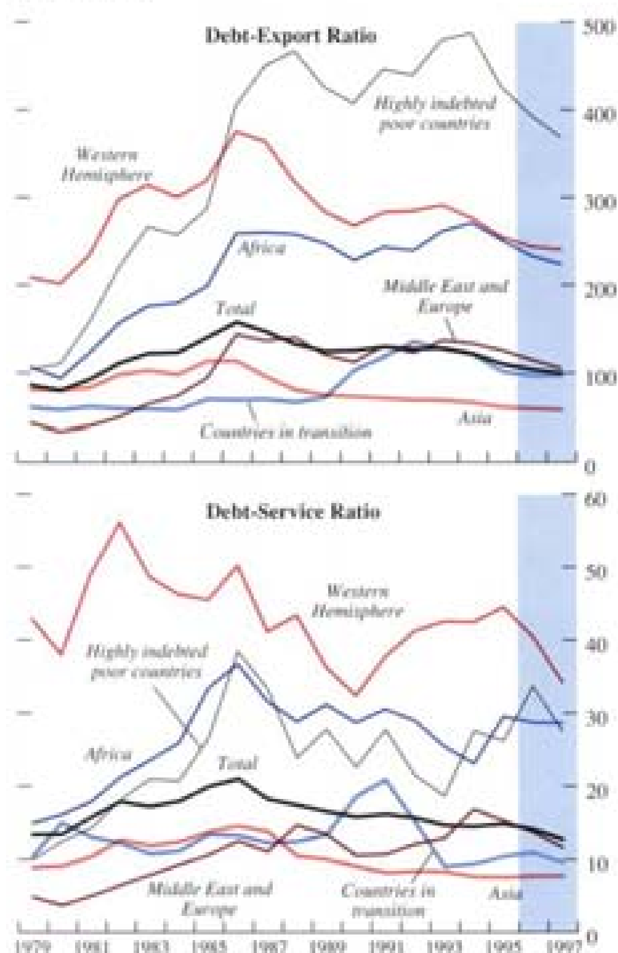
Chart 17. Developing Countries and Countries in Transition: External Debt and Debt Service[1]
(In percent of exports of goods and services)

Debt and debt-service ratios are expected to decline further in 1996 and 1997.



[1]Debt service refers to actual payments of interest on total debt plus actual amortization payments on long-term debt. The projections (shaded areas) incorporate the impact of exceptional financing items.

Agreements were reached on stock-of-debt operations under Naples terms with Mali and Guyana in May and with Burkina Faso in June. In July, the Congo reached agreement on a flow rescheduling under the Naples terms, the Congo's first concessional rescheduling. Also in July, agreement was reached on an exit rescheduling for Peru. Other countries also made progress toward completing debt and debt-service agreements with commercial banks. In April, Croatia signed an agreement in principle to assume 29½ percent of the former Yugoslavia's main debt of $4.4 billion; and in May, Vietnam signed an agreement covering about $1 billion of debt principal and interest arrears.

* * *

To provide an indication of *medium-term prospects* for the world economy, Table 13 presents the IMF's medium-term baseline scenario for growth and inflation. These estimates assume that established policies of national authorities remain unchanged. On this basis, world growth is expected to strengthen to an average annual rate of 4½ percent in the period 1998–2001, compared with the long-term trend growth rate of 3½ to 4 percent observed during the past quarter century. The resumption of growth in the countries in transition is the main explanation for this rise in trend growth. As discussed in Chapter V, after declining from the beginning of the transition process up to 1995, output in the transition countries is expected to grow at moderately high rates over the medium term provided that reform and stabilization policies are sustained. Continued gains are also expected in reducing world inflation, with marked progress in both the developing countries and countries in transition.

In the industrial countries, the scenario suggests that growth may firm modestly to 2½ percent over the medium term, reflecting sustained, albeit relatively slow, recoveries in Europe and Japan, and growth at potential in the United States. These projections assume that current policies to rein in government budget deficits will continue, resulting in a general government deficit of 1½ to 2 percent of GDP in 2001 for the industrial countries as a group, compared with a deficit of 3 percent in 1996. While this should help to reduce the upward pressure on real interest rates, efforts to reduce government dissaving are not expected to be sufficient to lower world real interest rates from their current high level. In the longer term, further progress with fiscal consolidation will be needed. The commitment to reasonable price stability by monetary authorities in the industrial world is expected to sustain the progress already made in reducing inflation. The scenario does not allow, in particular, for a cyclical downturn, which could occur as a result of supply shocks or policy reversals. However, on the assumption that inflation remains under control, the risk of a policy-induced recession needed to unwind inflationary pressures would be substantially reduced.

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Table 13. Summary of World Medium-Term Baseline Scenario[1]

	Eight-Year Averages		Four-Year Average					Four-Year Average
	1978–85	1986–93	1994–97	1994	1995	1996	1997	1998–2001
			Annual percent change unless otherwise noted					
World real GDP	**3.2**	**3.1**	**3.8**	**3.8**	**3.5**	**3.8**	**4.1**	**4.4**
Industrial countries	2.6	2.5	2.4	2.8	2.1	2.3	2.5	2.6
Developing countries	4.3	5.3	6.2	6.6	5.9	6.3	6.2	6.3
Countries in transition	3.0	–3.5	–1.6	–8.8	–1.3	0.4	4.0	5.2
World trade volume[2]	**3.6**	**5.5**	**7.9**	**8.8**	**8.9**	**6.7**	**7.2**	**7.0**
Imports								
Industrial countries	3.9	5.0	7.0	9.3	7.8	5.3	5.5	5.6
Developing countries	3.5	7.8	10.2	8.1	11.6	11.3	10.1	9.0
Countries in transition	4.0	–1.5	9.3	3.5	13.3	12.3	8.5	8.9
Exports								
Industrial countries	4.5	5.1	6.5	8.3	7.3	4.3	6.0	6.0
Developing countries	1.1	8.5	10.9	11.1	11.5	10.3	10.7	9.2
Countries in transition	3.3	–0.8	8.4	4.6	12.2	10.7	6.2	9.3
World prices in U.S. dollars								
Manufactures	2.8	5.5	2.7	3.3	11.2	–2.8	–0.5	0.8
Oil	10.2	–5.9	1.6	–5.5	8.0	13.2	–7.6	0.4
Nonfuel primary commodities	–0.1	2.1	4.8	13.6	8.2	0.7	–2.5	1.5
Consumer prices								
Industrial countries	7.6	3.7	2.3	2.3	2.4	2.3	2.4	2.4
Developing countries	26.8	42.4	21.9	46.8	19.8	13.3	10.8	8.8
Countries in transition	5.4	97.6	92.5	264.8	128.0	41.3	16.8	7.7
Interest rates (in percent)								
Real six month LIBOR[3]	5.3	3.2	3.4	2.8	3.6	3.5	3.7	3.5
World real long-term interest rate[4]	3.5	4.5	4.3	4.7	4.3	4.1	4.2	4.4
Memorandum								
Potential output								
Industrial countries	2.5	2.7	2.2	2.3	2.2	2.2	2.2	2.3

[1]Table A45 contains more detailed information relating to the medium-term baseline scenario.
[2]Includes goods and services.
[3]London interbank offered rate on U.S. dollar deposits less percent change in U.S. GDP deflator.
[4]GDP-weighted average of ten-year (or nearest maturity) government bond rates for the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada.

Among the developing countries, growth is expected to average 6½ percent in the medium term, assuming that adjustment and reform programs stay on track and that capital inflows are sustained. Although the projected strengthening in economic activity in Europe and Japan over the medium term, and the likely increase in capital flows to the transition countries, could slow capital flows to the developing world, increased global saving through sustained efforts to reduce government deficits in all regions is likely to be an offsetting factor. Further declines in inflation, and continued growth in trade volumes—although at somewhat lower rates—are also projected. The external debt-servicing burden of developing countries is projected to decline over the medium term, freeing up resources for infrastructure and welfare improving investments. Policy slippages and a reversal of capital flows are among the most significant downside risks to the medium-term scenario. A reversal of capital flows would be expected to lower growth among developing countries because of reduced external financing and would be most acutely felt by countries already suffering from policy imbalances.[6]

[6]An alternative medium-term scenario discussing the implications of a reversal in capital inflows was presented in the October 1995 *World Economic Outlook*, p. 59.

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